INTERNATIONAL TAX EVASION AND AVOIDANCE: TRANSNATIONAL CORPORATIONS AND STATES*

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I. INTRODUCTION

Any attempt to understand the behavior of transnational corporations has to be multidimensional. Such attempt has to encompass numerous indices to size up the increasing relevance of cross-border transactions and of the role of transnational corporations in the global economy. In the legal literature concerning transnational corporations (hereinafter referred to as TNCs), the subject of tax evasion and avoidance has of recent been given utmost importance.

A. *Taxation of TNCs and the State*

The emergence of TNCs has brought about some peculiar occurrence in international relations, the most apparent of which is the divergence in the systems of regulation. This divergence in the systems of regulation puts in issue the bounds of jurisdictional competence of States. On the domestic level, the State's right to tax is plenary.[1] There are few limitations on such right however in the international level. The three commonly known restrictions are:[2]

> a. the limitation on the power to tax foreign diplomats;
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> b. the rule against extra-territorial taxation; and
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> c. the rule prohibiting one government from acting within the territory of another.

Of the three, not one is of consequence and import in the taxation of TNCs. From the TNC's point of view, there being no prescription on its part to choose a particular business jurisdiction, its being the subject of a particular tax scheme for the most part is a matter of sound business

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[1]*See* R. PAUL, B. BLOUGH, B. TURNER, *et. al.*, THE HISTORY AND PHILOSOPHY OF TAXATION (1955).

[2]J. JACKSON & W. DAVEY, INTERNATIONAL ECONOMIC RELATIONS 104 (1986) [hereinafter referred to as JACKSON & DAVEY].

prerogative.[3] From the point of view of the taxing authority on the other hand, the imposition of taxes is a matter of state policy enunciated in laws and regulations. Theoretically, the situation puts the state on the losing side of the bargaining table. Left alone, even a state with the most comprehensive tax scheme could be confronted with the possibility of losing huge revenues from tax manipulations of TNCs.[4]

This inherent helplessness of states to counter global tax manipulation schemes of TNCs has led to the realization that unilateral measures to counter said schemes are ineffective. Recent trends in global trading has therefore seen the emergence of regional co-operation against international tax evasion and avoidance. This trend in co-operation however is double-faced in that while it is recognized that only by interstate regulation could profit movements be effectively monitored, the burden of regulation still lies with the individual state.[5]

This study is an attempt to explore this emerging trend in global fiscal administration. It seeks to investigate but one query: given the contemporary orientation in global trading, could international tax evasion and avoidance as practiced by transnational corporations be remedied?

B. *Domestic and international law on tax evasion and the limitations of the study*

While different tax policies of states influence business decisions of transnationals, the latter's response also affects the tax policies of home and host states to deter or encourage investments and curb unpleasant tax trade-offs. This is the cycle that states of the world have to contend with.

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[3]United Nations Center for Transnational Corporation, I UNIVERSITY CURRICULUM ON TRANSNATIONAL CORPORATIONS (1991) [hereinafter referred to as UNCTC].

[4]This analysis, of course, begs the issue of conflict. In the contemporary period, it could also happen that a state, through its national policies, may induce TNCs to maximize profit use without the burdensome effects of regulative taxation. The so called "tax havens" are cases in point. Of recent origin, these tax havens list foreign investment as the highest source of national income. In this context, conflicts between the state and the TNC are minimized with the eradication of regulative measures. In this same context, tax evasion and avoidance may not even exist.

But the superficial non-conflict situation stops there. For what price these tax havens have to pay in terms of self-determination negates what non-regulation could provide. The fact that these tax havens are historically colonial territories, leads the analysis back, by deduction, to the inherent losing stance of the states in the face of global forces, like TNCs. *See* Chapter Five, this Study.

[5]A. RAZIER & J. SLEMROD, TAXATION AND THE GLOBAL ECONOMY 3 (1990) [hereinafter referred to as RAZIER & SLEMROD].

How international prescriptions as outlined in numerous United Nations resolutions and international agency guidelines as well as national laws are implemented, is the immediate concern of this study. Many commentators put in issue the nature of international prescriptions in terms of implementation and adoption.[6] While most legal writers are in conflict as regards the most efficient means of countering the problem of tax evasion and avoidance brought about by the emergence of TNCs in the global economy, all legal writers are in agreement that international prescriptions do not form part of the so-called "hard" law in international law.[7] With this as the underlying premise, the study proposes to determine the conditions which facilitate tax evasion and avoidance in the international level with a view of arriving at plausible and feasible policy measures.

Special attention would be given to the Philippine situation for which a particular chapter is reserved. At the outset, it is to be noted that the study is limited with respect to the data required to support an empirical analysis. The fact that there is an absence of data that show the extent of manipulation putatively attributed to TNCs lends more credence to the assertion that evasion and avoidance practices of TNCs are indeed problematical.

II. UNDERSTANDING THE TRANSNATIONAL CORPORATION AND ITS TAX EVASION AND AVOIDANCE PRACTICES

International trade involves wide-ranged business transactions and exchanges of goods and services. All these transactions are not and cannot be carried out entirely by governments. International business transactions are also carried out by private enterprise. This enterprise is usually facilitated by the TNCs.[8]

A. *The Transnational Corporation*

There is no single agreed-upon definition of the transnational corporation. This is hardly surprising in view of the fact that "transnationality" has many dimensions and may be viewed from

[6]JACKSON & DAVEY, *supra* note 2, at 1047-1064.

[7]J. BARTON & B. FISHER, INTERNATIONAL TRADE AND INVESTMENT: REGULATING INTERNATIONAL BUSINESS 891 (1986) [hereinafter referred to as BARTON & FISHER].

[8]Also internationally referred to as the "multinational corporation." Transnational corporations are enterprises which own or control production or service facilities outside the country in which they are based.

several different perspectives — economic, political, legal, managerial, among others.[9]

It is a general criterion that a firm becomes a TNC when it extends its production and organization into foreign countries. A TNC centers on a company, predominantly located in one particular country, through which decision-making is undertaken for the whole of the enterprise's international operations. This controlling company, called the *parent company*, controls other companies operating in other countries through ownership of the voting stocks. The controlled companies are called the *subsidiaries*.

With this method of organization, the parent companies operate in *home* countries, or the countries of ultimate destination, within the transnational enterprise, of the profits of transnational activity. On the other hand, the subsidiary companies operate in *host countries*, or the countries of origin of the profits of the transnational. In total, the parent company along with the connected subsidiary companies, will in these cases define the multinational enterprise.[10]

In some cases, a TNC may operate abroad not through a subsidiary company, but instead undertake activity directly in the name of the parent company itself. When such operational structure is adopted, foreign affiliates are organized as *branches* or *affiliates* which parent companies use to conduct business in their own names

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[9]Some observers regard ownership as the key criterion. In their view, an enterprise becomes transnational only when the headquarters or parent company is effectively owned by nationals of at least two countries. Shell and Unilever, which are controlled by British and Dutch interests, are commonly cited as examples. By the ownership test, very few international companies may be called transnational. The ownership criterion has been rejected by most authorities.

A second definition of the transnational enterprise relies on the criterion of the *nationality mix* of headquarters management. An international company is seen as transnational only when the managers of the parent company are nationals of several different countries. Here again, very few international companies would qualify as transnational enterprises, because most have headquarters organizations that are entirely or mainly staffed with nationals of the home country. But international management may well prove to be a transitional phenomenon. Already it is commonplace for international companies to staff their foreign affiliates with local nationals all the way to the top levels, and some of these nationals are now being promoted to the parent headquarters. Multinational management, then, is more a consequence of the continuing evolution of the TNC than its distinguishing feature. F.ROOT, INTERNATIONAL TRADE AND INVESTMENT, 582-583 (1990) [hereinafter referred to as ROOT].

[10]The transnational enterprise system therefore consists of a parent company, its producing and marketing affiliates in foreign countries, and the flows of products, services, capital, technology, management, and funds. *See* JACKSON & DAVEY, *supra* note 2, at 2.

retaining full ownership thereof.[11] When the operation of a parent company extends in this way beyond a single country, the operations of the parent company abroad are called *branch operations* in host countries.[12] These distinctions are important because the overall tax position of a parent-subsidiary operation may sometimes differ from that of a parent-branch operation.[13]

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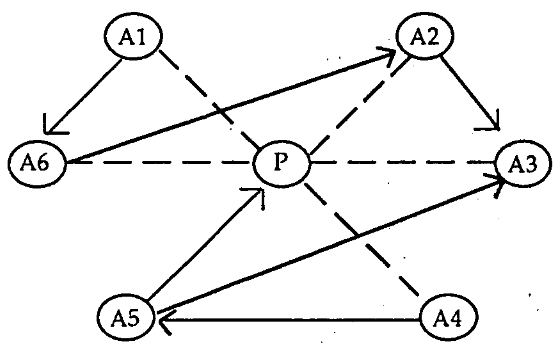
[11]ROOT, *supra* note 9, at 610.

[12]The transnational enterprise performs its role as an international transfer agent though institutional or organizational arrangements that collectively make up the *transnational enterprise system*. This system, as depicted in the figure below, comprises the parent company and its foreign affiliates.

The Transnational Enterprise (The Parent-Subsidy Network)



The parent company (denoted by the P circle) is the enterprise decision center that determines the goals and controls the operations of the entire system: the key decisions of the country, location, size, and "product mix" of its production affiliates; the direction, volume, and composition of transfers among the affiliates; and the national markets to be served by the affiliates. These strategy decisions generate a pattern of factor and product flows among the members of the system. The parent company and its affiliates (denoted by the A circles) are located in different countries, as indicated by the dashed lines. Most of the affiliates perform both production and marketing functions, but some perform only a marketing or financial function.

The affiliates are connected to the parent company and, in some instances, to other affiliates by a variety of cross-national flows of products, capital, technology, and management. Flows of factor services, usually accompanied by product flows, generally move from the parent company to the affiliates. Any of these kinds of flows may also link pairs of affiliates. To illustrate, A1 may transfer parts of components that it manufactures to A6, which uses them to manufacture other products. A4 may transfer certain finished products to A5, which then resells them in the local market. Idle funds accumulating in A2 may be transferred to A3 to finance a capital expansion. A5 may develop new technology that is transferred to A3. A manager in A6 may be transferred to a new position in A2. Some products and factor services may also be transferred from an affiliate to the parent company, such as from A5 to P.

[13]JACKSON & DAVEY, *supra* note 2, at 2.

B. *Facing the problem of tax evasion and avoidance practices of TNCs*

Tax evasion and avoidance are multivariate phenomena. In the case of the human taxpayer, evasion and avoidance are functions of economic motives, of the legal and the administrative framework of the tax system as well as of behavioral and psychosocial determinants[14]. In the case of TNCs as subjects of taxation, evasion and avoidance attain yet several other dimensions. Foremost among these added dimensions are the global shifts of supply and demand, the increasing regionalization of tax regulations and the host-nation resilience to profit maximization. All of these affect the behavioral responses of TNCs to tax.[15]

Although the evidence to support the assertion that transnational corporations engage in manipulative tax devices which result in tax evasion and avoidance in the international level is not found in terms of hard data,[16] the perception that they do preponderate over the lack of substantial proof.[17]

The perception that transnational corporations engage in manipulative tax practices is not without basis. Such perception springs from an understanding of the very nature of TNCs. A TNC is said to have the following attributes:[18]

> a. It is a business entity. Consequently, its goals among others, are profit maximization, long-run growth and protection of market shares;
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> b. It is an extension of the domestic multi-activity firm that runs on the concept of the cross-border value-added chain. Consequently, a TNC transcends boundaries, economic or otherwise; and

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[14]Study Group on Asian Tax Administration and Research, CONFRONTING THE PROBLEMS OF TAX EVASION AND AVOIDANCE : SELECTED COUNTRIES IN ASIA AND THE PACIFIC vii (1987) [hereinafter referred to as SGATAR].

[15]C.PLAMBECK, *infra* note 27, at 359. Frank A. Cowell also makes a very simple but interesting evaluation on this. He explains this theory thus: the tax structure itself is a cause of evasion; it is often the perception of taxes that matters in determining the response to the fiscal system, perceptions can be crucial in influencing the taxpayers' choices as to work, purchases, and risks involved--including the risks involved in breaking the law. F. COWELL, CHEATING THE GOVERNMENT: THE ECONOMICS OF EVASION 43 (1990) [hereinafter referred to as COWELL].

[16]A. ADAMS & J. WHALLEY, THE INTERNATIONAL TAXATION OF MULTINATIONAL ENTERPRISES IN DEVELOPING COUNTRIES ii (1977) [hereinafter referred to as ADAMS & WHALLEY].

[17]JACKSON & DAVEY, *supra* note 2.

[18]UNCTC, *supra* note 3, at 4.

> c. It has attained an increasing role in the world economy, there being more than a million TNCs around the world, accounting for over one hundred fifty billion dollars of foreign direct investments around the world.[19]

At present, TNCs have become responsible for a sizable and increasing share of world trade and for most international investments.[20] As big, oligopolistic companies, TNCs possess market power that makes them independent actors in the international economic system. TNCs enjoy managerial discretion in their decisions, unlike firms in purely competitive markets. They do not simply respond to market conditions and public policies in a predetermined way. Their actions have also in a way forced changes in national economies and have compelled governments to respond to them.[21] Although these characteristics suggest power limited only by self-restraint, it is doubtful that such power exists because some limitations arise out of the nature of the TNC itself.[22]

Despite the major role that TNCs play in the world economic order, their activities are not *per se* geared toward goals of development.[23] The objective of a TNC — just like any other business enterprise — is primarily to obtain profit as already explained. A TNC will establish a world-wide venture only if guaranteed a substantial amount of return on investment. It is not by chance that most of the activities of the TNC have their situs in economies which are capital intensive[24] and have related companies in countries where natural resources necessary for world trade can be utilized.[25]

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[19] *1980s Investment Highlights*, Transnationals, March 1991 at 3, col. 1.

[20] The Impact of Multinational Corporations on Development and On International Relations 29, U. N. Doc. ST/ESA/6 (N. Y. 1974) [hereinafter cited as U. N. DOC. ST/ESA/6].

[21] ROOT, *supra* note 9, at 7.

[22] This refers to the inefficiency of a large bureaucracy, the difficulty in setting up unified operations, and the limited mobility of the TNC due to government regulation. S. J. RUBIN, *Development in the Law and Institutions of International Economic Relations: The Multinational Enterprise at Bay*, 68 AM. J. OF INT'L. LAW 486-487 (1974) [hereinafter referred to as RUBIN].

[23] U. N. DOC. ST/ESA/6, *supra* note 20, at 28.

[24] When TNCs market in developing countries, they may introduce patterns of consumption which are not conducive to sustained development and confer very limited benefits to the enterprise. U. N. DOC. ST/ESA/6, *supra* note 20, at 29.

[25] U. N. DOC. ST/ESA/6, *supra* note 20. The Study reports that "Multinational corporations often exploit natural resources in developing countries for export to world markets." On the other hand, a different study has summarized the case against TNC behaviour as follows:

> Multinationals favour higher technology industries, employing capital intensive techniques, and their products generally cater to the demands of the rich. When marketed in

C. *Tax conflicts*

That TNCs cut across boundaries makes their taxation vary intricately from one jurisdiction to another. Unilateral actions and multilateral attempts by states to regulate tax evasion and avoidance in the international level have so far proven ineffective.[26] It is suggested that the greatest debacle in this area is how to monitor the movement of profit across boundaries.[27]

It has also been observed that even treaties, being merely domestic prescriptions, facilitate evasion and avoidance,[28] different tax rates facilitate transfer pricing, harsh tax regulations on the other hand could even cause TNCs to engage in treaty shopping.[29] The problems do not stop there, as one noted legal writer[30] observed:

> The differences lie not only in the levels of tax rates. They are found also in the definitions of taxable items, and above all, in the allocation of the firm's world-wide income among the taxing jurisdictions in which it does business, receives income or engages in some other taxable activity. Home countries differ in the degree to which they make allowance for host country taxes. A separately incorporated

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developing countries, they introduce patterns which benefit only a few. Multinationals apply restrictive provisions which limit the export potential of developing countries. They require excessive payment for royalty and technological licensing fees. They also practice "transfer pricing" by undervaluing their exports and overvaluing their imports to and from parent and affiliate companies. The technology of developed countries which is labour saving and capital intensive is not tailored to the needs of a poor society whose biggest problem is unemployment. Poor countries are the favourite recipients of technology that is often obsolete and overpriced. Because of the protection they give to, and overdependence on, foreign technology, developing countries cannot develop their own technology. Multinationals bring in less capital than the amount they send out of the region. They get their funding from domestic sources, thereby depriving the domestic industry of much needed capital. M. Q. BARON, *Fiscal Policy and Tax Structure in Australasia*, 5 STUDIES ON TAXATION AND ECONOMIC DEVELOPMENT (TWELVE COUNTRY SURVEYS, SIX PANEL PAPERS, SUMMARY AND HIGHLIGHTS) 185 (1978).

26 UNCTC, *supra* note 3.

27 C. PLAMBECK, *Taxation Implications of Global Trading: A Summary*, 14 HASTINGS INT'L & COMP. L. REV. 370 (1990) [hereinafter referred to as PLAMBECK].

28 SGATAR, *supra* note 14, at 16; JACKSON & DAVEY, *supra* note 2, at 111; PLAMBECK, *id*, at 13.

29 M. LANGER, *Practical International Tax Planning*, POSITION PAPER OF THE GERMAN FOUNDATION FOR INTERNATIONAL DEVELOPMENT IN THE INTERNATIONAL CONFERENCE ON INTERNATIONAL TAX AVOIDANCE AND EVASION 17-25, (Berlin, May 1980) [hereinafter referred to as THE BERLIN REPORT].

30 JACKSON & DAVEY, *supra* note 2, at 111.

> foreign subsidiary is often, but not always, treated differently from a foreign branch of the home country corporations[31]

D. *The problem of internal information*

Anent the rise in number of manipulative tax schemes, is the increasing difficulty of gathering information regarding TNC activities. Although courts in most countries have upheld the power of the revenue service to compel a taxpayer to produce information relating to businesses conducted by the taxpayer,[32] such information are limited to business transactions conducted within the territorial jurisdiction of states, except only when specifically covered by treaty arrangements.

This strategy is nothing but inadequate when dealing with TNCs whose multi-state transactions are characterized by data internal only to it. It should be noted that what is being dealt with is a corporation which is run under its own internal structure and policy, with the data involved likewise being subject to internal control. This brings to fore the question of whether information, if ever made available by the transnational corporation, is accurate and uniformly obtained to make it adaptable to the needs of the "other" taxing jurisdiction.[33]

> From the above observations, there are two general conditions *sine qua non* that are apparent in any study meant to understand TNC activities: the facility of taking advantage of tax regulations and the difficulty of gathering information regarding the TNC.

E. *Distinguishing between tax evasion and avoidance*

Generally, States have viewed the distinction between tax evasion and tax avoidance as purely a question of legal boundaries.[34] Evasion is outside the law, avoidance is not. Since the law attempts to

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[31]What is fast becoming more serious than the differences in tax rates is the proliferation of gaps and overlappings in the definition of taxable net profit. For example, one country may allow a 100 *per cent* depreciation deduction for the cost of the machinery and equipment in the year of purchase, while another country requires the depreciation to be spread more or less evenly over the years of useful life of the asset.

[32]In *United States v. Burbank & Co., Ltd.*, 525 F.2d 9 (2d Cir. 1975), the U. S. Court of Appeals ruled that the Internal Revenue Service has the power under the exchange of information article in the US/Canada Double Taxation Agreement to compel a taxpayer to produce information which is only for use in a Canadian tax investigation. In other words, the court sanctioned the use of summonses although the Internal Revenue Service had no tax interest in the information sought to be remedied.

[33]*See* secs 2.e and 4.b, this Study.

[34]COWELL, *supra* note 15, at 10.

make distinctions on the basis of *entitlement*, it attempts to specify the portion of resources to which the State is entitled. Evasion is a violation of that entitlement.[35]

Studies made in Australia, for instance, distinguish evasion from avoidance in that evasion is illegal and therefore morally wrong while avoidance, on the other hand, has received the sanctions of the Court.[36]

Philippine taxation adopts the same view. The term "tax evasion" has been made to apply to the deliberate escape accomplished by breaking the letter of the law while "tax avoidance" is referred to as an escape accomplished by legal procedures which may be contrary to the intent of the sponsors of the law but nevertheless do not violate the letter of the law.[37] Whereas the tax evader breaks the law, the tax avoider sidesteps it.[38]

Other countries, however, do not look kindly upon either tax evasion or avoidance practices of taxpayers. These countries believe that the gain of the tax evader or tax avoider is still the government's loss. This has led these States to adopt measures to curb and punish both tax evasion and avoidance practices. Malaysia, for instance, has

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[35]The SGATAR Study gives an overview of the definition in the following manner:

Tax evasion is usually defined as an attempt, whether successful or not, to reduce or totally eliminate tax liability by illegal means. It has been used interchangeably with tax fraud, both of which connote an integration of three factors, namely:

(a) the end to be achieved which is the payment of less tax than that known by the taxpayer to be legally due;
(b) an accompanying state of mind which is variously described as being evil, in bad faith, deliberate and not accidental or willfull; and
(c) an unlawful course of action tinged with the elements of deceit, mis-interpretation, trick, device, concealment and dishonesty.

Tax avoidance is the achievement of a similar end by means which are within the law. It involves an intelligent analysis and choice of schemes which will bring about less tax impact than the more commonly used methods. The process, which is also referred to as tax planning, starts even before the tax liability accrues. Three characteristics typical of tax avoidance schemes are, namely:

(a) the presence of artificiality where the various arrangements involved in a scheme would not, in the absence of tax factors, take the form they do;
(b) such schemes would often take advantage of loopholes in the law or apply legal provisions for purposes for which they were not intended; and
(c) secrecy may also be a feature of such schemes, where tax advisers sell ready-made avoidance devices with the condition that the taxpayer keep the facts secret as long as possible.

[36]SGATAR, *supra* note 14, at 1-9.

[37]*Republic v. Gonzales*, 13 SCRA 633 (1965); Perez v. Court of Tax Appeals and Collector of Internal Revenue, L-10507, May 30, 1958.

[38]DICTIONARY OF ECONOMICS AND BUSINESS 315 (Schultz and Harris, eds. 1953).

gone beyond merely penalizing "escape from the letter of the law," tax avoidance is also frowned upon. Both the practices of tax evasion and tax avoidance are associated with "exploitation and manipulation".[39]

The difference in views in dealing with tax evasion and avoidance, finds no room in the international sphere. This is because there is no law which regulates taxation and defines any "entitlement" to resources, so there can be no such violation of this "entitlement" to speak of. The terms "tax evasion" and "tax avoidance" are therefore used interchangeably and its application is found in one meaning: *escape from taxation.*

The legal distinction would also loosely apply to general discussions of tax evasion and avoidance at the international level because the scope of the two activities would vary among countries depending on the specific terms of domestic laws and international treaties.[40] A scheme may be illegal in one country and legal in another; and while the same practice may be within the letter of the law in one country, the other looks at the mere frustration of the intentions of the law already tantamount to breaking the law.[41]

Likewise, due to the fast changing attributes and policies of legislation, a method may presently be referred to as a tax avoidance practice but once it is detected and prohibited by subsequent legislation, it becomes a tax evasion scheme.[42]

International tax specialists suggest that despite distinctions in the legal aspect, a joint analysis of the two activites should be sought

> owing to the significant degree of substitutability and possible complementarity between the two activities for the taxpayers, and the singularity of their implications on the revenue maximizing goal for the government.[43]

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[39]SGATAR, *supra* note 14, at 1-9.

[40]SGATAR, *supra* note 14, at 4 *citing* N. M. QUERESHI, *Devices Used To Evade or Avoid Taxes and Possible Solutions to the Problem--Pakistan's Experience*, TAX PLANNING, TAX AVOIDANCE AND TAX EVASION 68 (1984).

[41]*Id.*; OECD Work on Tax Avoidance and Evasion 13 (1981), in SGATAR, *supra* note 14, at 4.

[42]SGATAR, *supra* note 14, at 4.

[43]R. CROSS and G.K. SHAW, *The Economics of Tax Evasion*, 37 PUBLIC FINANCE 36-47 (1982).

This suggests that the difference between tax evasion and tax avoidance may only be temporal.[44] In the succeeding discussion, therefore, the terms shall be spoken of in the alternative and without distinction, since the problem being dealt with is not about "going beyond the letter of the law" but on how intelligently schemes are employed to exploit the loopholes of legislation.

III. STATE JURISDICTION AND THE TNC: A REVIEW OF JURISDICTIONAL RULES

The threshold issue that must initially be resolved in this study pertains to jurisdiction which traverses all "conflicts" related to TNCs.

When corporations operate in many countries, a natural consequence would be to subject them to multiple tax jurisdictions. Multiple tax jurisdictions create two sets of problems:[45] (1) "overlapping" jurisdictions, and (2) "underlapping" jurisdictions.

When overlapping occurs, two or more governments claim tax jurisdiction over the same income of the same TNC. Hence, overlapping jurisdictions raise the problem of double taxation, a problem of immediate concern to enterprise managers.

Conversely, underlapping occurs when some or all of the income of a TNC falls between tax jurisdictions and thereby escapes any taxation. The result is tax avoidance, which is a problem for governments.

A. *Taxation and jurisdiction*

In either instances of double taxation or tax avoidance, the principal source of difficulty is the incompatible bases of jurisdiction between countries. The effect of these incompatible bases of jurisdiction is that the same income may be subject to tax in many countries, or in none. The major jurisdictional issue arises more frequently with corporate tax, because of the growth of these TNCs. It is in this respect that jurisdiction[46] has been looked upon as one of the oldest problems in

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[44] I. G. WALLSCHUTZKY, *Preventing Tax Avoidance--Australian Experience*, 2 ASIAN PACIFIC TAX AND INVESTMENT BULLETIN 135 (1984), in SGATAR, *supra* note 14, at 4.

[45] ROOT, *supra* note 9, at 648.

[46] Defined in taxation as "the question of who is entitled to collect any particular tax."

taxation.[47] This is because so long as there are several pots into which tax revenues may go, rules are required to determine which is the appropriate pot in any particular case.

B. *The interface between double taxation and tax avoidance*

To remedy the problem of double taxation, states enter into double taxation treaties. In these treaties, the states agree to a formula apportionment to minimize the instances of taxing the same income of the same enterprise twice. In so doing, however, it gives rise to the problem of tax avoidance, when in apportioning jurisdiction to tax, portions of income derived fall in one of these jurisdictions, in both, or in none.

C. *Principles of jurisdiction as they relate to taxation*

Notwithstanding the inconsistency and absence of international limits on tax jurisdiction, in practice the basis of national rules of income tax jurisdiction have tended to follow the source or the residence principle.[48] The jurisdictional rules adopted by most countries fall under one of these principles or some combinations of the two of them. However, as the succeeding discussion will show, the interpretation and application of these priniciples differ as jurisdictions change.

1. The source or territoriality principle

The source principle, which is also called the territoriality principle, makes taxation dependent on the nexus between the economic activity producing the income. Income which arises in a country is taxed in that country irrespective to whom the income is paid.

The classic concept of territoriality embraces both subjective and objective territoriality. The *subjective* territorial principle finds its application in States which have jurisdiction over acts commenced within a State even if completed or comsummated abroad. But generally accepted and often applied is the *objective* territorial principle according to which jurisdiction is founded when any essential constituent element of an act is consummated on state territory. This may be

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[47] J.A. KAY and M.A. KING, THE BRITISH TAX SYSTEM 202 (5th ed., 1990).

[48] Another jurisdictional principle is based on *citizenship*. Such is omitted here for the obvious reason that a corporation does not have the attribute of citizenship.

employed to found jurisdiction in cases of conspiracy, violations of anti-trust laws, and in many other fields of policy.[49]

It has been said that the territoriality of criminal law is not an absolute principle of international law and by no means coincides with territorial sovereignty because though fundamental, the territorial character of criminal law is adopted in so many various ways.[50] This is also true with source or territorial tax jurisdiction. Despite the fact that taxation has become a subject separate and distinct from criminal law, the scope of criminal law necessarily includes the violation of taxation laws. This may well account for the applicability of criminal territoriality rules to taxation.

Different states have applied "source" in different concepts to different subjects of taxation. For example, dividends can have their source in the country where the paying corporation is resident or the origin of the income out of which the dividend is paid; interest may have its source where the debtor resides, where the credit is made available, or where payment is to be made; personal income may have its source where the services are physically performed or where services are put to use; rents and royalties may be sourced in the country where the leased or licensed property is actually used, the investor's residence or where the invention is used and income from the sale of property may have its source at situs or at the place of the sale.[51] The UNCTC in a study, has concluded that taxes can be avoided at source. The Study observed that:

> Income which is neither attributable to a permanent establishment nor subject to gross withholding taxes usually escapes taxation at source. There are two major types of income that often fall into this category that escape taxation at source: income from the sale of goods where the sales activities in the source country are sufficiently insubstantial so as not to constitute a permanent establishment, and gains from the sale or exchange of intangible property, such as stocks and bonds.[52]

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[49] I. BROWNLIE, PRINCIPLES OF PUBLIC INTERNATIONAL LAW 303 (1990) [hereinafter referred to as BROWNLIE].

[50] *The Steamship Lotus* (1927), PCIJ, Ser. A, no. 10.

[51] Income Taxation in Developing Countries, U. N. Doc. ST/CTC/74 5-7 (1973) [hereinafter cited as U. N. Doc. ST/CTC/74].

[52] UNCTC, *supra* note 3.

2. The residency and nationality principle[53]

Unlike the source principle, the residency principle looks at the relationship between the taxpayer and the taxing jursidiction. It looks at corporations registered as "residents of a state" and as a taxpayer with both domestic and foreign source income paid to the resident potentially subject to tax.

Tests for residency of corporations , however, vary from state to state. This makes the residency or nationality of corporations more difficult to determine than where individuals are concerned.[54] It is also common for states to regard "residency" in terms of "nationality." Therefore, a corporation is deemed a national of a state under whose laws it has been incorporated, or a national of a state where its officers or shareholders are nationals.

The complex organization of modern business associations or corporations has made it difficult at times to determine the "nationality" or "residency" of such an association and has in consequence given rise to numerous controversies. For example, although the general principle holds that incorporated companies have their nationality or residency of the state in which they are incorporated or where their governing body is usually located, state interest sometimes mandates that the residency or nationality of a corporation be determined by the nationality of its shareholders.

3. Passive personality principle

According to this principle, jurisdiction may be acquired by states over acts done abroad which can be harmful to the stability of the forum. The application of the principle is generally one of import in criminal law jurisdiction. But where taxation is concerned, the application of this principle is a matter of state policy concerning acts which constitute an infringement on the taxing authority's jurisdiction

[53]These concepts are incompatible under international law when referring to individuals. But with respect to corporations, they being creations of the state and are granted rights of "residency" and "nationality" only by state action, these two concepts are deemed the same for the purposes of acquiring jursidiction over corporations.

[54]U. N. Doc. ST/CTC/74, *supra* note 51 at 7-8. For instance, the United States considers any corporation organized under its laws as a resident; the United Kingdom defines resident corporations as those managed and controlled by its Board of Directors in the United Kingdom; in the Federal Republic of Germany, corporate residence depends on the "seat" of management or registered office of the corporation. In each instance, the resident corporation is subject to full taxation in the country of residence.

and affect revenue collection measures[55] and is adopted regardless of where the acts are performed. Even in criminal jurisdiction, however, the justifiability of the principle has not been generally accepted.[56]

4. Protection/benefit or protection/security theory

Another fast emerging standard of jurisdiction which has been adopted by developed countries is the protection or benefit theory[57] or the protection or security theory.[58] If a jurisdiction confers some benefit or protection, it enjoys power to tax revenues growing out of the same.

Nearly all states assume jurisdiction over aliens for acts done abroad which affect the security of the state. This concept is applied to nearly most of the existing political offenses, though not confined to political acts, as a significant exception to the doctrine of territoriality.[59] When acts by aliens done abroad affect the security of the state, nearly all states assume jurisdiction. In so far as the protective principle rests on the protection of concrete interests, it is sensible enough. However, it is obvious that the interpretation of the concept of protection may vary widely[60] especially with respect to economic policies. Hence, as a principle of international tax law, the feasibility of its application is of limited value.

5. The universality principle

By virtue of this principle, all states would have jurisdiction to try and punish for certain crimes.[61] There are two categories of crimes which should be distinguished under this principle. The first is the category which includes crimes under international law. Under this jurisdictional category, authority is enforced over acts of non-nationals which, under the circumstances and the nature of the crime, justify the

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[55]The Philippine Constitution, for instance, mandates that "No combinations in restraint of trade or unfair competition" shall be allowed in the Philippines. CONST., art. XVI, sec. 11(2). Likewise, all acts which circumvent the Constitutional provisions on the national economy and patrimony are declared to be "inimical to the national interest and subject to criminal and civil sanctions." CONST., art XVII, sec. 22.

[56]According to Brownlie, it is "least justifiable." *See* discussion of the *Cutting Case* in MOORE, DIGEST IN INTERNATIONAL LAW II, 228-242.

[57]F. C. DE GUZMAN, *International Aspects of the Philippine Tax Code*, 6 JOURNAL OF THE I. B. P. 109 (1978).

[58]BROWNLIE, *supra* note 49, at 302-303.

[59]*Id.*, at 304.

[60]*Id.*

[61]D.W. BOWETT, JURISDICTION: CHANGING PATTERNS OF AUTHORITY OVER ACTIVITIES AND RESOURCES 11 (1986).

repression of some types of crimes such as murder, piracy, hijacking, drug trafficking in narcotics, and breaches of the laws of war.[62]

Obviously, this principle is applicable only to crimes which can be attributed to natural persons and cannot be extended to corporations. The recognition of the "crimes against humanity" has no counterpart when we speak of a universal acceptance of corporate business practices inimical to international interest and contrary to international policy. The latter finds no place in international law since the absence of any "international regulation" makes this field reserved only for domestic attention. The absence of any "universal law" in taxation thus accounts for its inapplicability.

A second category of offences includes crimes under municipal law for which all municipal legal systems make provisions.[63] The significant question here is whether tax evasion for which all states provide sanctions can be considered a universal crime under this category. In the face of the diversity of tax regulations, it could be asserted that it is the varied principles adopted by states which can account for the problems in taxation. It is even further aggravated with the non-concurrence of views regarding these jurisdictional rules. Absent a uniform application of tax laws, jurisdiction, by itself, poses as a problem which makes it possible for transnational corporations to "control" the taxing regime they will be subject to.

D. *Conflicts in jurisdictional rules*

Notwithstanding the general acceptance of the territoriality principle in taxation, there still arise conflicts of jurisdictional rules owing to the different bases for the application of the territoriality principle.

1. Source v. Residency Principles

The conflict between source and residency principles is inevitable in international transactions,[64] the circumstance of taxation of these transactions included. This makes it the "classic conflict" in international taxation.

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[62]Under the Hague Convention of 1907 and the Geneva Convention of 1949, breaches of the laws of war may be punished by any state which obtains custody of persons suspected of responsibility.

[63]BOWETT, *supra* note 61, at 13.

[64]International Income Taxation and Developing Countries, U. N. DOC. ST/CTC/56 12 (1973), [hereinafter cited as U. N. Doc. ST/CTC/56].

> If for example, a bank in the United States lends money to an Indonesian enterprise, the interest paid by the debtor is taxable in Indonesia under the source principle and is also taxable in the United States under the residence principle.[65]

Conversely, when a bank in Indonesia lends money to a US TNC, the interest paid by the enterprise is taxed only under the residence principle by U.S. laws. If so, then under what taxing principle may Indonesia assert taxing power over the US multinational enterprise?

> Similarly, if a Canadian engineering enterprise performs services in Dominica, the services income is taxable in Dominica under the source principle and in Canada under the residence principle.[66]

But what if a Dominican engineering enterprise performs the services in Canada, taking that the same residency and source rules do apply, how will both countries exercise their taxing powers?[67]

Because the source-residence conflict has become a common by-product of a large number of international transactions, attention has been focused to eliminate and reduce the harmful taxation effects on international business enterprise.

Now, where a country can tax under either the source or residency principle, as when the income arises within a country and is paid to a resident of that country, the residence principle usually predominates and the country taxes under the residence principle. The net effect is that income arising within a taxing jurisdiction paid to a resident of that jurisdiction normally is taxed on a net basis and not subject to the gross withholding taxes that could be imposed if taxation were based exclusively on the source principle.[68]

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[65]*Id.*

[66]*Id.* The same sort of conflict would commonly arise with royalties paid under international licensing agreements, with rents paid under international leasing agreements, and with income from a great many import and export transactions.

[67]It is this conflict that also gives rise to the problem of conflicting "application" of the source and residency principles, whereby States have arranged for interpretations of their laws to exercise their taxing powers.

[68]U. N. Doc. ST/CTC/74, *supra* note 51, at 8.

2. Residence v. Residence Principles

The conflict between taxing jurisdictions need not only exist when there are two different jurisdictional principles upon which States exercise their taxing power. If two countries apply different rules to determine the residency of taxpayers, tax evasion could result from a taxpayer having "no residence" when the rules of both States under which business is operated treats the taxpayer not as a resident of that State. Interestingly, a U.N. Study[69] has demonstrated the problem of double taxation of TNCs by analogy to an individual having "dual residence." Perhaps, it would also be understandable if the same problem, applied to tax evasion of multinational enterprises, would be demonstrated in terms of an individual who happens to be a "stateless person." An enterprise could be "stateless" if, for example, it happens to be a company organized in the United Kingdom but operates in the United States. Under the strict application of the United States doctrine of residency (which is based on the incorporation theory),[70] the company will be treated as a resident of the United Kingdom while under the laws of the United Kingdom, which defines residence of a corporation as that in which its officers or directors sit (the seat of management theory), the residence of the enterprise would be the United States. A simple application of the basic rules therefore displays a conflict of jurisdictions.

In the case of *Daimler Company v. Continental Tyre & Rubber Co.*,[71] the House of Lords held that a company incorporated in the United Kingdom might, in spite of its technical legal character, nevertheless assume an "enemy character" where its agents, as the persons *de facto* in control of its affairs, are residents of a different territory or are acting under the instructions of shareholders not of British nationality. This shows that although the nationality of the individual shareholders of a corporation does not determine the nationality of the corporation according to domestic laws, the courts, in the interest of the state, can define nationality of the corporation in terms of the nationality of its officers and shareholders.

[69] U. N. Doc. ST/CTC/56, *supra* note 64, at 12.

[70] This example of course operates under the application of the residency principle alone. It is naturally expected that the United States would levy taxes upon the operations of the company under some combined tax principle, if it cannot tax it on the basis of residency.

[71] 2 A.C. 307; HUDSON, CASES IN INTERNATIONAL LAW 310.

In the event, however, that the question of "residency" or "nationality" is put to issue, international law provides a justification for a single adopted theory.

In the *Barcelona Traction Case*,[72] the International Court of Justice declared that the two traditional criteria for determining the nationality of companies, i.e., the place of incorporation and the place of the registered office of the company concerned, have been "confirmed by long practice and by numerous international instruments." The Court also looked into other tests of corporate nationality but concluded that these tests have primary emphasis on the traditional place of incorporation and the registered office in deciding the case in point. Although the decision was taken within the framework of diplomatic protection, the principle pronounced reflects a general principle of international law.

Despite this determination under international law, the inconsistency still prevails. This is because the concept of nationality now differs not only in the internal rules of states; the concept as used in treaties has also differed from one treaty to another.[73]

3. Source v. Source Principles

The application of conflicting source rules creates risks of tax evasion. A pure[74] application of the rules pertains in the United States and in Columbia. If, for example, technical services are performed by a contracting company in Columbia but used in a construction project in the United States, under US law, where "source" is that where the services are actually and physically performed, the income is taxable in Columbia; Columbian law, on the other hand, points to the US as the "source" where the services are put to use.

Many of the conflicts in source rules are between developed countries and developing countries, and they reflect the different revenue interests the countries have in source taxation.[75] In a growing

[72]I. C. J. REPORTS 4 (1970).

[73]Introduction to the OECD Codes of Liberalisation, *fn.* 18 at 31 (OECD, 1988).

[74]Where the "source" rule on services rendered is applied in isolation of other applicable rules and where there are no other rules which determine what of the operation each taxing jurisdiction could effectively tax.

[75]U.N. Doc. ST/CTC/56, *supra* note 64, at 13.

number of cases, the conflicts in source rules are dealt with in tax treaties between developed and developing countries.[76]

E. *Obtaining information in different jurisdictions*

The fractionalization of jurisdiction also poses as a problem, especially where the informative approach to offering a solution to tax avoidance practices is concerned. Where different states adopt different jurisdictional rules, it follows that their concern to tax business enterprises are focused on different aspects of transactions. Hence, information used to enforce tax laws have different bases. This means that a given state has no means of acquiring from the parent corporation or from subsidiaries of the enterprise in other countries some of the information directly relevant to activities of the enterprise in that State. Furthermore, the information it receives may have been prepared on the basis of accounting and statistical principles different from those generally in use in that state, thereby making the information difficult to analyze.[77]

IV. THE FORMS OF TAX EVASION AND AVOIDANCE: TRANSFER PRICING AND TREATY SHOPPING

In general, tax evasion on the international level results whenever taxable income by transnational corporations is allocated among different subsidiaries, and the allocation is done in such a way as to take the income away from the purview of one taxing jurisdiction. Some known forms of "illegal non-payment of taxes" are bootlegging, misclassification,[78] smuggling, bribery and underreporting.[79] Apart

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[76]The treaties concluded between Argentina and the United States, and between Barbados and the United States, for example, contain specific source rules that are to be applied to income flows between the contracting countries.

[77]Multinational Enterprises, Report of the Secretary General 278, U. N. DOC. A/CN.9/104, March 21, 1975.

[78]Different income sources are often subject to different rates of taxation. The imposition of differential taxation gives rise to a special form of tax evasion under which total income is truly declared while its true composition is not. This is also known as income source misreporting. A taxpayer receiving income from different sources may report income as coming from a lower tax source. The rationale for adopting such practice rather than being pure underreporting is two-fold. *First*, it may be considered a less serious offence, being subject to a lighter penalty. Second, consuming in excess of one's declared income might attract the attention of tax authorities. (G. YANIV, *Tax Evasion Under Differential Taxation, The Economics of Income Source Misreporting*, JOURNAL OF PUBLIC ECONOMICS 337 [1990]). Yaniv's article inquires into the determinants of income source misreporting, focusing on the relationships between misreporting and taxation under

from these, TNCs may also resort to more sophisticated forms of devices to evade or avoid taxes. These devices include the following: allocation of inflated head office expenses to branches and of inflated company expenses to affiliates,[80] charging of inflated fees for technical assistance and special services,[81] concealment or misrepresentation of trading activities or income,[82] overstatement of the costs incurred in the implementation of turnkey projects,[83] abuse of incentive reliefs,[84] under-remuneration of local entities,[85] and abuse of tax treaties or "treaty shopping."[86] The more prevalent forms of tax evasion and

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alternative forms of evasion and determines the conditions under which one will be preferred to the other.

Under Philippine law, corporations and companies, among others, whose gross quarterly sales or earnings exceed twenty-five thousand pesos shall have their books of accounts audited and examined yearly by independent certified public accountants. (NIRC, sec. 232) These CPA's who certify financial statements of a business enterprise containing an essential misstatement of facts or omission in respect of the transactions, taxable income, deduction and exemption of his client shall, upon conviction, be punishsed by a fine of not less than P10,000 but not more than P50,000 or by imprisonment of not less than four years and one day but not more than six years or both. (NIRC, sec. 256) See Chapter 8, this Study.

[79]Other schemes employed by TNCs are enumerated in Chapter 2, i.e. "this Study".

[80]Non-resident parent companies may allocate to their affiliates in that country head office expenses or other charges which are arbitrary or unrelated or not commensurate with the actual activities of those affiliates.

[81]Non-resident parent companies may allocate to affiliates artificially inflated charges for the provision of technical assistance and specialist services; they are more likely to use this device in the case of new and complex technology where the artificial nature of the charges may be difficult to detect.

[82]Non-resident companies may be tempted to categorize their activities or receipts in such a way as to take the receipts out of the taxable class or subject them to a lower rate of tax. (This is the income misclassification resorted to by TNC's.)

[83]In package deals involving, for example, the provision of a complete factory by a non-resident, in which the contract provides for the provision of plant and machinery and the construction of the factory, together with the supply of technology and know-how, problems can arise in ascertaining the proportions to be allocated to the sale of tangible items and to the transfer of technology.

[84]When tax reliefs are provided to encourage industrial and other investments from abroad, such as pioneer industry exemptions or "tax holidays", there would be a temptation for the taxpayer to disguise, as income qualifying for a relief, income which does not qualify for it.

[85]Where research and development are undertaken by one entity in a transnational group for the benefit of other entities in the group, the group as a whole may pay less tax world-wide if the entity carrying out the research and development does not receive adequate remuneration for the benefits which it provides. This might happen if the research and development are carried out in a country imposing heavy taxes and the entities deriving a benefit from it are taxable in countries imposing a relatively lower tax burden.

[86]Tax may be lost by countries that are host countries to non-resident enterprises if those enterprises route the profits of their activities and investments through affiliated enterprises in countries having a convenient tax treaty with the host country simply in order to take advantage of the favorable treaty provision. (International Co-operation in Tax Matters, Guidelines for International Co-operation Against the Evasion and Avoidance of

avoidance schemes can be categorized into two: transfer pricing and treaty shopping.

A. *Transfer pricing*

The most common means of non-payment of taxes is transfer pricing.[87] Along with the increasing role of transnational corporations in world trade, there has been an equally rapid growth of trade within transnational corporations or intrafirm trade.

This results in the possibility of manipulation of prices to be used as the accounting basis for recording transactions between transnational parent and subsidiary companies or branches. To better understand the mechanism of transfer pricing, one will have to analyse the income statement on which the corporate tax liability is based.[88]

Business transactions are carried out on terms agreed upon by private parties. Regulatory laws may circumscribe the parties' freedom to contract but deals are made on terms privately determined. Where the contracting parties are unrelated, it is generally assumed for tax purposes, that each party will pursue its own interest and pay tax on the "true" economic income resulting from the transaction. Where dealings take place between related parties, the chances that parties may artificially "shift" potentially taxable income from one party to another becomes a material concern.[89] The essence of a transfer price is that it is not set by an independent transferor in an arm's length

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Taxes 18-19, U. N. DOC. ST/ESA/142 (1988) [hereinafter cited *as* U.N. DOC. ST/ESA/142].

[87]Transfer prices are sometimes referred to as clearing prices. For the TNC, transfer pricing is a business issue, for the government, it is a political one.

[88]This is an example of an INCOME STATEMENT:

G. C. S. Corporation
Income Statement
For the Year Ended March 9, 1992

	Sales	xxx
	Less: Cost of Goods Sold	xxx
	Gross Profit on Sales	xxx
	Less: Operating Expenses	xxx
	Selling Expenses	xxx
	Total Operating Expenses	xxx
Add:	Income from Operations	xxx
	Less: Interest Expense	xxx
	Income Before Income Taxes	xxx

[89]D. R. TILLINGHAST, *International Tax Aspects of International Transnations*, INTERNATIONAL ECONOMIC LAW 187 (2d. ed., 1984).

negotiation, but it is within the discretion of a single enterprise.[90] As can be seen from the sample income statement, an increase in the cost of goods sold arising from transfer pricing maneuvers will reduce taxable income resulting to lower taxes.

1. Forms of transfer pricing

Transfer prices are not limited to goods traded between the parent and subsidiary corporations or brother/sister corporations. They include the values attached to transfers of capital, services and technology such as royalties, research and development, interest rates paid on loans, management, technical and consultancy fees, and rental charges for equipment between such corporations.[91] Loans may be granted at excessively high or extremely low interest. An entity in a high tax jurisdiction may charge a related foreign company in a lower tax jurisdiction administrative and operational fees which are artificially low. Management and service fees may also be charged to an affiliate for activities which have never taken place or services which have never been provided. In the income statement, these manipulations will affect operating and interest expenses. Any increase in these items will lead to lower taxable income.

The cover afforded by transfer pricing is even more difficult to penetrate when the related companies involved are not overtly linked to each other and appear to be totally unrelated entities.[92] The following are instances of transfer pricing in transactions between companies which are not part of the same corporation group. Tie-in clauses in a licensing agreement for patents, trademarks or know-how may require the licensee to buy the raw materials from the licensor or a party designated by the licensor at prices different from open market prices.[93] Artificial prices can also be set in other areas such as freight, insurance and shipping charges, and also through variations in the quality and quantity of raw materials.[94]

Transfer pricing arrangements have become more attractive and feasible due to the presence of tax havens.[95] Many operations carried

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[90] U. N. Doc. ST/CTC/56, *supra* note 64, at 68.

[91] International Accounting and Reporting Issues: 1989 Review 94, U. N. Doc. ST/CTC/100 (1989), [hereinafter cited as U. N. Doc. ST/CTC/100].

[92] U. N. Doc. ST/ESA/142, *supra* note 86, at 27.

[93] Transnational Corporations in World Development, Trends and Prospects 94-95, U. N. Doc. ST/CTC/89 (1989) [hereinafter cited as U. N. Doc. ST/CTC/89].

[94] *Id.*

[95] The following are listed as tax havens: Anguilla, Antigua, Bahamas, Barbados, Bermuda, British Virgin Islands, Cayman Islands, Channel Islands, Cook Islands, Cypress, Gibraltar, Hong Kong, Isle of Man, Liberia, Lichtenstein, Luxembourg, Monaco, Nauru,

out in tax havens are tax motivated, being used to reduce tax payments in the investor's country of residence and/or in third countries. Many of those operations are legitimate operations conforming to both the spirit and the letter of the law of the investor's country of residence.[96] Tax havens will be discussed more fully in the next chapter.

If in country A the corporate tax burden is higher than in country B, other factors being equal, an enterprise with operations in both countries is logically inclined to shift profits from country A to country B in order to increase after-tax profits. This is better illustrated by the following example:

> There is a transnational corporation with a manufacturing subsidiary in Germany and a sales subsidiary in Hong Kong. Since the corporate income tax in Hong Kong is relatively low, while the tax in Germany is quite high, it would be in the transnational corporation's best interest to set the prices on transfers between the subsidiaries so that the bulk of the profits were allocated to the Hong Kong subsidiary. If the transfer price on goods manufactured by the German subsidiary and sold to unrelated parties by the Hong Kong subsidiary were set at or just

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Netherlands Antilles, Panama, Switzerland, Turks and Caicos Islands, United Kingdom and Vanuatu. M. GRUNDY, GRUNDY'S TAX HAVENS: A WORLD SURVEY (5th ed., 1987).

The Philippines was listed as a tax haven in W. DIAMOND, P. HAUSER, J. O'CONNOR, H. HYLIND, & D. DIAMOND, TAX HAVENS OF THE WORLD (October 1979 Rev., Release 21 1979). Part of the discussion reads:

> "Since long before World War Two, the Philippines has been regarded a a favorable site for overseas investment because of its traditional welcome to foreigners, abundance of English-speaking personnel, good clerical help, a central location and excellent sea and air communications. However, P[res.] D[ecree No.] 218 [1973], "Prescribing Incentives for Establishment of Regional or Area Headquarters of Multinational Companies in the Philippines" is designed to make the Philippines the business and financial capital of South East Asia . . . [Under this decree] if multinational corporations establish regional or headquarter's companies which do not earn income in the Philippines, they are 100% exempt from tax when they act as supervisory, communications and coordinating centers for their affiliates, subsidiaries or branches in the Asia-Pacific Region."

In the Tax Code, at present, aliens employed by these types of multinational corporations and earning salaries, wages, annuities, compensation, remuneration and other emoluments from the same are subject to a tax of 15% of such gross income (Section 22(c)) as contrasted with the 30% tax levied on the income of non-resident aliens not engaged in trade or business within the Philippines.

[96]Tax havens can be used to minimize taxes legally in various ways such as reducing the taxpayer's overall tax burden, by deferring the payment of taxes on income from foreign sources until it is repatriated enabling profits to accumulate without tax payments, by minimizing taxes on investment income or from certain transactions, arranging for income to be taxed in a low tax jurisdiction, centralizing income in the tax haven country, free of any tax chargeable in the country where the parent company of a group is operating and repatriating it to the company in a non-taxable form. U. N. Doc. ST/ESA/142, *supra* note 86, at 33.

> slightly above the German subsidiary's costs of production, the effect would be to have all the profits arise in Hong Kong. If this transfer price were below the range of defensible transfer prices, it would constitute abusive transfer pricing practice.[97]

Transfer pricing abuses are prompted by more than just corporate income tax differentials. They may be used to circumvent exchange control restrictions, as a device to withdraw profits in the face of political or economic uncertainties in the host countries or in any instance in which business considerations dictate showing low profits in a particular jurisdiction.[98] On the other hand, there are also restrictions on the ability to manipulate transfer prices. First are the managerial limitations. Transfer pricing maneuvers imply a large degree of central monitoring, planning and decision making which runs counter to the profit center philosophy.[99] Secondly, gains from transfer prices in one area may be nullified or reduced by losses in another. An example will be lower corporate taxes on one hand but higher import duties on the other. Third are the countermeasures by national governments such as tax treaties and general legislation. And fourth is the definition of "arms-length" prices. The third and fourth restrictions will be discussed fully later in this Study as remedies to transfer pricing.

Although transfer prices usually suggests that TNCs have a large leeway to manipulate the prices on intrafirm trade and service flows, this should not obscure the basic fact that, within any multi-division firm, prices must necessarily be applied to trade or service transactions between divisions, even if there is no inducement whatsoever for transfer pricing maneuvers.[100] Empirical evidence on the level of transfer pricing abuses is far from complete, but the evidence that does exist suggests that transfer pricing abuses constitute a major problem and result in significant economic damage in both developed and developing countries.

Developing countries are more vulnerable to transfer pricing maneuvers because (1) they frequently adopt a strict exchange control regime and sometimes other restrictions and regulations affecting foreign investment, (2) they are comparatively ill-equipped to detect

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[97]U. N. Doc. ST/CTC/56, *supra* note 64, at 68.

[98]*Id.*, at 70.

[99]That each subsidiary or branch is an independent entity responsible for its own revenues and expenses.

[100]S. R. F. PLASSCHAERT, TRANSFER PRICING AND MULTINATIONAL CORPORATIONS 19 (1973), [hereinafter referred to as PLASSCHAERT].

and control transfer pricing manipulations when they occur,[101] and (3) they are usually less politically stable.[102]

2. Some evidence of transfer pricing

The existence of transfer pricing is hard to prove by direct evidence, as stated earlier, but secondary evidence points to its existence. One method used was the comparison of increase in direct foreign investment to the reported income of foreign controlled subsidiaries. Prof. James Wheeler in an article on transfer pricing states that one of the most striking aspects of the increase in direct foreign investment in the United States is the fact that reported income of the foreign controlled subsidiaries has not kept pace when measured by their net income. He concludes that a lack of profitability need not by itself imply that transfer pricing abuses are present. To obtain a more informative picture a comparison of several key ratios[103] were made, he then concluded that since the prices paid for the goods obtained by the foreign controlled subsidiary are reported in the cost of goods sold,[104] the somewhat lower gross profit ratio for foreign controlled subsidiaries might suggest potential transfer pricing problem.[105] A similar approach can be adopted in the Philippines but the validity of any conclusion made will depend on the integrity of the information used.

B. Treaty shopping

The combined weight of concurrent tax claims, if not relieved by special measures, would in certain cirumstances, become excessive and even completely eradicate any profit, with serious adverse effects on the willingness and ability of firms to effect foreign investments.[106] Thus treaties are entered into to alleviate international double taxation. However, facilities provided by double taxation agreements can sometimes be used to reduce taxation in a way which was not intended by the negotiating parties.

A parent company can evade or avoid taxes by resorting to the technique known as "treaty shopping", whereby it routes its profits through affiliates in other countries which have concluded bilateral

[101]U. N. Doc. ST/CTC/89, *supra* note 93, at 94-95.
[102]U. N. Doc. ST/CTC/100, *supra* note 91, at 94.
[103]

Taxable Income	: Gross Profit	: Interest Expense
Assets	: Sales	: Assets

[104]*Refer to* INCOME STATEMENT, FN. 88, i.e "this Study"
[105]This study was cited in L. DWORIN, *Transfer Pricing Issues*, 43 NATIONAL TAX JOURNAL 9 (1990), [hereinafter referred to as DWORIN].
[106]PLASSCHAERT, *supra* note 100, at 112.

treaties for the avoidance of double taxation. This is done in order to take advantage of the favorable tax treatment provided under those treaties for residents of the contracting parties which is not intended for residents of third party countries. It is possible in certain circumstances for the residents of a third country to repatriate funds to that country through entities established in countries which are parties to a bilateral treaty under more favorable conditions than if those funds had been repatriated directly. This can be done if the treaty relaxes tax provisions in the source country and if there is a similar provision in a treaty between its partner country and the investor's party.[107]

Treaty shopping is difficult to stop because it is increasingly being used by major TNCs to eliminate excess foreign tax credits, under the name: *trinational use of tax treaties*.[108]

Despite many potential transactions involving various types of treaty shopping, there are no clear guidelines as to what is permissible and what is not. In the United States there are no provisions in the Internal Revenue Code that directly seeks to prevent treaty shopping. However some general rules and concepts of tax laws have been used from time to time by the Internal Revenue Service to attack treaty shopping.[109]

Treaty shopping practices are objectionable for various reasons aside from enhancing opportunities for international tax evasion by causing unintended revenue loss not contemplated by the treaty agreement. They may undermine the willingness of third countries to enter into treaty negotiations and, more importantly, such practices are

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[107]U. N. Doc. ST/CTC/56, *supra* note 64, at 72-73.

[108]The following will illustrate this: A United Kingdom TNC wants to create a new subsidiary to carry on business in the United States. A combination of US corporate income tax on the subsidiary plus withholding tax on dividends under a UK-US treaty will result in a US tax higher than 52 percent. Foreign taxes up to 52 percent can be credited in the UK but those over 52 percent are lost. THe UK coporation may therefore consider using a British Virgin Islands or Netherlands Antilles corporation to carry on its US business, thereby eliminating the US withholding tax or it may create a new US subsidiary under the umbrella of a Netherlands holding company. THE BERLIN REPORT, *supra* note 29, at 204.

[109]The Internal Revenue Service has attacked some attempts at treaty shopping on the ground that they are sham. This was the argument used successfully in Aiken Industries v. Commissioner (56 TC 925 [1971]). Aiken Industries Inc. owed more than $ 2 million to a related Bahamian corporation. Interest payments on the notes were substantial and subject to thirty percent US tax. To avoid this, the Bahamian corporation transferred the notes to a newly created Honduran corporation in exchange for nearly identical notes of that corporation. The Honduran corporation claimed that it was exempt from US tax under the income tax treaty then in force between the United States and Honduras. The tax court treated the interposition of the Honduran company under such circumstances as a sham. THE BERLIN REPORT, *supra* note 29, at 97.

contrary to the spirit of international double taxation treaties. Double taxation treaties are founded on the principle of allocating taxing rights based on "economic allegiance"; treaty shopping accords a revenue power to a third country (or to a TNC based in such country) which has little or no claim to such allegiance.[110]

V. EMERGENCE AND USE OF TAX HAVENS

When TNCs are given the opportunity to choose the jurisdiction where they can conduct their different operations, they are expected to seek to be taxed under a low-tax jurisdiction. These jurisdictions which offer favorable tax treatment by imposing low tax rates or none at all are called "tax havens."[111]

Although there is overlapping classification, most tax havens can be grouped into the following categories:[112]

(1) countries that have virtually no taxes;[113]

(2) countries that impose virtually no taxes on specific types of companies;[114]

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[110]JACKSON & DAVEY, *supra* note 2, at 1123.

[111]From the viewpoint of states aiming at increasing and protecting the inflow of investments, tax havens are small communities with independent tax authorities who have come to realize that by charging little or no tax on transactions within their jurisdiction, a potential is created for substantial financial flows through their country with beneficial effects. In these countries, each transaction tends to receive preferential tax treatment relative to a major industrialized economy. ADAMS & WHALLEY, *supra* note 16, at 129-130.

A novel observation is also that "every nation is a tax haven in some respect, relative to other countries." E. R. LARKINS, *Multinationals and Their Quest for a Good Tax Haven: Taxes Are But One, Albeit an Important Consideration*, 25 THE INTERNATIONAL LAWYER 483 (1991) [hereinafter referred to as LARKINS]. Notwithstanding this observation, a country generally must boast of low taxes or special tax breaks to merit the tax haven distinction.

[112]LARKINS, *id.*, at 483.

[113]Most tax havens are developing countries. Since taxes do not exist, double taxation problems do not arise. Hence, these tax havens usually do not have tax treaties with other countries. Among the "pure" no-tax countries are Andorra, Anguila, the Bahamas, Bahrain, Bermuda, the Cayman Islands, Djibouti, Nauru, Nevis, Turks and Caicos Islands, and Vanuatu.

[114]No significant taxes are levied on "international business companies" established in the island nations of Antigua and Barbuda, Jamaica, or Montserrat. Nor are "international companies" in the Cook Islands taxable entities. Generally speaking, an international business company or an international company is a corporation limited by shares (a corporation with limited liability) that, with few exceptions, may not conduct business activities within the tax haven. Depending on the specific country, other restrictions may apply. "Exempt companies" in Gibraltar, the Isle of Man, and Seychelles are also zero tax entities. An exempt company is similar to an international business company in its

(3) countries that exempt most foreign source income;[115]

(4) countries that impose relatively low taxes;[116] and,

(5) favored selected multinationals of country's possessions.[117]

Jackson and Davey trace the evolution of the use of these tax havens from the lack of uniformity of jurisdictional rules and of bilateral treaties entered into by states.[118]

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geographical restrictions, but "exempt" does not necessarily allude to tax exemption. In Bermuda, for example, the designation refers to a corporation that is immune from the normal rule that restricts the ownership interests of foreign parties in local companies. Among other no-tax entities are "exempt companies" (known as "corporation tax companies" before 1989) controlled and managed outside Guernsey or outside Jersey: this exempt company is a nonresident company that pays an annual fee of L500 and does no business in the haven. Resident corporations do not pay the fee, sometimes referred to as a corporate tax. Finally, "enterprises" in Grenada that engage in manufacturing or fishing activities and "holding and trading corporations" in Nauru generally escape taxation.

[115]Other tax havens impose significant taxes, but exempt earnings derived from specified activities taking place outside their borders. Among these countries are Costa Rica, Hong Kong, Jordan, Liberia, Macao, Malaysia, Nevis, and Panama. In addition to an income tax exemption on foreign earnings, the entire colony of Hong Kong is a free port, collecting no import duties on most goods.

[116]Relatively low taxes are imposed on an "international business company" in Barbados or the British Virgin Islands, an "offshore company" controlled and managed in Cyprus or established in the Netherland Antilles, a "public limited company" in Ireland, and an "exempt company" or a "nonresident company" in the Isle of Man. Likewise, an "establishment" (*Anstalt*) or a company limited by shares (*Aktiengesellschaft*, abbreviated A. G.) in Liechtenstein, a holding company in Luxemburg or the Netherlands, certain corporations in Oman, or Uruguay, and a company limited by shares (*Societe Anonyme*, abbreviated S. A.) in Switzerland will pay low taxes. Switzerland is unusual because it is one of the few developed nations, that depending on the availability of special concession, imposes a lower overall tax burden than the United States. Switzerland's bank secrecy laws, which encourage foreign investment to a great degree, and its historical avoidance of wars have enhanced the combined attractiveness of its federal, cantonal (state), and communal (municipal) taxes.

[117]So-called possession corporations are exempt from the accumulated earnings tax on income that qualifies for the tax credit. Coupled with this almost complete extinguishment of US taxes, Puerto Rico grants 50 to 90 *per cent* tax exemptions for periods of two to twenty-five years, depending on the particular industry involved. The US possessions of Guam and the Virgin Islands are popular venues wherein to establish foreign sales corporations. Under US law, foreign sales corporations receive an exemption for a portion of their foreign trade income. The exemption varies, depending on the extent of foreign activities and, consequently, the transfer pricing rules that are available, but it generally reduces US income taxes by 15 percent. In addition, these US possessions have voluntarily granted a tax holiday to foreign sales corporations on their foreign trade income through the end of 1996.

[118]JACKSON & DAVEY, *supra* note 2, at 1102.

Transnational corporations are reputed to operate extensively using associate companies located in tax havens. This is because aside from imposing minimal tax rates, tax havens have other characteristics that make them convenient escape routes for shifting profits from one country to another. In terms of information, such countries respect the confidentiality of information including banking transactions thus preventing other countries from obtaining documentary evidence to prosecute tax dodgers. Capital and monetary-wise, they do not impose currency restrictions in order to allow the free movement of currencies in and out of the country.[119]

A. *Incentives in tax havens*[120]

Another jurisdictional aspect related to the use of "tax havens" is the practice of offering tax incentives which include tax holidays and exemptions, tax reductions, tax credits and tax deferrals arising out of a policy to "divide" taxing authority among concerned states.[121] These have made possible the use of tax havens by TNCs to enable them to expand their global market without a percentage increase in worldwide income taxes.[122]

For example, consider a US company that wishes to establish a foreign subsidiary in either Country A where the income tax rate is 50 *per cent*, or Country B, where the income tax rate is 20 *per cent*. Currently, the company has annual net profits of $600. If its market can be expanded overseas, annual net profits are expected to reach $1,000 ($600 from US sources and $400 through the foreign subsidiary). Assuming for this illustration that the US income tax rate is 30 percent, does it matter where the subsidiary is established?

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[119]SGATAR, *supra* note 14, at 188.

[120]ADCs (African Developing Countries) have complained of the effects of tax incentives coupled with the use of tax havens as greatly affecting tax evasion and avoidance in their countries. According to a Study, "[t]he [fourth] major reason for tax evasion or avoidance in ADCs by foreign enterprises is the presence of tax differentials. The existence of tax haven countries is well known. Although industrialized countries are increasingly making use of legislation aimed at curbing the use of tax havens, not all industrialized countries have such legislation and that which does exist is not devoid of loopholes. As a consequence, there still are often substantial incentives to shift profits out of countries with even modest tax rates, such as ADCs, into tax haven countries. CHARLES R. IRISH, IV STUDIES ON TAXATION AND ECONOMIC DEVELOPMENT 49 (1978), [hereinafter referred to as IRISH].

[121]These incentives are reliefs from double taxation adopted by source countries and, primarily by residence countries.

[122]LARKINS, *supra* note 111, at 485.

Assuming that all of the earnings are repatriated to the US parent at the end of each year, the US taxes the full $1,000 profit, regardless of which country is chosen as the incorporation situs. Thus, the US tax, before considering the foreign tax credit, is $3000 under both scenarios. If the subsidiary is organized in Country A, that country imposes a tax of $200 [$400 x .50], and the US allows a foreign tax credit of $120, which is the portion of US tax, before credit, attributable to the foreign source income [($400/$1,000) x $300]. Accordingly, the US tax after the credit is $180 [$300 - $120.]. Worldwide taxes equal $380 [$200 + $180], which is 38 percent of worldwide income.

If instead the subsidiary is organized in Country B, the foreign income tax equals $80 [$400 x .20], all of which qualifies as a foreign tax credit. The US tax after the credit amounts to $220 [$300-$80]. Worldwide taxes equal $300 [$220 + $80], which represent only 30 percent of total income. Thus, establishing a foreign subsidiary in a country with an effective tax rate lower than the US rate (in a tax haven) allows the TNC to expand its market without incurring an overall income tax liability higher than what would be applied if the entire income were taxed only in the United States. Any excess foreign tax limitation that results, here $40 [$120 - $80], is available to absorb any excess foreign tax credit from other similar activities in the current year or a carryover year. Moreover, the multinational may find it can defer recognition of some foreign earnings for US tax purposes.[123]

An advantage which tax havens afford TNCs is an advantage of deferment in paying tax (referred to as the deferral privilege). Funds which come into a tax haven can remain there tax free (or at very low rates of tax on income generated on the profits) until such time as they are repatriated to a parent company. In periods of substantial inflation and high interest rates, a deferring TNC would be able to earn enough income in the interim to meet its tax liability.[124]

When activities are being conducted in high-tax jurisdictions but income is made attributable to low-tax jurisdictions, the normal source and residency rules result to giving transnationals the opportunity to insulate profits from taxation in high-tax jurisdictions where the income arises in a low-tax jurisdiction. The following demonstrates this:[125]

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[123] *Id.*

[124] This advantage accrues predominantly in those cases of subsidiaries of parent companies located in countries operating a credit system of double taxation relief (such as the United Kingdom and the United States) rather than an exemption system. ADAMS & WHALLEY, *supra* note 16, at 130.

[125] U. N. ST/CTC/74, *supra* note 51, at 10.

> Suppose a US transnational corporation has manufacturing operations in the Bahamas with the US corporate tax rate at 46% and the Bahamas having no income tax. If the corporation directly operates in the Bahamas, the income generated by the Bahamian operations will not be taxed under the source principle, but only because the Bahamas has no income tax. The Bahamian source income will be taxed in the US, however, under the residence principle. The Bahamian source income could be insulated from the US tax through the separate incorporations in the Bahamas of the Bahamian operations. In that case, the Bahamian source income would be paid to Bahamian corporation, so that income would not be taxed in the US under either the source or residency principle. The US tax would be deferred until the Bahamian subsidiary pays a dividend to the US corporation, at which point the US would tax the corporations on its foreign source dividend income under the residence principle.

The case against tax incentives are, however, neglected by most developing countries, due to the importance of foreign investment to them. This is evident in Asian, African and Carribean states. According to their simplistic view, tax incentives, whether in the form of full exemption or tax reductions, are intended to increase the profitability of foreign investments. However, if such profits are not exempted from taxation by the home country of the investor, then the desired effect of the fiscal incentives is neutralized. Tax revenue is then transferred from the host country to the investing country. The revenue lost may well mean loss of infrastructure support for domestic private investment.[126]

B. The anonymity of information in tax havens

To aggravate the existing problem of lack and inadequacy of information, tax havens voluntarily institutionalize non-disclosure.

Besides low taxes, one of the features which some tax havens have to offer is anonymity. Certain tax havens even publicize the fact that they do not have double taxation treaties with the major economies so no exchange of information is possible between authorities in the tax haven and elsewhere,[127] hence preserving the anonymity of tax haven operations.[128] In some tax haven jurisdictions, this preservation of anonymity is aggravated by institutionalization *i.e.*, by expressly prohibiting the disclosure of taxpayer's information.[129]

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[126]MIKE Q. BARON, *Foreign Investment Policies of Developing Countries in Southeast Asia: Revisited*, 5 STUDIES ON TAXATION AND ECONOMIC DEVELOPMENT 185 (1978).
[127]ADAMS & WHALLEY, *supra* note 16, at 131.
[128]*Id.*, at 130.
[129]SGATAR, *supra* note 14, at 14.

These, coupled with the lack of resources to adequately check the financial records of multinational firms and the lack of expertise on the part of tax officials in handling tax audits and investigation[130] account for the widening information problem.

C. *Evasion/avoidance devices in tax havens*

A U.N. Department of Economic and Social Affairs Study[131] has cited notable avoidance devices employing tax havens, namely:

> a. Payment of deductible expenses by an entity of high tax jurisdiction to a tax haven entity;
>
> b. Transfer of income-producing assets or income producing functions to the tax haven activity;
>
> c. Use of "insulators" located in tax havens to make assessments and investigations difficult;
>
> d. Shifting of income from a high tax country to a tax haven through over or under valuation of exports and imports;
>
> e. Under capitalization or high debt financing.

The same study concludes that transfer pricing arrangements have become more attractive and feasible due to the presence of tax havens.[132] However, no country has ever been successful in attacking the activities of TNCs since each country's power to enforce and criticize laws is limited to its border.

These evasion devices could be of considerable importance in contructing a maze of complications which may defeat tax authorities; indeed it is not unknown for a transaction which is basically domestic to an economy to be conducted through a tax haven or intermediary with the intent, presumably, of frustrating domestic tax authorities. Although the maintenance of tax havens is entirely a form of tax planning, the use of tax havens has been directly linked to scrupulous use of some offshore locations to evade taxes through double trusts, numbered bank accounts, transactions lacking in substance, and

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[130] *Id.*

[131] Tax Treaties Between Developed and Developing Countries, *Seventh Report* 48-49 (U. N. Department of Economic and Social Affairs, 1978) in SGATAR, *supra* note 14, at 14.

[132] SGATAR, *supra* note 14, at 13.

repatriation of unreported income.[133] How much of this gamut of activities takes place, and the extent to which it involves major TNCs is however, yet unknown.[134]

Regulating the use of tax havens presents a unique problem in international law. The doctrine of sovereign equality necessarily includes the inalienable right of each state to choose its economic principles without interference by another state.[135] This would seem to preclude states whose tax revenues are adversely affected by the use of tax havens from availing of remedies to regulate TNC use of tax haven. This is not to say that some state do not try. They do. Anti-tax haven provisions can be found in the national legislation of states like Japan and Australia.[136] The *UN Issued Guidelines Relating to the Use of Low-Tax Countries Regarded as Tax Havens* provides that countries affected by tax evasion or avoidance through the use of low-tax countries should endeavour to resolve the issues at stake through *bilateral or multilateral negotiations.*

VI. INTERNATIONAL LAW ON TAX EVASION

The sovereignty and equality of states represent the basic constitutional doctrine of the law of nations, which governs a community consisting primarily of states having a uniform legal personality.[137]

Any country in the exercise of its sovereignty is entitled to adopt a tax system which reflects its economic preference to either charge taxes at low rates or to refrain, if it so desires, from imposing taxes at all. However, the taxation and regulatory structures adopted by any country in the exercise of its sovereignty may result in tax advantages for foreigners which could have a serious impact on the tax revenue of other countries. Such other countries are entitled to take their

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[133]LARKINS, *supra* note 111, at 472.

[134]ADAMS & WHALLEY, *supra* note 16, at 131.

[135]General Assembly Resolution No. 3281 (XXIX), Charter of Economic Rights and Duties of States, states that:

Every state has the sovereign and inalienable right to choose its economic system . . . in accordance with the will of its people, without outside interference, coercion or threat in any form whatsoever. (Article 1)

[136]SGATAR, *supra* note 14. Measures taken to confront international tax evasion through the use of tax havens include tax screening measures, international enforcement programs, exchange of information through multilateral or bilateral cooperation among countries and general legislative provisions.

[137]BROWNLIE, *supra* note 49, at 287.

own measures to ensure that taxes which should properly be paid to them is not avoided or evaded.[138]

It is generally accepted that in today's contemporary economic system, sovereign states have the right to regulate and control the operations of the TNCs.[139] International law relating to competence to make law for governing private foreign enterprises and their activities contain both substantive grants of competence and limitations upon the competence so granted. The substantive grants of competence to both the host and home country to prescribe policy with respect to TNC's are contained in the familiar principles of jurisdiction.[140]

A. The subjects of international law

Although only states and other international legal persons can be the subject of international law,[141] it is also recognized that transnational corporations have the requisite economic power and resources to act as effective instruments of development in both developed and developing countries.[142] There is also the view that because the business transactions TNCs enter into with the government or government corporations of host countries may provide for the application of international law or the general principle of laws recognized by civilized nations and for direct recourse by the TNC

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[138]U. N. Doc. ST/ESA/142, *supra* note 86, at 6 (Guidelines relating to the Use of Low-Tax Countries Regarded as Tax Havens).

[139]D. A. IJALAYE, *Multinational Corporations in Africa,* 171 RECUEIL DES COURS 49 [hereinafter referred to as IJALAYE] The U. N. Charter states that nothing in the present Charter shall authorize the United Nations to intervene in matters which are essentially within the *domestic jurisdiction* of any state. (Article 2, sec. 4).

[140]F. P. FELICIANO, *Legal Problems of Private International Business Enterprises: An Introduction to the International Law of Private Business Enterprises and Economic Development* 236 [hereinafter referred to as FELICIANO] 118 RECUEIL DES COURS 12 (1968) *citing* FRIEDMANN, *The Changing Structure of International Law* (1964).

For the principles of jurisdictions - territoriality, nationality, passive personality, protection and universality - refer to the discussion on jurisdiction, "this Study".

[141]The principal formal contexts in which the question of personality has arisen have been: capacity to make claims in respect of breaches of international law, capacity to make treaties and agreements valid on the international plane, and the enjoyment of privileges and immunities from national jurisdictions. BROWNLIE, *supra* note 49, at 58.

[142]FELICIANO in his article states:

> Reflecting recognition of the increasing frequency with which private business enterprises extend, in varying great role they play in the international flow of capital, technology and goods, scholars have recently begun to cconsider private international business associations as distinct subjects of international law, that is, as bearer of rights and duties under international law. FELICIANO, *supra* note 140 at 286.

involved to international arbitral tribunals, the TNCs have the principal input of legal personality.[143]

The pervasive role attributed to TNCs and the disclosure of certain instances of corporate misconduct have generated grave concern about the negative impact of TNCs on the economic development and political and social affairs at both the national and international levels. This has led to the desire to establish a regime of minimum standards for the treatment of TNCs.[144]

The problems arising from controlling and regulating the operations of TNCs occupy an important place in the general complex of the struggle for the establishment of the desired new international economic order. The question arises whether there is international law on tax evasion and avoidance. The sources of international law are international conventions, international custom, general principles of law recognized by civilized nations.[145] Conventions embodying definite legal obligations of the contracting states -- at least *inter-partes* and if compatible with *jus cogens*--hierarchically are the top layer of "hard international law". Thus, treaties contracted by states on the avoidance of double taxation containing provisions on tax evasion can be considered the "hard law" on international tax evasion and avoidance.[146]

In response to the perceived need to control the conduct of TNCs, a number of international organizations have adopted or are in the process of adopting codes of conduct to be applicable to TNCs.[147]

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[143]Minimum access to legal processes transcending state lines. 118 RECUEIL DES COURS 12.

[144]22 INTERNATIONAL LEGAL MATERIALS 178 (1983).

[145]Article 38 of the Statute of International Court of Justice states that:

1. the Court, whose function is to decide in accordance with international law such disputes as are submitted to it shall apply:
   a. international conventions, whether general or particular, establishing rules expressly recognized by the contesting states;
   b. international custom, as evidence of a general practice accepted as law;
   c. the general principles of law recognized by civilized nations;
   d. subject to the provisions of Article 59, judicial decisions and the teachings of the most higly qualified publicists of the various nations, as subsidiary means for the determination of rules of law . . . *See North Sea Continental Shelf Cases*, I.C.J. REPORTS (1969).

[146]JACKSON & DAVEY, *supra* note 2, at 1052.

Refer to the *North Sea Continental Shelf Cases*, I.C.J. Reports (1969) 3, where the Court said that the provisions of the Convention will prevail in the relations between the Parties and would take precedence over any rules having a more general character, or derived from another source.

Read Chapter Six on Remedies, THIS STUDY.

[147]Following is a list of proposed and existing codes of conduct for TNCs:

Authorities are agreed that these codes do not partake of the nature of treaties. The major codes of conduct relevant to international tax evasion and avoidance are discussed below. The norms on international tax evasion are confined mostly to "soft international law."

A.1 The proposed UN Code of Conduct of TNCs

The UNCTC Draft UN Code of Conduct of TNCs contains provisions on transfer pricing,[148] taxation in general,[149] and disclosure of information,[150] among others. The nature of the code of conduct is envisaged as having any one of the following broad characteristics: (a) an international multilateral convention, signed and ratified by sovereign states, (b) a declaration of principles and rules adopted at an international conference by participating sovereign states, and (c) a

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1. International Chamber of Commerce, Guidelines for International Investment (1972)

2. International Labor Organization, Tripartite Declaration of Principles Concerning Multinational Enterprises and Social Policy (1977)

3. UNCTAD, Proposed Code of Conduct on the Transfer of Technology

4. United Nations Economic and Social Council, International Agreement on Illicit Payments

[148] "In respect to their intra-corporate transactions, transnational corporations should/shall not use pricing policies that are not based on relevant market prices, or, in the absence of such prices, the arm's length principle, which have the effect of modifying the tax base on which their entities are assessed or of evading exchange control measures [or customs valuation regulations] or which [contrary to national laws and regulations] adversely affect economic and social conditions of the countries in which they operate."

[149] "Transnational corporations should/shall not, contrary to the laws and regulations of the countries in which they operate, use their corporate structure and modes of operation, such as the use of intra-corporate pricing which is not based on the arm's length principle. or other means, to modify the tax base on which their entities are assessed."

[150] "Transnational corporations should disclose to the public in the countries in which they operate, by appropriate means of communication, clear, full and comprehensible information on the structure, policies, activities and operations of the transnational corporation as a whole ...

The financial information to be disclosed annually ... should include, *inter alia*, the following:

(1) A Balance Sheet;
(2) An Income Statement, including operating results and sales;
(3) A statement of allocation of net profits or net income;
(4) A statement of the sources and uses of funds;
(5) Significant new long-term capital investment;
(6) Research and development expenditure;
x x x

The non-financial information ... should include, *inter alia*:

(5) Policies applied in respect of transfer-pricing

x x x x x

"The information herein required should as necessary, be in addition to information required by national laws, regulations and administrative practice of the countries in which transnational corporations operate."

resolution of an international organization (similar to a UN General Assembly Resolution).[151]

Although the legal nature of the code was exhaustively discussed by an intergovernmental working group, its final determination was by consensus, deferred to the concluding phase of the negotiations and is still outstanding. Pending the final resolution of this issue, the group adopted the formula of "shall/should" in its formulations to denote the mandatory and non-mandatory provisions respectively.[152] At present there is no noticeable opposition to the preparation of the code from either governments or the TNCs themselves. Apart from the different delegations from governments, expert advisers from the transnationals are taking part in working out the code.[153]

A.2 Set of Multilaterally Agreed Equitable Principles and Rules for the Control of RBP's

Under international co-operation efforts, the treatment of TNC tax evasion practices are regulated indirectly via agreements on Restrictive Business Practices. In 1980, the *Set of Multilaterally Agreed Equitable Principles and Rules for the Control of Restrictive Business Practices* included tax evasion practice among the provisions pertaining to TNCs.

In the *Set of Multilaterally Agreed Equitable Principles and Rules for the Control of Restrictive Business Practices*,[154] TNCs:

> 3. except, when dealing with each other in the context of an economic entity wherein they are under common control, including through ownership, or otherwise not able to act independently of each other, engaged on the market in rival or potentially rival activities, should refrain from practices such as the following when, through formal,

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[151] IJALAYE, *supra* note 139, at 49.

The possibilities open to the Commission are described and analysed in DAVIDOW & CHILES, *The United States and the Issue of the Binding or Voluntary Nature of International Codes of Conduct Regarding Restrictive Business Practices*, 27 AM. J. INT'L. LAW 247 (1978) [hereinafter referred to as DAVIDOW & CHILES].

Developed countries have generally argued that the Codes should establish general equitable principles but should not be legally binding. Developing countries, on the other hand, have called for codes of conduct that would contain specific rules and be legally binding on all parties concerned. *Id.*, at 249.

See also SCHACHTER, *The Twilight Existence of Non-binding International Agreements*, 71 AM. J. OF INT'L LAW 296 (1977).

[152] 22 INTERNATIONAL LEGAL MATERIALS 185 (1987).

[153] IJALAYE, *supra* note 139, at 59.

[154] U.N. DOC. TD/RBP/10 (1980).

> informal, written or unwritten agreements or arrangements, they limit access to markets or otherwise unduly restrain competition, having or being likely to have adverse effects on international trade, particularly that of developing countries, and on the economic development of these countries:
>
> (a) agreements fixing prices, including as to exports and imports;
>
> x x x x x
>
> 4. should refrain from the following acts or behavior in a relevant market when, through an abuse or acquisition and abuse of a dominant position of market power, they limit access to markets or otherwise unduly restrain competition, having or being likely to have adverse effects on international trade, particularly that of developing countries, and on the economic development of these countries:
>
> x x x x x
>
> (b) discriminatory pricing or terms or conditions in the supply or purchase of goods or services, including by means of the use of pricing policies in transactions between affiliated enterprises which overcharge or undercharge for goods or services purchased or supplied as compared with prices for similar or comparable transactions outside the affiliated enterprises; [155]

From the above-mentioned provisions it could be seen that there is an indirect regulation of abusive transfer pricing practices on the part of the TNC. However such regulation is limited in scope as it applies only to instances when a particular TNC is in a "dominant position of market power". It should also be noted that the primary objective of the Set is to ensure that restrictive business practices[156] (RBPs) do not impede or negate the realization of benefits that should arise from the

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[155] Section D, para. 3

There seems to be a contradiction betwen the two sub-paragraphs as the first sub-paragraph expressly exempts companies which are under common control from the prohibition against practices that unduly restrain competition while the second sub-paragraph expressly includes transactions between affiliated enterprises as subject to the prohibition against discriminatory pricing. (The term "prohibition" should be taken to mean that the enterprises are enjoined to refrain from the same). The seeming contradiction can be explained by limiting sub-paragraph no. 4 to instances when enterprises engage in discriminatory pricing through an abuse or acquisition and abuse of a dominant position of market power. "Dominant position of market power" is a situation where an enterprise, either by itself or acting together with a few enterprises, is in a position to control the relevant market for a particular good or service or group of goods or services. *Id.*, at sec. B.

[156] Acts or behaviour of enterprises which, through an abuse or acquisition and abuse of a dominant position of market power, limit access to markets or otherwise unduly restrain competition, having or being likely to have adverse effects on international trade, particularly that of developing countries, and on the economic development of these countries, or which through, formal, informal, written or unwritten agreements or arrangements among enterprises have the same impact. *Id.*

liberalization of trade barriers. Any regulation of transfer pricing practices therefore is purely incidental to the main purpose of regulating RBPs.

Like other codes of conduct in the international level the principles enunciated in the Set are inherently weak. Hans W. Baade, in this regard observed:

> Conventions embodying definite legal obligations of the contracting states are --at least *inter partes* but not *ius cogens*- hierarchically the top layer of "hard" international law. The major codes of conduct for TNCs currently in existence or close to the point of formal adoption do not belong to that category. It is readily apparent that this is due not to any intrinsic defects of the international "legislative" process, but to a deliberate choice of the states concerned in the international norm-creating process,..[157]

It should also be borne in mind that the Set was adopted by the General Assembly as a resolution on December 5, 1980 and Article 10 of the United Nations Charter provides that:

> The General Assembly may discuss any questions or any matters within the scope of the present Charter or relating to the powers and functions of any organs provided for in the present Charter, and except as provided for in Article 12, may make *recommendations* to the Members of the United Nations or to the Security Council or to both on any such questions or matters.(emphasis supplied)

It seems clear therefore that this Set is merely recommendatory and therefore carries a strictly hortatory significance.

A.3 The 1976 OECD Guidelines for MNEs

The 1976 Guidelines for MNEs are subscribed to by member states of the OECD. Because most TNCs are based in those countries, the Guidelines are of considerable importance.[158] The Guidelines provides that:

> Enterprise should--
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> 1. upon request of the taxation authorities of the countries in which they operate provide in accordance with the safeguards and relevant procedures of the national laws of these countries, the information necessary to determine correctly the taxes to be assessed in

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[157]H. BAADE, *The Legal Effects of Codes of Conduct for Multinational Enterprises* in JACKSON & DAVEY, *supra* note 2, at 1051 [hereinafter referred to as BAADE].

[158]JACKSON & DAVEY, *supra* note 2, at 1057]

> connection with their operations, including relevant information concerning their operations in other countries;
>
> 2. refrain from making use of the particular facilities available to them, such as transfer pricing which does not conform to an arm's length standard, for modifying in ways contrary to national laws the tax base on which members of the group are assessed.

The "test case" where the Guidelines was successfully invoked is the *Badger Case*.[159] In this case, *Badger, Inc.*, an American TNC headquartered in Cambridge, Massachusetts ordered the closure of its Belgian subsidiary, Badger Belgium N.V. The subsidiary did not adequately inform its employees of the notice of closure and of the insufficiency of its assets to satisfy the termination payments to which the employees were entitled to according to Belgian law. Although the employees could have drawn upon a fund financed by the employer's contributions to satisfy part of their claims, they instead decided to contact the Trade Union Advisory Committee (TUAC)--with a view to invoking the Guidelines--because they believed that the US parent had manipulated *Badger's* income to induce its bankruptcy. They insisted that as a matter of principle *Badger Inc.* make good the shortfall because to allow otherwise would be to condone a financially robust TNC to rely on the legal technicality of separate incorporation.

Badger Inc. asserts that the obligation of a parent corporation to pay that part of the severance indemnities which its wholly owned subsidiary could not meet did not apply to it because the provision in the Guidelines only applied to the local entity and not to the transnational as a unit. This position brought into question the scope of the Guidelines.[160]

Failing to make headway via conventional means, TUAC introduced the Badger case to the Committee on International Investment and Multinational Enterprise (CIME).[161] CIME's conclusions after a discussion in which twelve countries participated, amounted to an endorsement of the Belgian Government's position.

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[159]*See generally* R. BLANPAIN, *The Badger Case and the OECD Guidelines for Multinational Enterprises* in JACKSON & DAVEY, *supra* note 2, at 51-132.

[160]Specifically the proper interpretation of paragraph 8 of their Introduction.

It took the participation of the Belgian Government to see this case through. The Belgian Prime Minister had to persuade the US Government to cooperate. The US Government, while maintaining a low-profile, merely "encouraged" American TNCs to comply with the Guidelines and took only an "informative role", due to the government's position on the voluntary nature of the Guidelines.

[161]A management group associated with the OECD.

First, to the extent that parent companies actually exercise control over the activities of their subsidiaries, they have a responsibility for the observance of the Guidelines by those subsidiaries. *Second*, multinational and domestic enterprises are subject to the same expectations in respect of their conduct wherever the Guidelines are relevant for both. *Third*, the question of the responsibility of parent companies for certain financial obligations of their subsidiaries "as a matter of good management practice ... consistent with observance of the Guidelines, could arise in special circumstances," particularly in those relating to important changes in the operations of a firm and the cooperation as to the mitigation of resulting adverse effects. In other words, the Guidelines may place moral obligations on a parent company that exceed what is strictly required by law.[162]

The meetings ended in a negotiated settlement favorable to the Badger employees.

B. *An international law on tax evasion?*

These codes and guidelines cannot be considered as having been transformed into customary international law as there is no evidence that they reflect norms or have crystallized into general practice accepted as law.[163]

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[162]BARTON & FISHER, *supra* note 7, at 895.

[163]BAADE, *supra* note 157, states:

Five major conclusions emerge from the present study. *First*, the codes, guidelines, and other declarations concerning the conduct of MNE's that are extant today or at advanced stages of elaboration are not "instant international law" in the sense that they are transformed into customary international law through the mere act of being adopted. *Secondly*, however, these instruments are not inherently incapable of rising to that level through state practice,... *Third*, self-descriptive clauses, declarations, and reservations specifying that compliance with such codes, guidelines, or declarations on the part of MNE's is voluntary and/or not legally enforceable do not shield MNE's from the domestic enforcement of these instruments or from their transformation into treaties or customary international law. *Fourth*, and most importantly, codes, guidelines, and other intergovernmental declarations concerning MNE conduct are declarations of international policy which, by virtue of the anti-inconsistency rule... "legitimize" the transformation of their substantive contents into domestic law at the option of the declarant states. *Fifth*, these instruments also have legal effects as agreed-on data and criteria of international public policy and legal terminology. Their application by domestic courts so as to refuse recognition to transactions in violation of their substantive contents is legitimate, although not as yet required. Furthermore, their provisions are relevant to the interpretation of prior instruments in force between the parties, including treaty clauses of a general or potentially ambiguous nature. JACKSON & DAVEY, *supra* note 2, at 1052-53.

On the other hand, these intergovernmental codes, guidelines, and declarations may be considered as multilateral declarations[164] affecting the rights and obligations of the declarant states. As enunciated in the *Nuclear Tests Cases,* the criteria of obligation are: the intention of the state making the declaration that it should be bound according to its terms and that undertaking be given publicly.[165] It is submitted however that the doctrine enunciated in the *Nuclear Tests Cases* could be limited to the parties involved in the case because under Article 59 of the Statute of the International Court of Justice, the decision of the Court has no binding force except between the parties and in respect of that particular case.

As a general observation, the norms embodied in these Codes can be considered "soft law."[166] Although they seem to take the form of conventions, they have no more scope than simple recommendations. The fact that states would agree to a set of principles and rules tends to alter the purely voluntary nature of the agreement. Once a consensus is reached,[167] the principles can have considerable moral and practical force on the conduct of both state and enterprise. The understanding and expectation in reaching such an agreement is that states will modify their practices to conform to the words of the agreement and any departure from the agreement could subject a state and its enterprise to pressure or persuasion from affected parties, which could be very effective sanctions.[168]

The legal nature of an international code and the types of effectuating mechanisms employed to give effect to it may well vary according to the legal nature of an international consensus existing or obtainable in regard to that subject matter.[169] Because of the difference

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[164]*See The Nuclear Tests Cases*, ICJ Reports (1976), 253 where the International Court held that France was legally bound by publicly giving undertakings, made on behalf of the French Government to cease the conduct of atmospheric nuclear tests.

[165]FITZMAURICE, *The Law and Procedure of the I. C. J. 1951-54*, 33 BRITISH YEARBOOK OF INTERNATIONAL LAW 229-232 (1957).

[166]A term utilized by Rene Jean Dupuy in his article refers to the transitional stage in the development of norms where their content is vague and imprecise or common declarations whose value and judicial effect remain uncertain. R. J. DUPUY, *Declaratory Law and Programmatory Law: From Revolutionary Custom to "Soft Law"*, in DECLARATIONS OF PRINCIPLES 247 (Akkerman, *et.al.* eds. 1977).

[167]As in the case of the Set of Multilaterally Agreed Equitable Principles and Rules for the Control of RBPs.

[168]DAVIDOW & CHILES, *supra* note 151, at 255.

[169]*Id* ., at 249.

in the legal impact of each "soft norm", the following generalizations can be made:[170]

> 1. If some sort of written norm has been consented to by the States involved, the future course of discussion, negotiation, and even agreement will not be the same as they would in the absence of the norm.
>
> 2. Once a matter has become the subject of such a norm, the matter can no longer be asserted to be one within the reserved domain or domestic jurisdiction of the State.
>
> 3. The norm will establish new standards of relevance for the negotiations between the parties.
>
> 4. The norm will establish the legal framework within which the dispute about its application may be resolved.

From the foregoing it can be seen that the trend in international law with respect to the regulation of international tax evasion and avoidance practices of TNC's is one from intra-state regulation to inter-state regulation. This could be attributed partly to the increasingly important role which the TNC plays in the international economy. This should not however be taken to mean that the answer is an unequivocal yes to the query posed earlier in this chapter as to the existence of international law regulating tax avoidance and evasion practices of the TNC. To the extent that there are conventions which, however indirectly, regulate tax evasion and avoidance, then the answer must be in the affirmative. But absent these conventions, are there international customs or generally accepted principles of law on the regulation of international tax evasion or avoidance?

It seems that there are none. International custom to be binding must have two requisites: first, it must be a general practice of states; and second, it must be accepted by states as law. The enactment of legislation can be considered state practice. State practice as an element of customary international law must however be extensive and virtually uniform. There is no evidence to show that there is a general recognition among states that the regulation of tax evasion and avoidance practices of TNCs is obligatory, and that what they are conforming to amounts to a legal obligation, not being motivated by mere courtesy or convenience. States enact legislation to control tax evasion and avoidance practices of the TNCs because it is in their best interest to do so; that they need the additional revenue. The continued presence of tax havens attest to this.

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[170] R.R. BAXTER, *International Law in Her Infinite Variety*, INTERNATIONAL AND COMPARATIVE LAW QUARTERLY 565 (1980).

On the other hand, it cannot be said that taxation is still wholly within the exclusive domain of domestic jurisdiction. The proliferation of codes, guidelines and declarations agreed upon by states may eventually bring about the development of international law on international tax evasion or avoidance. But as of present, international prescriptions on the matter still remain "soft" law. The effects of these soft laws should not however be underestimated, for as stated by Seidel-Hohenveldern:

> rules cannot on the one hand, claim to be law i.e. legal rules, while on the other hand, they would not impose any obligation whatsoever on their addressees. If this were the case, then the only merit in drafting . . . a non-binding Code of Conduct . . . would be to present a laundry list of desiderata.[171]

VII. REMEDIES

Having laid down the assertion of the inherent weakness of international prescriptions regarding tax evasion and avoidance, remedies presently implemented to counter manipulative tax devices of TNCs are primarily domestic-based.

A. *National legislation*

In many states, transfer pricing is circumscribed via domestic laws of both host and home state, usually by the requirement and definition of "arm's length" prices to be used in transactions between related corporations. There is general acceptance of the "arm's length" principle, which is incorporated in the OECD Model Double Taxation Convention, the United Nations Model Double Taxation Convention Between Developed and Developing Countries, and most bilateral treaties for the avoidance of double taxation. According to this principle, the profits attributable to a permanent establishment are those which would be earned by that establishment if it were a wholly independent entity dealing with its head office and as if it were a distinct and separate enterprise operating under conditions and selling

[171] I. SEIDEL-HOHENVELDERN, INTERNATIONAL ECONOMIC "SOFT LAW" 194 (1976). The 1987 Report of the International Law Commission for instance, mentions transfer pricing and restrictive business practices in its discussions on the international liability for inperious consequences arising out of acts not prohibited by international law.

at prices prevailing in the regular market.[172] The use of the "arm's length" standard will be easy where identical goods and services are traded among unrelated entities. But in the absence of comparable prices, the transfer price might be set by reference to the uncontrolled market price method, the resale price method, and the cost plus method.[173] Under the uncontrolled market price method, the transfer price is established by reference to prices paid for comparable products by independent third parties.[174]

The resale price method involves taking the price at which goods are resold by the related purchaser to independent third parties and then subtracting an appropriate mark-up for the reseller. The cost-plus method involves establishing the seller's cost and then adding an appropriate mark-up to that.[175] As regards the three methods, the prevailing view is that the transfer established under the uncontrolled market price method comes closest to the actual price in the market-place.[176] Transfer prices may also be set by reference to the functional

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[172]U. N. Doc. ST/ESA/142, *supra* note 86, at 27. Different states use the arms length principle. In Belgium's Code of Direct Taxes, it is provided that:

> When an enterprise in Belgium has, directly or indirectly, any links of interdependence with an enterprise established abroad, any abnormal or gratuitous advantages which, because of this relationship, it grants to that latter enterprise or to any person or enterprise sharing common interests with it shall be added to its own profits. (Article 24)

In Sweden, the arm's length principle is formalized in section 43(1) of the Municipal Tax Act, to which Sec. 2(1) of its national Income Tax Act refers. It provides that:

> If the income of an enterprise has become lower as a result of conditions being agreed that deviate from what would have been agreed between unrelated enterprises, such income shall be calculated as the sum to which it would have amounted if such conditions had not obtained [subject to several conditions].

France has a more specific provision which states that:

> In assessing income tax due from undertakings which are controlled by or which control enterprises established outside France, the income which is indirectly transferred to the latter, either by increasing or decreasing purchase or sale prices, or by any other means, shall be restored to the trading results shown in the accounts.

> In the United States, the Secretary is given the power to distribute, apportion, or allocate gross income, deductions, credits or allowances between organizations, trades or businesses owned or controlled directly or indirectly by the same interests, if he determines that such distribution, apportionment or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the effect of the income of any such organizations, trades, or businesses. (U. S. INTERNAL REVENUE CODE, sec. 482.)

[173]U. N. Doc. ST/CTC/56, *supra* note 64, at 72-73.

[174]To ensure that the transfer price is fairly representative of the market-place, adjustments may be necessary for such factors as transport costs, minor differences in the products, servicing obligations and differences in quantity.

[175]Under the last two methods, establishing the appropriate mark-up requires an evaluation of the functions performed by the related party selling the product.

[176]U. N. Doc. ST/CTC/56, *supra* note 64, at 151.

activities conducted by the domestic and foreign entities, allowing an "arms-length return" to the input factors for each activity.[177] This is the so called "formulary approach".

Government officials must have a clear view of the causes for transfer pricing so that they will be able to detect the practice. Detection requires detailed examinations of corporation records.[178] Prevention depends not only on detection but also on the formulation of a standard which can effectively deal with this problem.[179]

B. *Tax treaties*

Bilateral tax treaties are also used to combat international tax evasion and avoidance schemes primarily through the exchange of tax information between the contracting parties and through the use of simultaneous examination procedures. Bilateral tax treaties commonly contain an article authorizing the contracting parties to exchange information as necessary to carry out the provisions of the treaties and to curb tax evasion practices.[180] The exchange usually contemplated are either on a routine basis or on the request of a contracting state with reference to a specific taxpayer or transaction.[181] A typical treaty provision would state that the competent authorities shall exchange information as is pertinent to carrying out the provisions of the

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[177]DWORIN, *supra* note 105, at 10.

[178]Situations which warrant investigation will include the following: (a) where the transfer prices adopted by a transnational corporation in a given country differed from those charged for comparable goods and services in transactions between unrelated parties in that country or elsewhere, (b) where the transfer prices adopted do not correspond with the amounts declared for customs purposes, (c) where the information provided by an entity to its home tax authorities about the profits of foreign affiliates does not correspond to the details given to the tax authorities of the countries in which they operate, (d) where a parent company establishes a subsidiary or affiliate in a low tax jurisdiction or where a transnational group which is operating domestically has a resident subsidiary in a low tax jurisdiction, (e) where a company transacts business with other companies in a low tax jurisdiction or in countries which operate tax shelter arrangements, (f) where goods sold abroad are shipped to one destination but invoiced to another, (g) where royalties, discounts or commissions are paid to a foreign affiliate in a low tax-jurisdiction or where payments are made to such an affiliate for trademarks or for partly finished goods. U. N. Doc. ST/ESA/142, *supra* note 86, at 27.

[179]U. N. Doc. ST/CTC/100, *supra* note 91, at 94.

[180]In particular, such agreements might include provisions dealing with: (a) the service of documents in one country relating to the taxes of the other; (b) measures of conservancy; (c) the stage at which proceedings can be started in the other country to recover tax or enforce the tax rules; (d) the documentation necessary; (e) the rules concerning relevant exchanges of information; (f) the priority status, if any, of the other country's tax; (g) the limitation necessarily placed on the obligation to provide assistance; (h) other administrative matters.

[181]U. N. Doc. ST/CTC/56, *supra* note 64, at 27.

convention or preventing fraud or tax evasion and that any information so exchanged shall be treated as secret or confidential. There are however limitations on the obligation for this cannot be construed so as to impose on one of the contracting states the obligation to carry out administrative measures at variance with the laws or the administrative practice of that of the other contracting state, or to supply particulars which are not attainable under the laws or in the normal course of the administration of that or of the other contracting state, or to supply information which would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information the disclosure of which would be contrary to public policy.[182]

As stated before, no country has been wholly successful in attacking the actions of transnationals since each country's power to enforce its laws are limited to its border. The problem is aggravated by the lack of resources to adequately check the financial records of TNCs, the lack of expertise on the part of tax officials in handling tax audits and investigation, and the prohibition against the disclosure of taxpayers' information.[183] Furthermore, a wide range of information may be available to the tax authorities in the country of the parent company which the tax authorities in the country of the subsidiary company will be in no position to acquire.[184] It should always be borne in mind that adjustments of prices for tax purposes by one country might have a direct effect on the tax chargeable by the other country/ies and that very sizeable sums could be involved.[185]

Two observations can be made from a survey of tax treaties: first, the exceptions to the mutual exchange of information are so broad as to negate the obligation to exchange information; and second, such provisions are merely incidental in treaties for the prevention of double taxation which are not primarily entered into to prevent tax evasion or avoidance. These observations may well serve as guideposts for further clarifications on the bounds of treaty stipulations.

C. *International co-operation*

The very inducements for tax minimization strategems would disappear if burdens of corporate taxes and other regulations were

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[182]This provision is found in the OECD Model Treaty on the Prevention of Double Taxation and is embodied on all such tax treaties entered into by the Philippines.

[183]SGATAR, *supra* note 14.

[184]JACKSON & DAVEY, *supra* note 2, at 1121.

[185]U. N. Doc. ST/ESA/142, *supra* note 86, at 29.

equalized or closely harmonized among countries.[186] Harmonization of domestic legislation and protocols to treaties may provide a solution in the long term; but an advance determination of feasible procedures seems to be the most viable solution. The process is essentially a flexible and voluntary procedure under which the taxpayer and competent authorities agree to an apportionment methodology and to reporting obligations. Experience with these agreements may lead to principles of general application that can be incorporated into protocols of domestic legislation.[187]

Under the OECD Model Treaty, the right of each state to tax profits from global trading are determined by the presence of an enterprise within a jurisdiction and the extent to which the firm's profits are connected with that presence. The two gauges of jurisdictional presence are the existence of an enterprise in a contracting state and the existence within one contracting state of a permanent establishment of an enterprise of another contracting state.[188] These measurements are also known as the *arm's length approach*.[189] At present, the application of this principle to global trading is difficult because of the high degree of global integration of modern industries, and because of the outmoded assumptions upon which the arms' length approach is based. Among the outmoded assumptions are the integrity of distinct legal entities and the relevance of national boundaries to capital markets.[190]

The approach prevalently used under the OECD Model Treaty can be called the *realization approach*.[191] This approach is a modification of the arm's length approach in that while the connecting factor in the latter is the jurisdictional presence of the taxed entity, the connecting factor in the realization approach is the end-use of the profit which may eventually cross the physical taxing authority.

Another measurement would be to treat transnational corporations which are themselves global entities, in a global way and view them from the top. The home country would assess the consolidated company and the resulting tax revenue would be allocated

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[186]PLASSCHAERT, *supra* note 100.

[187]PLAMBECK, *supra* note 27.

[188]ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, OECD MODEL DOUBLE TAXATION CONVENTION ON INCOME AND CAPITAL, art. 9, para. 1 (1977).

[189]This should not be confused with the arm's length principle discussed in Chapter 6.1, "this Study".

[190]PLAMBECK, *supra* note 27, at 359.

[191]C. KRAUSE & A. DAM, FEDERAL TAX TREATMENT OF FOREIGN INCOME 46 (1964).

over the various countries concerned.[192] Allocation can be made through the "*mark-to-market*" approach[193] or the "*profit split*" approach[194] which divides trading profits according to an agreed-upon formula.[195]

However, these so-called "*Global Methods*" are criticized as being necessarily arbitrary, tending to disregard market conditions as well as the particular circumstances of the individual enterprises and tending to ignore the management's own allocation of resources thus producing an allocation of profits which may bear no sound relationship to economic facts and inherently running the risk of allocating profits to an entity which is in truth making losses (or

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[192]PLASSCHAERT, *supra* note 100.

[193]This method would first isolate trading profits by valuing a global book's assets, hedges and allocable liabilities. The profits attributable to a particular jurisdiction would be the change in value of the book from the beginning to the end of the trading day in that jurisdiction, on the theory that the economic contribution of traders in that jurisdiction will be reflected in increased or decreased value of the book. This process would be performed by marking the book to market at each passing of the book. The second step would be to subtract from these allocated trading profits any allocable expenses, such as commissions paid to sales people and compensation for management and support.

[194]The first step under this approach is to define the tax base upon which the formula is to be applied. This would be the gains and losses from trades and hedges, less allocable expenses such as interest and commissions to sales people. The second step would be to apply the apportionment formula to this tax base. Most in accordance with economic theory would be to select factors of productions (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. These inputs may include costs of associated enteprises, turnovers, or labor forces or some other similar factors.

[195]*See* R. GORDON, S. GREENBERG & S. ROSEN, GLOBAL TRADING: TAX ISSUES IN INTERCOMPANY PRICING OF SECURITIES TRANSACTIONS *cited* in PLAMBECK, *supra* note 13, at 362. This is broadly how corporate income tax is levied in the United States and it allows different states the capacity to levy tax at different rates without major conflicts or anomalies. This system is often known as unitary taxation. This method requires the TNC to calculate the worldwide payroll, sales, and property related to activities deemed unitary for the purpose of determining the proper ratio to be applied to the resulting income from such activities. California has been the most aggressive in applying the method, although the other states apply the same method or a similar one. 19 INTERNATIONAL LEGAL MATERIALS 726 (MAY 1980).

The attempt to apply unitary taxation internationally as well as domestically has now been abandoned at least for the time being. Unitary taxation, generally applied makes companies pay tax, somewhere, on all their income. This greater effectiveness of international corporation taxation is unwelcome to the companies concerned but good news for the other taxpayers. However most formulas have been biased in favor of the government choosing the formulas. Without international agreement on the basis of apportionment- which will not be easily secured-unitary taxation might create more anomalies and distortions than it removes. IRISH, *supra* note 120, at 206-207.

possibly the contrary).[196] There is also the additional problem of constitutional limitations.[197]

The standardization of concepts, principles and criteria of interpretation in the international area, while a less ambitious approach than the harmonization of regulation, would be highly useful in narrowing the area of potential conflict between TNCs and governments and between governments.[198]

D. *Treaty shopping remedies*

It is for the partner tax administration in relation to each tax treaty to decide whether examples of such abuse are important enough or intolerable enough for measures to be taken to counter them. Normally, the first step to be taken will be the incorporation of provisions in the relevant double taxation agreement. Some protection against abuse is a normal feature of double taxation agreements. The agreement may provide in the first place that relief from the tax of one country should not go to the taxpayer of the other unless that taxpayer is subject to tax in that other country or the taxpayer should not be given relief if the relevant income payment is excessive by reference to open

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[196]JACKSON & DAVEY, *supra* note 2, at 1121.

[197]In *Mobil Oil Corporation v. Commissioner of Taxes of Vermont* (19 INTERNATIONAL LEGAL MATERIALS 754 [MAY 1980]), the U.S. Supreme Court was called upon to consider constitutional limits on a non-domiciliary State's taxation of income received by a domestic corporation in the form of dividends from subsidiaries and affiliates doing business abroad. If a taxpayer corporation dooes business both within and without Vermont, the State taxes only that portion of the net income attributable to it under a three-factor apportionment formula. Taxpayer contended that the same was a violation of the due process clause under the Constitution creating an unconstitutional burden of multiple taxation because the dividends would be taxable in full in New York. The Court held that the Due Process Clause imposes two requirements: a "minimal connection" between the interstate activities and the taxing State and a rational relationship between the income attributed to the State and the intrastate values of the enterprises. The Court held that both requisites were present.

[198]PLASSCHAERT, *supra* note 100.

Plasschaert goes on to say that it is utopian to expect that harmonisation can be achieved on a world-wide basis and that the only prospect is for progress to be achieved in groups of countries that are moving towards economic unions, as in the European Economic Community area. The multilateral OECD sponsored model of double taxation agreements contributes towards reconciling the claims of various countries and in furthering more certainty in international business relations. The steps initiated under UN sponsorship towards standardization of accounting concepts and practices would enhance the transparency and comparability of business accounts.

Rubin, on the other hand, states that a modest proposal for a forum may be the most acceptable and useful. Regular meetings of experts, discussing issues on a non-crisis and regular basis, might result in some agreements, starting with the easier issues on which there is mutuality of interest and on that basis additional and broader proposals might be suggested.RUBIN, *supra* note 22, at 486-487.

market payments of the same circumstance. It may be useful to include more restrictive conditions.[199] Care would need to be exercised to ensure that taxpayers carrying on bonafide activities were not deprived of the benefits which the treaty was intended to provide to them. Arrangements for information may be needed to operate such provisions.[200]

The OECD and the United Nations Model Income Tax Treaties both deal with the question of treaty shopping to a limited degree. Article 10 of the OECD Model provides that the reduced rate of withholding of dividends shall apply if the recipient is the *beneficial owner* of the dividends. The same language applies to the interest and royalty provisions. This means that the reduced withholding rate in the source country is not available when an intermediary, such as an agent or nominee is interposed between the beneficiary and the payor of the dividend unless both the intermediary and the beneficial owner of the dividend are resident in the same country. Countries may make this language more explicit during bilateral negotiations.[201]

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[199]Denying relief for example unless the tax rates in the country of residence of the claimant make it likely that the claimant will be subject to tax at a high enough rate to remove any significant inducement to the parties to use the provision for the construction of abusive arrangements. Or similarly, the relief in the country of source of the income may be restricted so as to ensure that tax is suffered in total at a high enough rate to remove or reduce the inducement to abuse the provisions. Another possible expedient may be to provide that the relief should not go to persons who are controlled by non-residents of the country of residence of the claimant. Another might provide that the relief should be denied to any person if the sole or main purpose of the transactions giving rise to the relevant income profits was to take advantage of the relief or provision may be written into the agreement to exclude from its benefits particular taxpayers such as companies carrying on "offshore" business. U. N. DOC. ST/ESA/142, *supra* note 86, at 37-38.

[200]*Id.*, at 37.

[201]THE BERLIN REPORT, *supra* note 109, at 101. *citing* par. 12 of the New OECD Commentary on Article 10.

In the *Convention Between the Republic of the Philippines and the Republic of Korea for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income* done at Seoul on 21 February, 1984, the provisions read:

However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State, but if the recipient is the beneficial owner of the dividends the tax so charged shall not exceed:

a) 10 *per cent* of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 25 *per cent* of the capital of the company paying the dividends; and

b) 25 *per cent* of the gross amount of the dividends in all other cases. (Article 10, para. 2)

However, such interest may also be taxed in the Contracting State in which it arises, and according to the laws of that State, but if the recipient is the beneficial owner of the interest the tax so charged shall not exceed:

a) 10 *per cent* of the gross amount of the interest if the interest is paid in respect of public issued of bonds, debentures or similar obligation; and

VIII. TNCs IN THE PHILIPPINES

That tax evasion and avoidance practices of TNCs could be analyzed in the concept of development and underdevelopment proves that tax evasion and avoidance are multidimensional concepts. The literature on the correlation between development and the infiltration of TNCs in developing states reinforces a scenario of entangled legal, political and economic constructs. As one legal writer, expounding on the nature of conventions, explained:

> This process (of integrating the various jurisdictions into some international tax law) is an aspect of a broader movement to unify legal systems around the principle of protecting property, particularly private property invested for profit in a foreign country.
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> x x x x x
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> There should be no dispute on this: the main thrust of recent developments in international law is the encouragement and protection of foreign investment. The *foci* of this orientation are the underdeveloped nations, a feat which coincides with the shift of investment direction toward these regions . . . The position of the capital exporting countries on this question is represented by the view that since by the nature of their economy, underdeveloped countries could not generate capital resources for economic development, necessarily, their capital requirements could only be met by relying on foreign capital. And to attract foreign capital, underdeveloped countries should not only eliminate deterrents to foreign investment but provide a wide range of incentives as well. Concommitantly, they have to make adjustments in their legal system to accomodate the demands of foreign capital the entry of which, it is assumed, is not predominantly inspired by a beneficent mission to bring good life to the peoples of underdeveloped countries.[202]

The movement of investment into the less developed countries is thus a matter of historical eventuality. Regulation or deregulation being functions of state policy and incentives being the most prevalently used scheme of attracting investment,

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b) 15 per cent of the gross amount of the interest in all cases. (Article 11, para. 2)

However,such royalties may be taxed in the Contracting State in which they arise, and according to the laws of that State, but if the recipient is the beneficial owner of the royalties the tax so charged shall not exceed 15 *per cent* of the gross amount of the royalties. (Article 12, para. 2)

[202] M. M. MAGALLONA, *The Philippines-United States Tax Convention*, 41 PHIL. L. J. 690-691 (1966).

> (It) is axiomatic that tax incentives are vitally important in decisions to invest . . . *A fortiori*, the minimization of the obstacles to investment will encourage investments that might not otherwise be made. Tax incentives in less developed countries make otherwise compromising investments because they permit a rapid recovery of capital and a higher rate of return. Similarly, they encourage reinvestment by making available to the taxpayer funds that would not otherwise be at his disposal for this purpose. It should be pointed out that tax incentives are available as an indirect stimulant to investment as they publicize and enhance the country's investment climate. They inevitably draw attention to the favorable disposition of the Government toward private investment by advertising the values and calling the attention of the investor to the less developed country as a desirable locale for investment.[203]

Barring these supra-legal truism, there could be achieved a realistic gauge, though indirectly, of how much harm could be generated by tax evasion and avoidance practices of TNCs in the Philippines.

A. *The TNC investment climate in the Philippines*

TNCs are entering the country in ways not quite as visible as in direct equity. Their import cannot now be easily accounted for. The longer they stay, the more they become part of Filipino culture, or perhaps it is the other way around. And while their stay has been profitable for them, the desired growth that the Philippines hopes to obtain from them, remains insubstantial.

In 1984, estimates place the level of tax evasion to some 50 *per cent* of the potential individual income tax revenue and 7 *per cent* of the corporate tax revenue.[204] At the time, these same percentages amounted to some six to eight billion pesos in foregone revenue which could have been used to narrow down the budgetary gap or expand the provision for public services.[205] The Ibon Data Bank in 1988, observed that TNCs accounted for more than half of the 387 billion total gross revenues that the top 1,000 corporations generated for the year.[206] The study continues , "while non-TNCs suffered a combined loss of 4.0 billion pesos",[207] the 354 TNCs among the top 1,000 corporations in 1988 had combined assets worth 489 billion pesos or 56.29 *per cent* more than non-TNCs. In 1990, total foreign investments registered 4.7 billion pesos, more than twice the combined foreign investments recorded in the last

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[203]INSTITUTE ON U.S. TAXATION OF FOREIGN INCOME, PRACTICAL PROBLEMS IN TAXATION OF FOREIGN OPERATIONS 123 (1965).

[204]SGATAR, *supra* note 14.

[205]*Id.*

[206]IBON DATA BANK, DIRECTORY OF TNCS IN THE PHILIPPINES 26 (1988).

[207]*Id.*

five years of the Marcos era.[208] Of the 344 TNCs in the Top 2,000 corporations, total net income after tax reached a record 15.15 billion pesos. This was 3.5 billion more than the 11.5 billion profit recorded in 1988.[209]

As of September 1991, the Securities and Exchange Commission recorded around 1,161 companies owned by foreign stock corporations and 109 non-stock corporations operating in the Philippines.[210] Partnerships with foreign equity numbered about 1,437 during the said period.

B. *The problem of transfer pricing in the Philippines*

The Philippines has been and is confronted with a respectable number of tax evading transfer pricing activities but many of which have passed unnoticed and unrectified. In fact, new devices are conceived and adopted by TNCs before tax examiners realize what is happening.[211]

It is true that the schemes employed by TNCs which constitute transfer pricing are so numerous, and depending on the economies of scale and the nature of the business, are so difficult to realize. It is however pathetic if even the noteworthy and common ones are overlooked and left unattended to. To date the widely known schemes (classified by the kind of income items involved) involving export and import prices,[212] royalties,[213] interest,[214] research and development and administrative overhead expenses,[215] and fees for personal services[216] are hardly even monitored.

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[208]SECURITIES AND EXCHANGE COMMISSION, TOP 2,000 CORPORATIONS (1990) 183.

[209]*Id.*

[210]SECURITIES AND EXCHANGE COMMISSION, *Monthly Paid-in Equity Investments Report for September 1991 to November 15, 1991*, 14 ANNUAL REPORT 11.

[211]F. G. MONTEJO, JR., *Transfer Pricing in International Transactions--Philippine Experience*, 23 THE PHIL. REVENUE J. 6, 35 (1986).

[212]Depressing export prices and inflating import prices. To compensate for the artificial prices, hidden or third party commissions or discounts, are extended. Where the prices are at arm's length, excessive discounts are allowed.

[213]Payments for intangibles are substituted for dividend remittances to maximize after-tax income. The royalty route for repatriation of profits is found effective as royalties are deductible from taxable profits, which is not the case for dividends. Thus, royalty charges are excessive.

[214]The interest charges to Philippine companies are usually over the normal rate on trading credit. Banks also lend at commercial rates supposedly as part of their ordinary business transaction but the loans are really equity investments.

[215]Companies are also organized as a group for research and development purposes but the member companies do not receive reciprocal benefits. For instance, one company in

The most basic form of transfer pricing is definitely not absent in the Philippine setting. Report has it that a local company sold its goods to its foreign parent at cost, with a provision in the sales agreement that the local company would share 50 *per cent* of the net profit from the resale of the same goods. The Philippines had difficulties in determining the net profit of the parent company upon which the taxable income of the local company was to be based.[217]

With respect to royalty payments to foreign parent companies, it has been observed that oftentimes, the royalty charged does not take into account the user's contributions to the development of the technical property used and with respect to the sale of goods. The royalty is included in the price charged.[218]

The Philippine scenario is neither spared of the transfer prices involving remittances of interest payments to parent corporations by domestic enterprises.

A Philippine case involved a local management company that was granted a loan by its parent in the form of machineries and equipment evidenced by promissory notes. The machineries and equipment were re-loaned to a local sister company for its use. The sister company paid interest to the parent. In this case, the Bureau of Internal Revenue examiners and authorities were unable to conclusively resolve whether the loan was an equity investment and whether the interest payments to the parent were disguised dividends.[219]

By way of administrative overhead expenses, almost always, local companies are charged excessive research and development expenses and other office and incidental funds by their parent companies and head offices. The excess expenditures are sometimes hidden as specific debts but with much larger amounts passed on as "capital assets," "purchases," and similar debts. Sometimes the research and

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the group may centralize the expenditures (*i.e.*, reimbursing other members for expenditures) but another company levies the group owners.

[216]Under certain conditions, fees for personal services rendered in the Philippines are exempt from tax. For this reason, some corporations, usually closed and family corporations, include dividends and royalties due their officials and shareholders in the fees paid for personal services rendered by them. Some contracts for services are arranged for and on behalf of a controlled entity which is a shell corporation incapable of performing the services unless it uses personnel and/or property of the controlling unit. Typically the controlled entity is in a tax haven country.

[217]MONTEJO, *supra note* 211.

[218]*Id.*

[219]*Id.*

development expenses are charged without giving credit for the royalties paid.[220]

Aside from the implementation of and internal revenue policies incorporated in tax treaties, the Bureau of Internal Revenue has continuously adopted the "traditional" method of meeting the issue of tax evasion and avoidance practices of TNCs by entering into compromise agreements.[221] This seems to be the prevalent mode of regulation implemented by Philippine authorities. Despite the recognition of the harmful effects of tax evasion,[222] no law, legislated nor administratively imposed, exists as part of the Philippine tax structure which intends to curtail the problem of tax evasion and avoidance.

C. *The legal framework*

The National Internal Revenue Code does not explicitly define tax evasion and avoidance. Penalties are however provided for tax fraud and specific tax violations.[223] By large, tax evasion and avoidance is not regulated actively by the government. At present there is still lacking a comprehensive device which could at least monitor tax manipulation schemes by the TNC.[224]

The 1987 Constitution has only a general statement as to foreign investments. Article XII, section 10 provides:

> The Congress shall, upon recommendation of the economic and planning agency, when the national interest dictates, reserve to citizens of the Philippines or to corporations or associations at least sixty per

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[220]*Id.*

[221]Interview with Atty. Lucilla Fernando, International Tax Affairs Division, Bureau of Internal Revenue, BIR Main Building, Quezon City, January 27, 1992. "There are no BIR regulations on transfer pricing."

[222]B. DIOKNO, *Harmful Effects Of Tax Evasion, Avoidance Cited,* MANILA CHRONICLE March 5, 1992, at 11, col. 1.

[223]NIRC, secs. 247-281. Taxation of Foreign Corporations is regulated in NIRC, Title II.

[224]Interview conducted with legal and administrative officers of the BIR revealed that as of January 1992, the Bureau is still at the formulation stage in its present program of coming up with feasible guidelines to curb tax evasion. A similar interview conducted with legal offficers of the Securities and Exchange Commission shows that as of January 1992, there has been no case brought before the Commission relating to the prosecution of violations by foreign corporations of the Philippine Internal Revenue Code. The same observation was made by the legal officers of the Bureau of Internal Revenue. Interview with Atty. Lucilla Fernando, Legal Officer,International Tax Affairs Division (BIR), Quezon City, January 13, 1992; Interview with Atty. Arturo Lam, Investments and Research Department (SEC), San Juan, Metro Manila, January 9, 1992.

centum of whose capital is owned by such citizens, or such higher percentage as Congress may prescribe, certain areas of investments.

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The State shall regulate and exercise authority over foreign investments within its national jurisdiction and in accordance with its national goals and priorities.

The above cited provision is a reiteration of the constitutional principles found in previous Philippine constitutions. Under the 1973 Constitution, the modes of regulation that were implemented proved unsatisfactory in regulating tax evasion practices of TNCs. Commissioner Ancheta in the 1982 ASEAN Confab Meeting of the Working Group on Tax Matters, reported that the regulative measures under the Old Internal Revenue Code were:

1. Allocation of income and deductions,[225]

2. Classification of income from sources within and without the Philippines,[226]

3. Gross system of taxation for airlines,[227]

4. Imposition of Branch Profit Remittance Tax,[228] and

5. Clearance from tax authorities for dollar remittances.[229]

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[225]NIRC (1984), section 44 authorized allocation of income and deductions of controlled corporations if the Commissioner of Internal Revenue determines that such distribution, apportionment, or allocation was necessary to prevent evasion of taxes or to reflect their true incomes.

[226]NIRC (1984), section 37 enumerated income that were considered derived from sources within, sources without and partly from sources within and without the Philippines. Paragraph (e) of said section authorized the Commissioner to make allocations of income from sources partly within and partly without the Philippines. Under this same provision, the Commissioner was likewise authorized to apportion deductions which cannot definitely be allocated to some item or class of gross income.

[227]Foreign international carriers were subjected before to income tax determined under the so-called "Massachussetts formula". Under that system, the Philippine income tax collection from foreign international airline companies was very small. In order that the Philippines would be assured of its rightful share of revenue from international air traffic, the system of taxing foreign international airlines was modified by adopting the gross Philippine billings as a basis of the income tax at a reduced rate.

[228]A 15 *per cent* branch profit remittance tax was imposed under the Code in addition to the regular corporate income tax in order to put in parity for income tax purposes, subsidiaries and branches doing business in the Philippines. This form of tax was intended to deter these types of entities from shifting dividends, interests and royalties as profits and vice versa.

[229]Under this regulative scheme, no remittance of dollars is allowed in the country without clearance from the BIR. For a complete report, *see* Report of the Philippine

Under the present National Internal Revenue Code, the schemes above-mentioned are replicated.[230]

The investment legislation governing TNCs in the Philippines is the **Omnibus Investments Code of 1987.**[231] The Code amends and codifies the laws and decrees on investment, as well as on agricultural and export incentives in the Philippines.[232]

Under the Omnibus Investments Code of 1987, the Board of Investments[233] is responsible for the regulation and promotion of investments in the Philippines.[234] In so doing, the Board is empowered to cancel the registration or suspend the enjoyment of incentive benefits of any registered enterprise "after due notice"[235] on grounds laid down in the Code.[236] While under the previous laws, "notice and hearing" were required before the cancellation of registration or of the suspension of benefits granted to an enterprise, in the present Code, it is no longer necessary to determine whether the firm had violated provisions of the investment code.

The Board may likewise suspend the nationality requirement provided for in the Code[237] in case of ASEAN projects or investments by ASEAN nationals in preferred projects.[238] Philippine companies which

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Commissioner to the ASEAN Confab Meeting of the Working Group on Tax Matters, Denpasar, Bali, Indonesia, December 6-8, 1982.

[230]Allocation of income and deductions is provided in section 43; Classification of sources within and without the Philippines is provided in section 36; Rules on Taxation of Airlines as well as Imposition of branch profit remittance tax are provided in section 25.

The principle applied by the Philippines with respect to taxing foreign income has consistently been the source principle. *See* R. MEDALLA, *The Income Tax Treaty Between the Philippines and the United States: Its Impact on U. S. Corporations Deriving Income from Philippine Sources, and Its Effect on Philippine Investment Policies and Tax Revenues*, 58 P.L.J. 305 (1983).

[231]EXEC. ORDER NO. 226 (1987).

[232]Consolidated into this Code are REP. ACT NO. 5186 (1967), as amended, the Investment Incentives Act; REP. ACT NO. 6135 (1970), as amended, the Export Incentives Act; PRES. DECREE NO. 1159 (1977), as amended, the Investment Incentives Decree; REP. ACT NO. 5455 (1968), as amended, the Foreign Business Regulations Act; and PRES. DECREE NO. 1789 (1981), The Omnibus Investments Code of 1981.

[233]Composed of the Secretary of Trade and Industry as Chairman, three Undersecretaries of Trade and Industry, three representatives from other government agencies and the private sector.

[234]EXEC. ORDER NO. 226 (1987), art. 7.

[235]EXEC. ORDER NO. 226 (1987), art. 7(8).

[236]For (a) failure to maintain qualifications for registration, or (b) violation of provisions of the Code.

[237]Book I, Chapter III defines registration requirements of enterprises.

[238]EXEC. ORDER NO. 226 (1987), art. 7(13). "*Preferred areas of investments*" shall mean the economic activites that the Board shall have declared as such in accordance with

had been originally capitalized under the Philippine Repatriations Law of 1956 may also accept more than 30 *per cent* foreign equity investment with BOI approval, as well as permit foreign investors to own up to 100 *per cent* equity in preferred amd non-pioneer industries[239] included in the Investments Priorities Plan.[240]

Foreign investments may be with or without incentives.[241] TNCs which establish regional or area headquarters in the Philippines are granted the following incentives for expatriates: multiple entry visa,[242] withholding tax of 15 *per cent*,[243] tax and duty free importation,[244] and travel tax exemption.[245]

Incentives to the regional headquarters of the transnationals in the Philippines are exemption from income tax,[246] from contractor's tax,[247] from all kinds of local licenses, fees, dues,[248] tax and duty free importation of training materials and importation of motor vehicles,[249] and exemption from registration requirements.[250] For TNCs establishing regional warehouses to supply spare parts or manufactures, components and raw materials to the Asia-Pacific Region and other foreign markets, incentives are granted in the form of exemption from customs duty, internal revenue tax, export tax and local taxes for qualified good,[251] from payment of applicable duties and taxes on qualified goods,[252] and exemption from the maximum storage period.[253]

Amidst all the above-cited laws and incentives, the regulation of tax evasion practices of TNCs remains to be administrative, founded on treaties, agreements and protocols entered into by the Philippines

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art. 28 which shall be either non-pioneer or pioneer. EXEC. ORDER NO. 226 (1987), art. 16.

[239]EXEC. ORDER NO. 226 (1987), art. 17 defines "pioneer enterprise", and art. 18, "non-pioneer enterprise."

[240]EXEC. ORDER NO. 226 (1987), art. 27; criteria in art. 28.

[241]Book II pertains to foreign investments without incentives; Book III provides for incentives to TNCs.

[242]EXEC. ORDER NO. 226 (1987), art. 59.

[243]EXEC. ORDER NO. 226 (1987), art. 60.

[244]EXEC. ORDER NO. 226 (1987), art. 61.

[245]EXEC. ORDER NO. 226 (1987), art. 62.

[246]EXEC. ORDER NO. 226 (1987), art. 63, if the headquarters do not earn or derive income from the Philippines and which act as supervisory, communications and coordinating center for their affiliates, subsidiaries, or branches in the Asia-Pacific Region.

[247]EXEC. ORDER NO. 226 (1987), art. 64.

[248]EXEC. ORDER NO. 226 (1987), art. 65.

[249]EXEC. ORDER NO. 226 (1987), art. 66.

[250]EXEC. ORDER NO. 226 (1987), art. 67.

[251]EXEC. ORDER NO. 226 (1987), art. 69(a).

[252]EXEC. ORDER NO. 226 (1987), art. 69(b).

[253]EXEC. ORDER NO. 226 (1987), art. 70.

with other States.[254] In general, these treaties follow the 1976 OECD Model Double Taxation Convention on Income and Capital.

As aforestated, however, these agreements are double-faced, in that while the benefits are presumed to redound to both contracting states, the meat of regulation inevitably depends on each state. Under this scenario, and truthfully reflected in Philippine experience, the problem of regulation would inevitably depend on the efficiency of the tax machinery of the state. Amidst increasing influx of foreign investments and heaping internal economic problems, Philippine taxing authorities are continuously being rendered helpless. And despite numerous tax schemes, losses in revenue due to manipulative tax practices still pertain.

D. *Review of Philippine tax regulation measures*

The prevalent mode of regulating tax manipulations by TNCs in the Philippines is undertaken via administrative entities like the Securities and Exchange Commission, the Board of Investments, the Central Bank and the Bureau of Internal Revenue. As aforestated, the measures are laid down by treaties or agreements entered into by the Philippines with other States. In all these agreements, the regulation schemes are patterned after the 1976 OECD Model Double Taxation Convention on Income and Capital.

In 1991, the Philippine Legislature enacted the Foreign Investments Act.[255] Strangely enough, the said Act does not contain a particular regulative measure on tax evasion practices of TNCs, signifying the inevitable conclusion that the regulation of tax scheme manipulations does not impinge on the State's capacity to prescribe unilateral arrangements but on mutual cooperation with other states.

At present, the administrative agencies that directly implement regulative measures depend largely on the documents presented by TNCs. The SEC for its part requires that TNCs submit financial statements annually.[256] This same requirement is enforced by

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[254]As of December 1991, the Philippines has entered into tax treaties with the following countries: Denmark, Singapore, Canada, France, United Kingdom, Pakistan, Australia, Japan, Belgium, New Zealand, Finland, Indonesia, United States of America, Austria, Thailand, Germany, Malaysia, Korea, Sweden, the People's Republic of China, Mexico and Italy.

[255]REP. ACT NO. 7042 (1991).

[256]Santos observed that instead of regulation, investments are in reality protected in all levels of law. The four sources of protection for foreign investments are: treaties, organic laws, legislation and international arbitration rules. *See* G. SANTOS, JR., *Protection of Foreign Investments Under International Law*, 58 PHIL. L.J. 293 (1983).

the Bureau of Internal Revenue and the Board of Investments. Whatever benefit this scheme could provide is offset by the fact that at present there has yet to be a case or an administrative proceeding that delves with tax manipulation schemes of TNCs. Even the exchange of information scheme has not facilitated the exaction of penalties that are prescribed by the National Internal Revenue Code. No state with whom the Philippines has regulative ties has so far reported a particular tax anomaly.

E. *The "development" dilemma*

The inability of current regulations to curb the problem of tax evasion as practiced by TNCs is founded not perhaps on the built-in defect of the regulative measure but on the notion of helplessness that states entertain in the face of the capacity of TNCs to counter even the most restrictive regulation. For states, foreign investment often seems both a real and psychological infringement on sovereignty.[257] At the same time, foreign investment is often seen as a way of bringing technology and employment

> Nations thus have a variety of laws dealing with foreign investment. Some seek to attract it, as through tax holidays and special privileges . . . some, in contrast, seek to regulate it. These may control the areas of investment, for example, to keep foreign investment out of sensitive areas like telecommunications, they may control the terms of investment, as though restricting rates at which profits may be expropriated; or they may protect specific local concerns such as that of labor.[258]

This dilemma of attraction or regulation is more blatantly manifested in Third World states like the Philippines.[259] With an external debt crisis, the resurrection of a dwindling economy is often seen as a function of liberal policies that induce the influx of foreign investment. As already stated, the laws currently in force in the Philippines, reflective of the Constitution,[260] define vaguely the state policy on foreign investment. Presumably, this deliberate vagueness is to ensure flexibility in the enactment of regulations.

This requirement is found in the provisions of the CORPORATION CODE (Batas Pambansa Blg. 68).

[257]BARTON & FISHER, *supra note* 7, at 860.

[258]*Id.*

[259]*See Dependence and Dependency In the Global System*, 32 INTERNATIONAL ORGANIZATION (SPECIAL ISSUE) 14 (J. Caparoso, ed. 1978).

[260]CONST. art. 12, sec. 10.

The development dilemma therefore has a two-pronged effect on Philippine tax regulations: one, flexibility in policy formulation in order that certain other factors could be considered in the regulation or liberalization, and two, utter disregard of factors affecting the entire economy if only to pursue the flexible formulations.[261]

IX. RECOMMENDATIONS

A. *The improbability of regulation in the international level*

As stated in the outset, a recommendation for solving the problem of tax evasion in the international level has to contend with overlapping and underlapping jurisdictions. Also to be considered is the realization that the present measures implemented are meant to curtail the problem of double taxation principally with the regulation of tax evasion and avoidance being merely incidental. More so, the present modes of regulation are enforced by states with the constant constraint that the eventual result would be an incursion into the jurisdiction of other states. Hence, the general attitude is one of minimalistic regulation.[262] With these caveat, any solution should be weighed vis-a-vis the relative legal economic and political bargaining stances which states take, passively or otherwise in the present state of global

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[261]THE FOREIGN INVESTMENTS ACT OF 1991 (REP. ACT NO. 7042, *inter alia* reads as follows:

Sec. 2. *Declaration of Policy*.-It is the policy of the State to attract, promote and welcome productive investments from foreign individuals, partnerships, corporations, and governments, including their political subdivisions, in activities which significantly contribute to national industrialization and socioeconomic development to the extent that foreign investment is allowed in such activity by the Constitution and relevant laws. Foreign investments shall be encouraged in enterprises that significantly expand livelihood and employment opportunities for Filipinos; enhance economic value of farm products; promote the welfare of Filipino consumers; expand the scope, quality and volume of exports and their access to foreign markets; and/or transfer relevant technologies in agriculture, industry and support services. Foreign investments shall be welcome as a supplement to Filipino capital and technology in those enterprises serving mainly the domestic market.

As a general rule, there are no restrictions on extent of foreign ownership of export enterprises. In domestic market ownership, foreigners can invest as much as as one hundred *per cent* (100%) equity except in areas included in the negative list. Foreign owned firms catering mainly to the domestic market shall be encouraged to undertake measures that will gradually increase Filipino participation in their businesses by taking in Filipino partners, electing Filipinos to the board of directing, implementing transfer of technology to Filipinos, generating more employment for the economy and enhancing skills of Filipino workers.

[262]U. N. DEPARTMENT OF INTERNATIONAL ECONOMIC AND SOCIAL AFFAIRS, UNITED NATIONS MODEL DOUBLE TAXATION CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES 244 (1980).

trading. One legal writer noted that possible solutions formulated with the caveat in consideration should include:

> the establishment of a forum for discussion of issues both private and governmental interests; a data gathering service; expansion of efforts to harmonize national policies on such matters as taxation, restrictive business practices, and perhaps "extraterritorial" application of securities regulations or export controls; and some sort of register of MNEs (or TNCs), Investments Codes based perhaps on the provisions contained in the abortive Charter of the International Trade Organization, or the proposals of the OECD, or the suggestions of the U.S. Chamber of Commerce.[263]

This is not to say that principles emerging from guidelines formulated by such a forum will not crystallize into norms of customary international law. Even now, such principles are already influencing the development of national legislation. In the future, international law on tax evasion and avoidance may come from general practice of states accepted as law or from general principles of law recognized by civilized states. However, at present, the burden of regulating international tax evasion and avoidance lies completely on each individual state.

B. *A prescribed solution for the Philippines*

Recommending a policy formulation to curb the problems of international tax evasion needs a consideration of the vantage point wherein the Philippines situates herself, or is situated, in the global trading economy. Like any Third World state, the Philippines is beset with inefficient substantive and procedural rules to regulate TNC transactions, if effficiency should be equated with results. The present substantive rules found in treaties and agreements as well as internal revenue regulations have failed to ease the problem of tax manipulation. Reliance on procedural solutions on the other hand is self-defeating in the face of a bureaucracy that lacks the speed and dispatch. Amidst these constraints, there is constantly an underlying fear for any policymaker that behooves him to categorically state the proverbial "*eureka!*" This study treads on such fear. To be considered foremost is the constitutional provision that mandates that the rule of taxation shall be "uniform and equitable".[264]

The principle of uniformity impinges on the manner of how the subjects of taxation are classified. Note is to be taken of the *Mobil Oil*

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[263]RUBIN, *supra* note 22, at 487.
[264]CONST. art. 6, sec. 28.

case[265] where the constitutionality of a Vermont State law was attacked. In a similar manner, a law passed to curtail income of TNCs in the Philippines could be subjected to queries considering the almost passive attitude of the Government toward TNC tax evasion. Any legislation therefore should be founded on the rationale behind the shift in regulative orientation. And this rationale should be one that is based on data of the concrete effects of tax evasion on the economy. And this data on the other hand is one that is founded on efficient monitoring schemes.

In 1982, the Philippines as a member of the Study Group of Tax Administration and Research (SGATAR),[266] has submitted proposals for effective regulations of transfer pricing and other tax evasion and avoidance schemes. If implemented, these proposals could serve as the initial stage of the process of regulating tax evasion practices of TNCs. The proposals consist of schemes geared to:[267]

> (a) strengthen and make full use of exchange of information among its members, by agreeing on what information should be exchanged on routine and on request basis; to include in the information to be exchanged actual cases on transfer pricing on industry wide basis, including new or apparent patterns of techniques used, studies and analyzes undertaken, and possibly detailed information on MNCs, their structures, fields of operations, investments, sources of funds, expenditures for R&D, price policies within the group, etc.; to consider the exchange of information as authorizing member countries to set up an industry-wide exchange of information similar to the exchange program entered into by Australia and the United States on petroleum and aluminum industries;
>
> (b) develop formulas and techniques for evaluating arm's length prices on particular items such as on sale of goods, rents and royalties, fees for personal services, etc.;
>
> (c) store information on MNC's internal management policy audit techniques, agreements among their groups, etc., and publish manuals thereon;
>
> (d) conduct simultaneous audit programmes on a particular MNC at the same time by each country and to exchange the information derived therefrom; to conduct specific audits for a member country upon

[265] U.S. 425 (1980). 100 S. Ct. 1233, 63 L.ed. 2d 510 (1980). *See* discussion of the case, this study.

[266] The members of SGATAR are Australia, Indonesia, Japan, Korea, Malaysia, the Philippines, Singapore, Thailand and New Zealand.

[267] *Discussions and Solutions in the Recent Developments and Problems in Dealing with the Taxation of Multinationals*, in MONTEJO, *supra* note 211, at 20.

request; and to set up special audit task forces to look into the activites of selected MNCs;

(e) develop industry expertise and specialists in the investigation of MNCs in every tax office of member countries, and provide for training courses for this purpose;

(f) study the feasibility of establishing a permanent institution where MNC related tax problems may be submitted for resolution;

(g) utilize research centers, including SGATAR, to help member countries combat tax evasion thru transfer pricing; and

(h) encourage constant consultations and periodic meetings among tax administrators of the Group.

Submitting that these proposals are steps which ought to be taken by the Philippines as a member-state, it would be wise for the Philippines to not only adopt these proposals as goals for the SGATAR member countries but instead, materialize these goals for itself. Concrete efforts should be made at updating the National Internal Revenue Code and at formulating standard accounting requirements in order that information could be obtained from which could be derived estimate of losses that are incurred because of manipulative tax devices.

X. CONCLUSION

Asserting the necessity of controlling tax evasion practices of TNCs in the international level stresses two basic presuppositions: that tax evasion practices of TNCs impinge on the jurisdictional competence of States and that the international community recognizes the damage that international tax evasion brings. This study has laid down the parameters of tax evasion practices of TNCs. It has been shown that the problem could not be totally contained within the capacity of individual states. Indeed, states are not totally helpless in controlling tax evasion and avoidance practices within their jurisdiction. The manifold remedies available to them, some already enacted as national legislation, confirm this. But the lot of each individual state would improve if assistance from other states were sought and given. Evidently, the best possible ground for a solution lies in interstate co-operation.

Albeit the increasing recognition that tax evasion practices of TNCs can be curbed in the international level, the international guidelines formulated by States to curtail the problem are considered as mere hortatory prescriptions termed in international law literature as "soft law". At present, the international guidelines on tax evasion and avoidance are in a limbo between "non-law" and "hard law". Only time will tell to which end of the spectrum they will gravitate. Suffice it to say, such guidelines have definitely affected the practice of states.

To what extent international guidelines have affected state practice is beyond the scope of this Study but the modern trend in fiscal administration was shown as emphasizing the individual character of regulation. Amidst this development, the regulatory initiative is reverted to the individual state, the fact being, that taxation is and would remain a sovereign prerogative. The Study has surveyed the regulative measures implemented by some States but there is lacking the ideal method that would encompass all problems that are inextricably linked with tax evasion practices of TNCs, considering the non-uniform bases of jurisdiction states adherence to. In the ultimate analysis, there is no more efficient countermeasure against tax manipulative devices, international or otherwise, than that founded on efficient state tax administration and inter-state co-operation.

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