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LOCATION SAVINGS AND SEGMENTED FACTOR INPUT MARKETS: IN SEARCH OF A TAX TREATY SOLUTION

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INTRODUCTION

This article is about a fairly discrete issue of topical importance demanding immediate attention, but is also about a much more open-ended problem that will likely take many years to resolve. The discrete issue is: What is the appropriate way to handle so-called "location savings" under arm's length transfer pricing? Specifically, when an affiliate realizes cost savings specific to its local market, to what extent should its compensation under an arm's length standard reflect such savings? Should the affiliate earn some premium to reflect the cost savings it is contributing to the overall enterprise? The longer-range problem relates to how international double taxation conventions will have to evolve in order to deal with the pressures of globalization, particularly regarding both the right and ability of countries to impose source-based tax. Double taxation conventions will likely have to evolve to also deal with pressures on residence-based taxation, as reflected, for example, in the fluidity of corporate residence. But, this specific issue is beyond the scope of this article.

In isolation, these issues have been widely discussed. The problem of location savings has recently been addressed by the Organisation for Economic Co-operation and Development (OECD) under Base Erosion and Profit Sharing (BEPS) action item 8.[1] Discussions of the pressures of globalization and the international community's increasingly outmoded body of international tax rules—including those embodied in the double taxation conventions and the essential source-residency dichotomy on which the treaties are premised—are fairly ubiquitous. This article, however, is innovative in its attempt to connect these two issues. To see the nature of the connection, and at the risk of simplification, this article would broadly like to suggest that the combined forces of globalization and technological innovation have presented at least three sorts of pressures on the international tax system and the basic source-residence paradigm.

The first pressure involves the problem of intangibles. As has been oft noted, more and more economic value over time has

1. See ORG. FOR ECON, CO-OPERATION & DEV. [OECD], GUIDANCE ON TRANSFER PRICING ASPECTS OF INTANGIBLES, ACTION 8: DELIVERABLE 12–14 (2014) [hereinafter ACTION 8 DELIVERABLE] (adding paras. 1.80–1.84 to the OECD Transfer Pricing Guidelines).

come to be reflected in intangible assets.[2] This presents grave problems for the historic approach to international taxation, which depends crucially in part on the ability to demarcate income properly taxable on a source or territorial theory. Intangibles, by definition, have no physicality and thus present an immediate conundrum regarding the source of income they produce.[3]

The second pressure concerns remote access to markets. This is also a feature of the combined forces of globalization and technology. Globalization makes remote markets relevant. Technology allows one to derive economic value from such markets without being physically present, by targeting a market for sales through the use of the Internet or by delivering skilled services remotely. As with intangibles, this force has eroded part of what constituted the historic source tax base—the taxation of foreign enterprises tapping a local market, based on some local presence.

The third pressure presented is location savings. To be sure, some may resist the juxtaposition of location savings with the issues of intangibles and remote access to markets. The question of location savings certainly has not historically demanded the same degree of attention from either policymakers or scholars. If one pauses for a moment, however, it is fairly evident that the whole phenomenon of location savings is a key driver of globalization on the production side (that is, in jurisdictions where goods are made as opposed to consumed). At present, location savings arise because markets are only partially integrated. Since globalization is an ongoing, dynamic process, it is possible to achieve savings (and ultimately profits) by relying on factor inputs that are provided by relatively inexpensive markets. If globalization were to reach some end state, then we would expect the opportunity for such savings and profits to be nonexistent. In that end state, such profits would have dissipated through arbitrage across factor input markets until such markets were fully integrated. We are not at that end state and likely will not

2. J. Clifton Fleming Jr., Robert J. Peroni, & Stephen E. Shay, *The David R. Tillinghast Lecture "What's Source Got To Do With It?" Source Rules and U.S. International Taxation*, 56 TAX L. REV. 81, 84 (2002).

3. There is no immediate consensus on the precise definition of "intangibles" for purposes of tax law. For the basic approach under U.S. law (which includes both an extensive list of exemplars, as well as a catchall for items similar to those in the enumerated list), see Treas. Reg. § 1.482-4(b).

be for many years. In the meantime, profits will arise from cost savings through selective location of factor inputs. How does the existing tax framework measure up with respect to this problem—the problem of location savings? This too presents a grave challenge for source taxation.

Although the OECD's basic stance in its BEPS action item 8 deliverable is that location savings generally do not present an appropriate occasion for source taxation, this is likely to lead to non-taxation of profits derived from location savings.[4] A brief sketch of an argument for this proposition runs as follows. First, consider the basic OECD stance. Suppose the nature of the location savings is from low-cost labor inputs, which generate an economic rent—a "labor rent."[5] According to the OECD view, labor rents will either be competed away in product markets (that is, the savings will be passed on to consumers) or, pending dissipation, will be taxed to the party that would have bargained to retain the profits at arm's length.[6] Assuming the affiliate that offers the low-cost labor inputs functions in a competitive market where unrelated parties also offer such inputs, one would expect that a firm offering low-cost labor inputs would not be able to bargain to retain the profit at arm's length.[7] Other actors would undersell, ultimately competing away the rent as between the factor input suppliers and shifting it to the factor-input purchaser. Then, according to the OECD view, the affiliate providing the low-cost labor input should simply be compensated at the prevailing (low) local market rate, thereby retaining none of the rent.[8] Any rent, in according to the OECD, would be taxed in the hands of the party properly taxed on the intangibles related to whatever products are produced with the benefit of the low-cost labor inputs.

Importantly, however, this analysis seems incomplete. Of course, one should accept that some cost savings will routinely not be passed on to consumers, at least not right away. To state the obvious, if cost savings were always passed on immediately

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4. Mitchell Kane, *Labour Rents, Arm's Length Transfer Pricing, and Intangibles: Still Searching for a Solution to the BEPS,* 6 BULL. FOR INT'L TAX'N 371 (2015).

5. For elaboration on the concept of a "labor rent," see *id.* at 372.

6. *Id.*

7. The U.S. Treasury regulations reach essentially the same result. *See* Treas. Reg. § 1.482-1(d)(4)(ii)(C).

8. *See* Kane*, supra* note 4, at 372–73.

there would be no incentive for firms to realize location savings in the first place. Therefore, there must generally be some prospect of economic rent—a supernormal profit, pending the time when market demand is fully met by firms that are benefitting from the relevant location savings.[9] Furthermore, to the extent that any non-competed-away rent is attributed to the party entitled to intangible-related returns—as under the OECD transfer pricing analysis—and to the extent the relevant intangibles migrate to low-tax jurisdictions, the rents will face little or no tax at all. Importantly, under the OECD approach, there is no good way to pull the rent back into the tax base by adjustments to transfer pricing of the relevant intangibles because, in the OECD's view, location savings do not constitute an "intangible" for these purposes (as they are not capable of separate ownership).[10]

The odd and troubling situation faced here is that the labor rent will likely be reflected as a return to some intangible, simply because the intangible is likely to pick up residual value not otherwise captured in a transfer pricing analysis of routine items, and not because the rent is actually a return to the intangible. This point is crucial. To be concrete, if the labor rent arises from low-cost labor inputs to make branded goods, any rent from the low-labor cost is not derived from brand value. Indeed, employing low-cost labor may actually degrade brand value for firms. Appropriate adjustments to transfer pricing of the brand will thus not pick up the labor rent, even though the rent will likely be taxed (or not taxed) in the same locale as the return to the brand.

Importantly, there are substantial departures from the OECD approach by key countries that offer location savings. These are evident in the country-specific materials (though not in the general discussion) in the United Nations Practical Manual on Transfer Pricing for Developing Countries ("U.N. Manual"). The most far-reaching approach is that espoused by China.[11] Under

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9. *See* Michael McKee & Michael McDonald, *Location Savings in Competitive Markets*, 9 TAX MGMT. TRANSFER PRICING REP. 700 (2001) (arguing that cost structures will vary across providers in the final market, and market price to consumer will be determined by marginal supplier).

10. *See* ACTION 8 DELIVERABLE, *supra* note 1.

11. *See* U.N. DEP'T OF INT'L ECON. & SOC. AFFAIRS, U.N. PRACTICAL MANUAL ON TRANSFER PRICING FOR DEVELOPING COUNTRIES, at ch. 10, U.N. Doc.

China's approach, an appropriate markup for a local affiliate would be determined by referencing developed-country comparables (on the grounds that comparables are difficult to locate locally). More crucially, however, that markup is applied to both the local cost base and to the difference in cost bases. In the example provided, a local Chinese affiliate has costs of 100, even though comparable services provided in developed countries would involve costs of 150. The local affiliate in this case is entitled to an 8 percent markup (determined by looking at developed-country comparables, as just mentioned) on the 100 base and on the 50 differential. The markup applied to that difference (i.e., .08 * 50 = 4) is the entirety of the profit attributable to "location savings," and it is all allocated to the local subsidiary.[12] Although this is claimed to be consistent with the arm's length standard, it is not clear exactly how this is the case.

A similar issue is present in the country-specific materials with respect to India.[13] India takes the position that resort to local-market comparables will not allocate any of the location savings to the local subsidiary—and that this is in conflict with an arm's length result. The argument is that, at arm's length, no transaction would even occur unless each party enjoyed some benefit from the mutual gains from trade. This would not seem, however, to rebut the basic line of analysis presented in the OECD Transfer Pricing Guidelines and the U.N. Manual. At least under the assumption that there is a thick local labor market, a local company could be presumed to conclude contracts in any case where it can earn the market-clearing price for the market to which it is constrained. This is just another way of putting the bargaining power point mentioned above. If there is sharing of the gains from a trade at arm's length, this means there must be some bargaining power at the level of the local production company. If that is the case, then all authorities seem to agree that part of the profit should be allocated to a local production affiliate under an arm's length standard.[14] Authorities conflict when there is no such bargaining power. The OECD Transfer Pricing Guidelines and U.N. Manual provide for no allocation to the local production subsidiary in such circumstances. India

ST/ESA/347 (2013), http://www.un.org/esa/ffd/documents/UN_Manual_TransferPricing.pdf.

12. For a full description of this example, see *id.* para. 10.3.3.9.

13. *See id.* para. 10.4.7.

14. *See id.* para. 5.3.2.45.

would appear to take a contrary view, but again it is not clear how this should be squared with an arm's length approach.

Thus, all three of these issues—intangibles, remote access to markets, and location savings—seem to pose various challenges to source taxation. To date, both scholarly and policy focus has largely been on the first two issues above.[15] By contrast, the OECD deals with the location savings issue in but a few short paragraphs in the Transfer Pricing Guidelines. These challenges have sometimes been fundamental, leading to draconian calls to abandon, or at least greatly move away from, source-based taxation on the grounds that the very nature of source tax is no longer workable.[16] Alternatively, the challenges have led to calls for incremental reform to existing tax instruments to deal with the problems of intangibles and remote access to markets.[17] In the category of incremental reform, one should include the consideration of expansion of the historic permanent establishment ("PE") concept under Article 5 of the OECD Model Convention[18] to deal with matters such as electronic commerce and remote provision of services and specific measures to match the taxation of intangible profit to the jurisdiction where intangible value has been created.

As stated, this article's particular concern is with the issue of location savings (and associated location rents), but it also contemplates fundamental and narrower, discrete reform. In recent prior work, it has been generally argued that some of the extreme criticisms of source taxation have been overstated.[19] This

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15. *See* Mitchell A. Kane, *A Defense of Source Rules in International Taxation*, 32 YALE J. ON REG. 311, 340–46 (discussing problems with applying source rules to intangible assets); Walter Hellerstein, *Jurisdiction to Tax in the Digital Economy: Permanent and Other Establishments*, 6 BULL. FOR INT'L TAX'N 346 (2014) (discussing problems with the application of jurisdictional rules for taxpayers who access markets remotely through the "digital economy").

16. *See* Alan J. Auerbach, Michael P. Devereux, & Helen Simpson, *Taxing Corporate Income*, *in* DIMENSIONS OF TAX DESIGN: THE MIRRLEES REVIEW 837, 882–88 (Stuart Adam et al. eds., 2010).

17. *See* ORG. FOR ECON. CO-OPERATION & DEV. [OECD], ADDRESSING THE TAX CHALLENGES OF THE DIGITAL ECONOMY, ACTION 1 - 2015 FINAL REPORT para. 210, at 87 (2015) (noting possible revision of the "preparatory and auxiliary" standard under permanent establishment ("PE") definitions to address expansion of the digital economy).

18. MODEL CONVENTION WITH RESPECT TO TAXES ON INCOME AND ON CAPITAL art. 5 (ORG. FOR ECON. CO-OPERATION & DEV. 2014) [hereinafter OECD MODEL CONVENTION].

19. *See supra* note 15.

is not to say, however, that there is not a need to drastically rethink the implementation of source taxation going forward. This leads to the precise nature of the proposals offered in this article.

The first proposal—which will be referred to as the "transfer pricing proposal"—articulates that arm's length transfer pricing in the case of location savings ought to proceed by compensating local affiliates (where savings are realized) by reference to comparables based on the market of the purchaser of the input rather than the seller of the input, as is the case under the OECD analysis. This would have the effect of pushing the taxation of the location rent into the source country. To be clear, this stance should remain, even in instances where there is a competitive local market over the input and an unrelated party likely would not be able to bargain to retain the rent.

The immediate response to this will be that one cannot possibly adopt such an approach because it will simply invite organizational distortion. If there is an additional source-country tax imposed under this proposal, then parties will simply shift to acquiring the input from unrelated parties. That would seemingly run counter to the whole point of the arm's length standard. This concern may be overstated, however, as there may be independent reasons the firm does not want to acquire the input from unrelated parties.[20]

But, it also brings us to the second proposal—what will be referred to as the "source entitlement proposal." It is implicit in the criticism just sketched that if the transfer pricing analysis pushes some of the location rent to the local affiliate, and if that affiliate could not bargain for such rent at arm's length, then there would be greater source-country tax in the related party case than in the unrelated party case. This is true under prevailing norms of source taxation and under existing forms of double taxation conventions, but this is a point of existing positive law, not conceptual necessity. The obvious way to equalize the source tax burden would be to tax the nonresident-related party on the location rent on a source basis. That cannot happen under existing double tax conventions because the party will lack a PE within the meaning of Article 5.[21] This raises the question, however, of why this should necessarily be the case.

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20. *See supra* Part I.A.3.

21. That is, the nonresident party would have neither a "fixed place of business" PE under Article 5.1 nor an "agency" PE under Article 5.5. *See* OECD MODEL CONVENTION, *supra* note 18, art. 5(1), (5).

At present, policymakers approach these problems in a predictable, understandable way. Article 5 can be pushed at the margins to deal with novel situations like e-commerce, but when the procedural context is one of drafting commentary to a model convention or passing domestic law and regulation aiming to be consistent with ratified treaty text, then there are serious constraints on available reform options. Thus, in such a case, everybody tends to take the extent of source tax of the nonresident party as a fixed point (established by Article 5).[22] From there, it is important to think about organizational neutrality under the transfer pricing analysis. Operating an affiliate cannot generate incremental source-country tax over and above what would be collected from an unrelated party performing the same functions. But, from the standpoint of theory, this perspective gets it backward. The extent of source-country tax is the primary concept, not organizational neutrality. In principle, first one needs to know the proper bound of source-country tax given a certain degree of economic activity. Once that issue is settled, we should strive to write rules that do not distinguish between the case where such economic activity is conducted through a related party or by contract with an unrelated one.

To recap, this article advances two proposals: the transfer pricing proposal and the source entitlement proposal. The transfer pricing proposal provides that transfer pricing analysis in the case of location savings and rents should resort to nonlocal comparables. The source entitlement proposal provides that we radically rethink the nature of the source tax entitlement over nonresidents in the case of location savings and rents under double taxation conventions.

The remainder of this article will develop these proposals further. Part I will further develop the normative argument for source-country taxation of location rents. Part II will address various implementation issues, complications, and likely objections. The arguments are general ones and should apply to the full range of location savings and rents. For purposes of emphasis and specificity of exposition, however, the remainder of the article will consider the case of labor savings and labor rents

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22. *See* Sébastien Gonnet, Pim Fris, & Tommaso Coriano, *Location Specific Advantages –Principles*, TRANSFER PRICING INT'L J., June 24, 2011, at 4 (stating that allocation of right to income across entities under transfer pricing analysis implies allocation of right to tax income across countries).

specifically, as this is likely one of the most important sectors where this issue arises.

I. SOURCE BASED TAXATION OF LABOR RENTS: A NORMATIVE ANALYSIS

So far, this article has emphasized two basic points. First, according to the near universal approach to the problem of location rents under a functional transfer pricing analysis, local production subsidiaries in competitive markets will only be compensated based on the prevailing wage rate in the jurisdiction of labor supply, thus allocating none of the labor rent to such subsidiary. Second, this approach presents a substantial opportunity for BEPS, as the rents are likely to be absorbed as residual profits associated with mobile intangibles, rents which cannot adequately be dealt with under existing approaches to the transfer pricing of intangibles.

If the current approach is grounded in basing the search for labor comparables in the jurisdiction of labor supply (often referred to as the "local" labor market), the transfer pricing proposal defended here is for labor comparables (and associated compensation) to be based on the jurisdiction of labor demand.[23]

In the paradigmatic case of outsourcing of labor from a developed to a developing country, the basic result, under the transfer pricing proposal, would be that the developing country subsidiary is compensated as a labor input provider, the same compensation scheme prior to the decision to outsource. This part of the article will evaluate this proposal with respect to three criteria: efficiency consequences, doctrinal implications of existing treaty text under Article 9, and internation distribution.

A. Efficiency Consequences

The discussion of the efficiency consequences of the transfer pricing proposal will focus on three points. First, there is an important issue of tradeoffs to consider. Specifically, although the transfer pricing proposal could be expected to lead to organizational distortions, it is also the case that the transfer pricing proposal would yield certain efficiency gains to the extent it involves

23. The proposal is thus similar to the position defended by China, as described in the U.N. Manual and discussed above. The goal in this part of the article is to offer a normative defense of this result within the bounds of a justifiable understanding of the arm's length principle.

incremental taxation of currently untaxed rents. Second, organizational distortions under the transfer pricing proposal could be removed if we reconsider the basic source entitlement in this context. Third, even if the source entitlement is not revised, any organizational distortion from the transfer pricing proposal may well be diminished by the fact that there are independent advantages to operating through a related party structure.

1. Tradeoffs Between Organizational Neutrality and Non-distortionary Rents Taxes

As already noted, from an efficiency standpoint, the almost certain response to the transfer pricing proposal is that it would invite substantial distortions of organizational form. The standard transfer pricing analysis in a thick local labor market is premised on the idea that a production subsidiary at arm's length would not be able to bargain for any part of the labor rent. Thus, in order to equalize the commonly controlled and arm's length cases, one must not allocate any of the labor rent to the commonly controlled subsidiary. Any alternate approach, under which one attempts to tax part of the labor rent in the jurisdiction of labor supply, would seem to invite taxpayers to contract with unrelated parties instead. That result would fly in the face of the basic commitment to organizational neutrality across commonly controlled enterprises and unrelated enterprises, which is a bedrock principle of the arm's length standard in the first place. Why is this not a disqualifying critique of the transfer pricing proposal? Why would one ever define the relevant market for comparables as anything other than the market where the labor is in fact supplied?

The answer to these questions begins with a reminder that the entire analysis in this article is premised on some degree of segmentation in the international markets for factor inputs. Because of segmentation, we do not even come close to equalization of after-tax wages on an international basis. With the assumption of segmented markets, one can now introduce an important distinction between cases where units of a multinational enterprise are operating within a segment of a segmented market versus where the units are operating across segments.

The former instance presents a strong case to resort to local-market comparables on the grounds of organizational neutrality. Further, while extension of the argument to the case involving intrafirm trade across segments is very tempting (and consistent with the standard analysis adopted under the OECD Transfer Pricing Guidelines and the U.N. Manual), this case actually presents a range of further complications that, to date, have not been adequately analyzed.

In order to illustrate the case of a multinational enterprise operating within a segment, consider the following example. Assume at the outset that a U.S. manufacturing firm produces branded goods that it is selling in Canada through a local Canadian distribution subsidiary. The U.S. firm then moves the manufacturing function inside the Canadian subsidiary but retains the valuable intellectual property in the United States. To complete the example we need two further factual assumptions. First, suppose that the U.S.-Canadian labor market is essentially integrated because barriers to immigration, language acquisition, relocation costs, etc., are sufficiently low, such that any differences in after-tax wages can be expected to dissipate in equilibrium. Second, suppose that the Canadian corporate tax rate is higher than the U.S. rate. With these assumptions, there is a very good reason, when determining the profits of the Canadian subsidiary, to define the market for labor services based on the integrated market of which the United States and Canada are components. For example, consider the likely result if one did not take that approach. The taxpayer would have an incentive to minimize the allocation to the return to labor inputs in Canada, where the tax is higher. It could attempt to do so by basing the Canadian subsidiary's cost-plus markup on a sample of labor inputs that includes a nonintegrated labor market, say Mexico, where the returns to labor are lower. Strictly from a tax perspective, this would give the combined group a competitive advantage over similarly situated parties operating at arm's length. In the arm's length case, an unrelated Canadian manufacturing company would demand the higher return to labor commanded by the Canadian market, thereby driving up the tax burden. This would provide a pure tax reason to bring the firms under common control, thus violating the basic principle of organizational neutrality that supports adoption of the arm's length standard in the first place.

Now, let us consider the case where the U.S. enterprise in fact operates across segments of a nonintegrated market. To be sure, one can construct an entirely parallel fact pattern, which would demonstrate the same prospect of organizational distortion in cases where comparables are based on a sample that includes data from a different market segment. Thus, consider a case in which the U.S. enterprise has moved its manufacturing to Mexico, has migrated its intellectual property to Bermuda, and conducts sales/distribution in the United States and Canada. If we were to assume that Mexico has a relatively low corporate tax rate, then the mirror image of the Canadian case is produced. The integrated firm would have the incentive to benchmark the return to the labor inputs of the Mexican subsidiary by reference to the relatively high-cost labor inputs in Canada. This would shift profit to Mexico and lower the tax burden. By contrast, at arm's length, the U.S. company would likely bargain for a Mexican production counterparty to earn only what the segmented Mexican labor market would bear. This would also result in a tax-motivated reason to favor common corporate control over contractual arrangements between unrelated parties, seemingly once again in violation of the foundational premise of arm's length transfer pricing.

The assumption of segmented markets is crucial to the analysis, however, because it tells us that, at least in the near term, the firm can earn not only normal returns but also economic rents from buying labor in one segment of the market and selling finished products in another. Such rents are not available, of course, so long as the firm is operating within a segment of the market as opposed to across segments. This factor is central to the efficiency analysis because, in such circumstances, it is far from clear that one should view the efficiency costs of organizational distortion in isolation.

Achieving organizational neutrality in these circumstances comes at a very real cost—namely, it implicates the non-taxation of at least a portion of labor rents generated by outsourcing. Such non-taxation of rents is an unequivocally bad outcome from an efficiency standpoint. For a given revenue constraint, the non-taxation of rents implies the unnecessary use of some fiscal instrument with distorting effects (assuming, as is always the case, that at least some such instruments are actually in place).

In short, the efficiency consequences of the case where multinationals operate across segmented markets is importantly incomplete if we look only at the organizational consequences under current law. A more complete analysis would compare the cost of potential distortions to organizational form to the benefits from incremental taxation of rents (and reduction of otherwise distortionary taxes). In general, one confronts an important tension in this context. It is possible to follow the status quo and eliminate organizational distortions, but this likely comes at the cost of undertaxation of the relevant labor rents. Alternatively, one could divert from the status quo and attempt to tax a greater portion of the labor rent, but this would seem to come at the cost of inviting organizational distortion.

This raises the issue of how one could possibly balance these two effects across the range of real world scenarios where they are likely to be implicated. This would be incredibly difficult to say the least. There are, however, two mitigating factors from an efficiency standpoint.

First, the organizational distortion that would seem to arise under the proposed approach is a creature of the combined effect of the rules regarding the commonly controlled scenario and the unrelated party scenario. Yet, the tax rules regarding the unrelated party scenario are themselves contingent and could be revisited. This implicates this article's source entitlement proposal, which is a radical rethinking of the scope of Article 5.

Second, even if such radical change was not made, imposition of tax on a portion of the labor rent would not automatically drive firms to adopt an unrelated party structure, thus yielding all cost (distortion to organizational form) and no benefit (i.e., zero tax on rents because nobody elects the form that bears the extra tax). Such a result is unlikely because we suspect there are further (pretax) rents to be earned strictly from firm integration (particularly where there is exploitation of valuable intellectual property). Those rents would similarly go untaxed in the current regime for much the same reason as with respect to labor rents. This suggests that there may be some cushion to tax labor rents without driving firms out of the preferred organizational form.

2. Rethinking Article 5—the Source Entitlement Proposal

This article has discussed how labor rents present a problem of BEPS under current approaches to arm's length transfer pricing. One should remember though that the very prospect of organizational distortion (in the case where there is an attempt to tax the rent) presumes that taxpayers can also achieve low to zero tax on labor rents in the unrelated party context. That seems almost certain to be the case. To continue with the example of a segmented market, if we imagine the U.S. parent company contracts with an unrelated Mexican counterparty for provision of low-cost labor inputs and is able to bargain for a price reflecting the local conditions in the Mexican labor market, then of course the U.S. company could avail itself of any available intangible migration strategies to keep tax levels on the labor rent low. Efforts to combat such strategies through legal instruments on the transfer pricing of intangibles would be ineffective, and also for the reasons already discussed.

The crucial point to observe is that the taxation of the commonly controlled case and the unrelated party case arise under two completely different sets of doctrine. To assert organizational distortion when one alters one body of doctrine (as proposed in altering the interpretation of the arm's length standard under the transfer pricing proposal in this article) is to ignore the fact that the distortion is a consequence of the simultaneous operation of both bodies of doctrine. Moreover, although there may be reasons grounded in inertia to hold treatment of the unrelated party case constant, there is no good reason as an analytical matter to ignore the possibility of the doctrine in that evolving area as well.

We confront a general problem here: How should one deal with the taxation of labor rents in the case of segmented labor markets and (imperfectly) competitive product markets? That general problem transcends organizational form, precisely because the rent can arise in both the related and unrelated scenario. Figuring out the proper taxation of the labor rents should thus take analytical priority. In other words, it is unambiguously true that from an efficiency standpoint one should impose a tax on the labor rents, if possible, and use such revenues to reduce other distortionary tax instruments. It is then a secondary question of whether one can achieve taxation of the labor rents in an international setting in a way that does not introduce a different type of distortion, namely a distortion to organizational form. Answering that secondary question requires paying attention to the relevant doctrine for each organizational form.

The transfer pricing proposal is a doctrinal response regarding the commonly controlled case. What is the analog in the unrelated party case? Of course, the mere fact that at arm's length the firm that is contracting for labor inputs has market power to bargain for the labor rent does not solve the question about which jurisdiction should be allocated the rent for tax purposes. Rather, it simply means that the jurisdiction of labor supply will not be able to tax the rent in the hands of a local production company under a residence theory of taxation. But, it tells us nothing about whether it should be able to reach the rent in the hands of the foreign firm under a theory of source-based taxation.

To be sure, there is no prospect of reaching labor rents under a source theory with current instantiations of double taxation conventions. Amending the current regime in a way that would allow this is not likely contemplated by anything in the (very expansive) charge under the BEPS project.[24] But, it remains important to pose the question, even if the modifications to the current rules would be viewed as radical. Further, it is fairly straightforward to state what the modified rules would have to look like. Reaching the labor rent in the hands of the purchaser of the labor inputs under a source theory would require two basic doctrinal modifications: one to the PE standard and a second to the determination of profits attributable to a PE.

First, it would be necessary to relax the standard for what constitutes a PE under Article 5.[25] Specifically, the basic change from current law would be that a PE could arise merely in virtue of purchasing activity, where such purchasing activity generates labor rents from labor inputs.[26]

It should also be mentioned that, although the context is a familiar one, this proposal goes quite a bit beyond historical arguments raised by jurisdictions that are prominent hosts to labor outsourcing arrangements. For example, consider the litigation that culminated in the decision before the Indian Supreme Court in *DIT v. Morgan Stanley*.[27] In that case, the Indian Supreme Court considered whether the taxpayer, Morgan Stanley, had a

24. Admittedly, action item 7 in the BEPS Action Plan deals with the "artificial avoidance of PE status." The core of that action item, however, deals with matters such as the use of commissionaire structures to plan around the agency rules in Article 5. The proposal in the text goes much beyond this, as it would implicate PE status in the absence of anything that remotely resembles an agency relationship. It would thus require revisions to Article 5 that would seem to go well beyond what is contemplated by action item 7 (or anything else in the BEPS Action Plan).

25. OECD MODEL CONVENTION, *supra* note 18, art. 5.

26. Recall that these arguments are meant to be general to location savings and rents. Thus, a proper revision to Article 5 would cover the purchase of any factor inputs generating location rents.

27. DIT (Int'l Taxation), Mumbai v. Morgan Stanley & Co., (2007) 8 SCR 52 (India).

PE in India in the form of outsourced back office functions performed by a controlled subsidiary in India.[28] The court concluded that there was neither a fixed place of business PE nor an agency PE.[29] A decision running in the other direction would have likely destabilized the general understanding and interpretation of Article 5, under which the circumstances in which a controlled subsidiary creates a PE are relatively rare.[30] The source entitlement proposal, however, is really addressing something different. It is advocating for a substantive change in which there would be a PE strictly in virtue of certain sorts of purchasing activity (namely those that give to labor rents) from an unrelated party. Though creating numerous complicated issues, the proposal would not destabilize the traditional understanding of when subsidiaries function as PEs. In other words, it does not advocate for also treating the controlled subsidiary as giving rise to a PE in the context of labor rents. In that case, the rent would be taxed in the hands of the controlled subsidiary under the transfer pricing proposal that looks to the jurisdiction of labor demand for appropriate comparables. More specifically, in the case of the controlled subsidiary, that subsidiary should be viewed as purchasing low-cost labor inputs (from its employees) and then providing such labor on to the parent at the higher labor cost associated with the parent's labor market. The spread is thus booked at the controlled subsidiary level. In the unrelated party case, the unrelated corporation would be viewed as purchasing the low-cost labor inputs and passing them on to the foreign counterparty at a relatively low price (i.e., at the price reflecting actual market conditions). The very fact that the foreign counterparty can acquire at this deflated price is the element that would drive the PE determination.

Although this is radical, it is worth considering the fact that the original architects of the PE concept were almost certainly not thinking about this general class of problems. It is by now a stale truism to observe how much the economy has changed since the original formulation of the concepts that underlie the current international tax framework. As international tax lawyers confront this ever-evolving space, they should be mindful

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28. *Id.* at 60–68.
29. *Id.* at 65–66.
30. *See* OECD MODEL CONVENTION, *supra* note 18, art 5.

that the appropriate normative source taxation base should generate the boundaries of the doctrinal PE concept, not vice versa.

What is the appropriate normative base here? It is worth observing that, even under existing norms, if a source country were to nationalize the labor production function or grant a monopoly right to the labor production function to a single private firm, there would be no issue about the right of the source country to tax the labor rent. Under nationalization, it would retain the rent in the first instance, as it could charge prices up to the point that just undercut the prevailing rates in the jurisdiction of labor demand. Under single firm monopoly, the analysis would be that single firms could bargain to retain the labor rents. It can be assumed that no one would find these results objectionable on a normative analysis of the appropriate scope of source taxation because it is understood that, in some sense, the rent is local to the source country. It is geographically tied to it. Now, suppose the source country disbands the monopoly and competing local firms offer the same labor input as before (or perhaps even with superiority and greater costs savings, if competition is beneficial to productivity). It is extremely difficult to articulate any normative argument why the mere fact of local firm competition should erode the normative base for source taxation. That is, of course, an easy result to achieve if it is assumed that one wants organizational neutrality as a paramount concern, but the entirety of the point here is to give priority of analysis to the proper source theory of taxation.

Finally, it is important to mention a more mundane point, which ties the proposal more closely to existing understandings of PE than might have originally been thought. Specifically, if one considers the basic notion of "permanency" embedded in the general concept, it is worth observing that the relevant locational savings could well have temporal duration far in excess of the temporal cutoffs that would push a taxpayer outside of the various safe harbors under Article 5.[31]

Second, it would be necessary to change the approach to attributable profits under Article 7.[32] Consistent with the basic goal of organizational neutrality, one could tailor the approach to that described above for commonly controlled parties. Thus,

31. For example, under Article 5.3, the safe harbor for building sites and construction or installation projects is twelve months. *See id.* art. 5(3).

32. *Id.* art. 7.

the PE could be treated as if it were a separate entity purchasing the labor inputs at the price stipulated in the arm's length contract and then selling the labor inputs to a parent of the developed country at a markup reflecting the price of the associated labor in comparable transactions in the jurisdiction of labor demand. There are some obvious pitfalls here that would likely generate objections. Perhaps most problematically, the approach would require a search for comparables where currently there is none because current rules would not generate a PE and thus no need to determine attributable profits on these facts. But, the proper response is that the PE threshold should be set independently based on an appropriate theory of source taxation. The need for comparables flows from that determination; potential difficulties with comparables should not themselves determine the appropriate extent of the source tax. Moreover, as a general matter, it is well established that developed countries have far superior databases of comparables upon which to draw as compared to developing countries. Companies may like that there is no comparables analysis in the developed countries under current law, but to let that point dictate the substantive PE standard seems to get things backward. Further, it might seem odd that under Article 7 one would have to search for comparables (in the jurisdiction of labor demand) when one already seems to be sitting on a perfect benchmark—the actual contract concluded at arm's length. But, this just reflects the fact that Articles 5 and 7 have not, to date, been tested with respect to the very difficult problem of segmented markets for factor inputs.

3. Organizational Distortions and the Cushion to Tax Organizational Gains

In the absence of the admittedly radical modification to Articles 5 and 7 in the way just discussed, the chief criticism of the transfer pricing proposal would likely continue to be its creation of organizational distortions. Here, this article will address the magnitude of this organizational neutrality issue, as the problem may not be as large as it appears upon first glance. Specifically, one must take into account the relevance of organizational rents under arm's length transfer pricing. An incremental tax on labor rents earned solely through an organizational form of common control (as would be the case with modification of the geographic market definition under a functional analysis without corresponding modification of Articles 5 and 7) would automatically lead to shifts toward the unrelated form, only if the organizational forms are otherwise equally profitable. But, this will often not be the case. It is a basic lesson from the literature on the theory of the firm that ownership or common control should be understood to arise when this is more profitable than operating at arm's length by contract. In the literature on multinationals, it is common to explain ownership of foreign subsidiaries under a transaction costs story.[33] This is often the case, for example, where a firm uses valuable intellectual property in its production processes. A firm with valuable intellectual property may thus identify a jurisdiction with low labor costs but be unwilling to contract with unrelated service providers because of expropriation risk. Put another way, the firm can earn profits through common control that it could not earn at arm's length. This amount can be referred to as the organizational or synergy rent. It is now a very familiar critique of the arm's length standard that it is inherently flawed because no comparables-based approach could ever capture the elements of profit that literally cannot be earned at arm's length.[34]

In prior work, I have argued that the issue of synergy rents does not amount to an inherent flaw in arm's length transfer pricing.[35] Whether one accepts the standard "inherent flaw" critique or not, there is a very real possibility that synergy rents arising from organizational form remain lightly taxed. The mechanics whereby firms can achieve that result is much the same as with labor rents. That is, under current transfer pricing approaches, there is no meaningful way to capture such value through an analysis of comparables. The value can only be captured through a focus on residuals, and this creates the likelihood that such residual value will be absorbed into other, difficult to value, mobile intangibles.

This article will not attempt to provide a full discussion of the best solution to the broader problem of organizational rents.

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33. *See, e.g.*, Mihir A. Desai & James Hines, *Evaluating International Tax Reform*, 56 NAT'L TAX J. 487, 488 (2003).

34. *See* ORG. FOR ECON. CO-OPERATION AND DEV. [OECD], TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS para. 1.10 (2010) [hereinafter OECD GUIDELINES].

35. *See* Mitchell A. Kane, *Transfer Pricing, Integration and Synergy Intangibles: A Consensus Approach to the Arm's Length Standard*, 6 WORLD TAX J. 282 (2014).

Many scholars use the problem as an opportunity to reject fully the arm's length standard.[36] A less radical approach (working within the parameters of the arm's length standard) might seek to introduce further defined intangibles into the analysis in a better attempt to reflect the gains from organization. Here, however, the approach of introducing specific synergy intangibles, a position that mirrors the view presented in the BEPS action item 8 deliverable should be rejected.[37]

To the extent that organizational rents remain undertaxed, the best approach would be enhanced rules on the migration of intangibles and/or the strengthening of controlled foreign corporation (CFC) rules. Even this approach will not be perfect, as CFC rules can be difficult to enforce.[38] Further, absent the unlikely coordination of national level CFC rules, stricter approaches to inclusion of foreign-source intangibles income will lead to predictable migrations of corporate residence in order to benefit from less stringent CFC rules. The bottom line here would seem to be that, currently, synergy rents from organizational form are almost certainly undertaxed and will likely remain undertaxed for the indefinite future. The relevance of this to the labor rents problem under consideration here should be clear. If there are untaxed organizational rents, then there is some cushion to impose relatively more onerous taxation of labor rents earned by integrated firms compared to those operating at arm's length without generating an organizational distortion. To be more concrete, if a firm fears piracy when outsourcing to an unrelated provider of labor, then the amount of surplus value it places on the commonly controlled form can be taxed (in the guise of a tax on labor rents) without leading to switches in organizational structure.

To be clear, this article does not intend to suggest that one could plausibly measure with any precision the organizational premium and tailor the taxation of labor rents accordingly. Nor does it ignore the fact that the rents from organizational form could be expected to be competed away over time, thus rendering

36. *Id.* at 284.

37. *Id.*

38. See I.R.C. §§ 951–965, for the United States' CFC rules. These rules attempt to strike a compromise between current taxation of certain (generally passive) income earned by controlled foreign subsidiaries and deferred taxation of certain (generally active) income earned by controlled foreign subsidiaries.

the cushion a diminishing quantity. As a first-best option, one would want to measure the organizational rents directly and accurately and formulate a non-distortionary rents tax on that basis. What this article suggests is two steps removed from this, as it is not proposing an attempted quantification of the organizational rents, and the thing to be taxed (labor rents) is, as I have set up the problem, conceptually separate from the organizational rents (insofar as I presume the rents could be earned by parties contracting at arm's length as well). Even so, there is substantial merit to the point made here, which is offered in a qualitative vein rather than demanding strict quantification. There likely is some cushion. In this way, the argument to tax labor rents becomes less of an implausible option than it first appears.

There is an appealing conceptual purity to the strong claim for geographic market limitation and strict adherence to organizational neutrality as it exists in the OECD Transfer Pricing Guidelines. But, it is also helpful to step back and remind ourselves of the big picture. Currently, numerous multinational enterprises hold valuable intellectual property and benefit from low-cost labor inputs that are used with the retention of intellectual property in-house. Further, many of these firms would seem to bear relatively low overall tax rates. Against this backdrop, it would seem quite plausible that there is space to increase the tax burdens on these firms without thereby inviting some wholesale shift into less efficient organizational forms. If this looks like an unappealing *ad hoc* approach, it is worth remembering the various defects under the current approach.

B. Doctrinal Analysis Under Article 9

The above subsection analyzed the efficiency case for the transfer pricing proposal advanced in this article regarding allocating labor rents to controlled production subsidiaries. In particular, it dealt with ways of minimizing the efficiency costs from distortions to organizational form that would seem to result from the proposal. This section will address the relevant doctrinal analysis under Article 9. In particular, this section will evaluate whether it is consistent with Article 9[39] to interpret the arm's length standard in a way that would seem to lead to disparity of

39. OECD MODEL CONVENTION, *supra* note 18, art. 9.

treatment as between the commonly controlled taxpayers and unrelated taxpayers.

It is important to note as an initial observation that the foundational reason to adopt an arm's length standard in the first place is not limited to the fact that it helps to achieve non-distorted choices regarding organizational form. To be sure, if commonly controlled entities are required to implement prices and report profits in the same fashion as unrelated parties then there will be no tax advantage to taking on the organizational form reflecting common control. Such decisions, rather, would reflect pretax gains to an organization.[40] But, there are other reasons to adopt an arm's length standard, most importantly that an arm's length standard supplies access to undistorted information that can be used to check taxpayer incentives to shift profit.[41] This can overlap with the first consideration, but it is very important to see that the organizational neutrality aspect of the arm's length standard and the information aspect of the arm's length standard are analytically distinct. Consider, for example, the many cases that will arise in practice where commonly controlled firms realize a (pretax) premium from organizational form and also potentially realize further (after-tax) premium through the manipulation of intercompany prices. There may be a wide range of adjustments the tax administrator could make that would be consistent with leaving organizational incentives in place. Arm's length pricing is one such approach, but why is this elevated above other possible approaches? The information aspect of the arm's length standard provides an answer. Specifically, this accords with the way in which the tax administrator treats market prices as sound, non-manipulated information as a *general* matter in questions of administering the income tax.[42] In light of these two aspects driving the arm's length standard (organization and information), it would be wrong to

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40. *See* OECD GUIDELINES, *supra* note 34, para. 1.8.

41. *See* I.R.S. Notice 88-123, 1988-2 C.B. 458.

42. A third justification for the arm's length approach is the argument from consensus, which is really a point about path dependency. The point here is that there is good reason to implement arm's length transfer pricing because most countries have already coordinated around this approach and it would be costly to forge consensus on some other basis. *See* OECD GUIDELINES, *supra* note 34, para. 1.9. As a practical matter, this may be the most important consideration of all. It is ignored here, however, because it is not a substantive argument in favor of the standard and thus cannot be used to inform the content of specific prescriptions, such as that regarding market definition.

conclude that issues of organizational neutrality must always be paramount in application of the standard.

Moreover, there is nothing in the language of Article 9 itself that provides any meaningful guidance on how to deal with the problem of locational savings or locational rents.[43] One imagines that the original drafters of Article 9 were not really focused on the problem of segmented markets in the first place. Even within an integrated market, the problem of locating suitable comparables will loom large. Thus, it is plausible to think that from the outset the issue of the arm's length standard producing a range of results was recognized. The need to deal with such a range would have been apparent from the earliest attempts to administer the arm's length standard.

The issue here, though, is different. With segmented markets, a comparables based analysis could produce either multiple, discrete ranges (if we keep the markets separate) or a single, particularly intractable range (if we simply combine the markets). It is apparent that it would be a natural result and interpretation to avoid the latter result. Working on the assumption that the markets should be kept separate, to which market should one look? The relevant treaty text would seem to provide no guidance. The comparables suggested under the transfer pricing proposal (based on the jurisdiction of labor demand), after all, certainly are arm's length prices. They just happen to be the wrong arm's length prices if one elevates the principle of organizational neutrality above everything else. While granting that issues of organizational neutrality are crucially important, as suggested above, it is a stretch to say that organizational neutrality should necessarily be the dominant interpretive consideration. To the contrary, taken against the backdrop of the broader function of double tax conventions, of which the rules on arm's length transfer pricing obviously form only one part, the goal of organizational neutrality should plausibly be subordinated to the broader goals of eliminating double taxation and preserving the tax base.

On this score, it is plausible that my proposal is better than the standard approach. It relies on arm's length prices from a single, segmented labor market and provides as good a chance as the current approach in reaching coordinated agreement to avoid double taxation. In terms of preserving the tax base, the

43. *See generally* OECD MODEL CONVENTION, *supra* note 18, art. 9.

basic argument is that the proposal is better than the current approach (which will likely result in the value from the labor rent being absorbed into other firm intangibles), with the increased likelihood that this portion of the base will face low or zero tax. Given the character of the portion of the base under consideration as a rent, this is a particularly harmful result. There should be room to tax this rent without discouraging efficient relocation of labor services. Under current approaches, however, we are unlikely to achieve this.

There is one final argument that needs to be addressed regarding the range of permissible interpretations of the arm's length standard under Article 9. The arm's length standard under Article 9 could be read to mean that each contracting state may only tax resident enterprises up to the amount that they would have earned had the enterprise been operating at arm's length.[44] If that were the actual meaning and function of Article 9, then one might argue as follows. A controlled subsidiary operating in a jurisdiction of low labor costs would not be able to bargain for any portion of the labor rent given the dynamic of the segmented labor markets. Thus, the proper reading of Article 9 would be that it functions as a substantive limit on the ability of the jurisdiction of labor supply to tax the labor rent in the hands of the affiliate.

Under what I have called the "fractional" interpretation of Article 9 in my prior work, this is not a convincing reading of Article 9.[45] As a functional matter, the arm's length standard performs two basic roles regarding allocation of the tax base in the treaty context. First, it grants contracting states the right to restate reported profits, leading to tax liabilities that would not have been permissible under the treaty absent restatement (because of limits under Articles 5[46] and 7[47] on the ability to tax the party initially reporting the profits). Second, it functions as a limit on the ability of a state to restate profit. Reference to an

44. *See* OECD MODEL CONVENTION, *supra* note 18, art. 9.

45. *See* Kane, *supra* note 35. In that paper, I linked the faulty interpretation with the mistaken view that the arm's length standard is conceptually flawed because it cannot give a substantive allocation of the gains from organization, which cannot (by definition) be earned at arm's length. That criticism fails because, under the best reading of what the arm's length standard is doing, it is not meant to achieve substantive allocation of that premium.

46. OECD MODEL CONVENTION, *supra* note 18, art. 5.

47. *Id.* art. 7.

arm's length standard, then, should be viewed as an effective means of coordinating one state's adjustment to stated profits and the other jurisdiction's acceptance of that restatement. What matters then is coordination—not the use of an arm's length standard to allocate profits that could not have been earned at arm's length. But, once one views the matter as merely coordination over arm's length profits, there is no immediate reason to assume that greater coordination will occur with a benchmark that looks to comparables based on the jurisdiction of labor supply rather than the jurisdiction of labor demand. The bottom line is that, as an interpretive matter, there is no clear indication from the text of Article 9[48] or the broader function of double taxation conventions on how to treat the problem of labor rents (or locational savings more generally). Any approach is likely to involve tradeoffs of important goals of the overall framework. One needs to countenance those broader tradeoffs rather than fall back upon doctrinal interpretations that would emphasize only a subset of the relevant considerations.

C. Internation Distribution

The previous two subsections have argued that (i) source taxation of labor rents can be defended on efficiency grounds and (ii) the transfer pricing proposal to allocate labor rents to local production subsidiaries is doctrinally consistent with Article 9. Under that proposal, tax base would be allocated to developing countries where labor outsourcing takes place. This section will discuss the defensibility of that result from the standpoint of internation distribution. Supposing it is a desirable outcome to tax labor rents, the question of which jurisdiction should be accorded that part of the tax base is somewhat complicated. Since we are talking about a species of "location savings," there is a natural impulse to conclude that the jurisdiction where the savings arise should tax the rent. But, what is the actual basis for this? After all, if the question were simply a matter of efficiency in the sense of reduction in worldwide deadweight loss we could generate other prescriptions. For example, if Country A has a very high marginal cost of funds and Country B a very low marginal cost of funds, then one could increase efficiency by having Country A tax a rent that is location specific to Country B and remove one

48. *Id.* art. 9.

of its relatively distortionary instruments. Such a line of analysis, however, is not convincing. Whatever the potential for worldwide reduction in deadweight loss, we are so far removed from a situation which takes equalization of marginal cost of funds across jurisdictions to be a goal that it is near impossible to consider forming international tax policy around such an outcome.[49]

From a realistic point of view, the best one could hope to do is assess how the implementation of a rents tax would improve the marginal cost of funds of a given jurisdiction. But, if we may not use a standard of relative reduction, then on what basis should one determine which jurisdiction is entitled to tax? Not all rents are alike for these purposes. Some rents are not location specific, in which case it is difficult to say much of anything about which jurisdiction should collect the tax. That situation presents a problem of pure, arbitrary coordination. It makes sense for some jurisdiction to tax the rent, but typical tax competitive pressures will drive the rate of tax to a suboptimal level.

In other cases, however, rents might reflect the effects of prior state investment. In this case, it is sound policy for the jurisdiction that incurred the cost of the investment to have the entitlement to the tax. The existence of the rent here essentially reflects some unpriced government-provided benefit, and granting the right to tax the jurisdiction providing the benefit will preserve the incentives to make investments in the first place.

This provides a potential basis for according the jurisdiction of labor supply the entitlement to tax labor rents. In the case of unskilled labor rents, it may be fairly difficult to identify the nature of the investment that makes the rent possible.[50] However, one plausible story is that developing countries that are able to attract buyers of outsourced labor are those jurisdictions where labor is relatively inexpensive compared to the case in other developing countries, precisely because some state investment in infrastructure and institutions relieves foreign enterprises of the need to incur certain costs privately. If that is the case, one could then characterize jurisdictions that supply relatively low-

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49. Consider, for example, just how radical a world like that would look. Given the increasing distortionary costs of tax with increasing marginal rates, countries with systematically smaller public sectors would have to collect tax on behalf of countries with systematically larger public sectors.

50. With skilled labor, by contrast, matters may be clearer to the extent that the skilled labor force represents obvious investment in human capital through, for example, state-provided education.

cost labor as enjoying a sort of return on state investment. A less happy story is that the low labor cost does not reflect so much state decisions about investment but rather state decisions to compete downward on regulatory standards.

II. PROBLEMS AND CHALLENGES

This Part addresses potential issues with the proposals offered in this article. This Part will focus on the transfer pricing proposal, as this is the more concrete proposal that works off an existing doctrinal base. Everything said here, however, ultimately informs the source entitlement proposal as well, given that the ultimate goal would be to adopt a treaty architecture that taxes labor rents on a PE theory and on a related affiliate theory in the same fashion. The first set of issues relates to measurement of labor rents, and the second set of issues relates to tax competition.

A. Measurement of Labor Rent

This section considers two practical measurement problems. The first relates to the question of dissipation of the labor rent over time in the product market. The second relates to the determination of the appropriate labor demand market under the proposed comparables test.

1. Dissipation of Rent

The overarching theme of this article is that it would be desirable to shift the taxation of labor rents to the jurisdiction of labor supply. Within the context of arm's length transfer pricing, this presents a very complicated problem of measurement. The reason is that the required information about the dissipation rate of the rent, which is a phenomenon that arises because of competition in the product market, does not naturally appear in the arm's length analysis. That analysis will take account of two factors of relevance to the calculation of the rent. First, one will look to the actual costs of labor in the jurisdiction of labor supply. These are sound third-party prices because they reflect amounts paid to individual employees. Second, one will have gross income from sale of the final product in the product market. This is also a good third-party price. Ignoring other expenses and value creation from the sales function, the gap between these two factors should embed a normal return and any amount of rent. The rent will disappear over time, as there is downward pressure on gross income when prices fall. The particular issue faced by an arm's length analysis, however, is the compensation of the related party service provider. The reference price under arm's length principles will be other service providers.

Suppose that we have segmented labor markets, with a single integrated high-cost segment and a single low-cost segment. If we reference the low-cost segment, as under current approaches, then the pricing captures none of the rent. If we reference the high-cost segment, as under this article's transfer pricing proposal, we then accurately capture all of the rent at the outset, but the measure will increasingly come to overstate the rent as product market competition drives prices downward. Put simply, the problem is that the magnitude of the rent is dynamic and reflects competitive pressures. But, the seemingly available reference points to determine compensation for the related party services company are all static because they reflect market segmentation. The labor markets, of course, may be internally competitive, but those competitive forces will not correctly capture the dynamics of the rent dissipation. In this way, it should be acknowledged that each of the current approaches and this article's proposal are clearly second-best options. The current approach has no mechanism to separate the labor rent from other elements of profit. Arguably, this produces the correct result when the labor rent is gone in product market equilibrium. But, in the dynamic process leading to equilibrium, we have an undesirable result to the extent that the profit from labor rent is reflected as residual profit from mobile intangibles and thus faces little or no tax. The proposal in this article faces something of the opposite problem. Arguably, it separates and measures the rent correctly at the beginning of the competitive process but then begins to overstate systematically the rent as consumer prices begin to come down.[51]

51. As an aside, I would observe that formulary apportionment does not achieve a first-best solution to this problem either. It is true that formulary apportionment will never "overstate" the labor rent, as my proposal is bound to do. Because the approach begins by calculating the overall profit of the organization, such overall profit will always take full account of effects on gross income from competitive pressures in the product market. But, it fails in two ways. First, the apportionment factors are not plausibly going to assign the labor rent portion of the profit to the "correct" jurisdiction, as understood by the argument presented above. For example, a formula that included any sales

It is very difficult to assess at a conceptual level the relative magnitude of the problem under the current approach versus those encountered under this proposal. To do so would involve empirical analysis of several important issues. The first is the nature of the competitive process in the product market. As a general matter, the more competition in the final product market the greater becomes the mismeasurement problem. But, there is no generally applicable answer to this question across the universe of taxpayers. Results will vary across sectors and also within sectors. The second is the degree to which taxpayers are currently able to treat labor rents as embedded in other valuable intangibles and shift associated profit to low tax jurisdictions. As is acknowledged by this article, there is reason to believe this is a substantial problem, but presently we lack any quantitative assessment of this effect.

Obviously lacking the empirical measures necessary to make the required comparisons, consider a few observations. First, it is worth emphasizing that the current approach to labor rents under the accepted geographic market criteria is importantly flawed in ways that seem to be ignored in current treatments. Second, to the extent that one approaches transfer pricing policy as a part of the general project of development finance, this should alter the nature of the comparative question. That is, one should consider not just the measurement of the rents issue across the two approaches but rather how this proposal, with the acknowledged flaws, compares to other available (imperfect) means of development finance. Finally, it may be possible to address some of the measurement issues under this proposal. A few possibilities will be briefly suggested here, all of which might be described as achieving a sort of middle ground between the current approach and this proposal for a jurisdiction of labor-demand comparables test.

One possibility would be to rely on a range of arm's length comparables derived from both the jurisdiction of labor supply and

factor would allocate some portion of the labor rent to the jurisdiction of ultimate consumption. It is difficult to square that result with the preferred approach to the taxation of location-specific rents. Second, and related, any approach that applies apportionment to overall group profit as a single category will fail to separate out the labor rent from the rest of the base. Necessarily, then, it will fail to achieve the first-best benchmark defended in this article, which demands accurate and separate measurement of the labor rent over time, which is then fully allocated to the jurisdiction of labor supply.

the jurisdiction of labor demand. On the assumption of segmented labor markets, this range should evidence a low cluster and a high cluster. The idea would be that the taxpayer would be required to base arm's length pricing at some point in the middle of this distribution. As a splitting of the difference, this would allow some taxation of the labor rent in the jurisdiction of labor supply at the outset. The amount would be suboptimally low to begin with but would reduce error cost, compared to the basic proposal, in the state of product market equilibrium. A variation of this approach would be to have a discrete shift at some point from using demand-jurisdiction-based comparables to supply-jurisdiction-based comparables. This would clearly never achieve perfection, but if the discrete shift were tailored to information about speed of rent dissipation then it would have the potential to perform better than an approach that simply used a combined demand-supply jurisdiction range in perpetuity. Even without particularly detailed information on the rate of dissipation, it is possible that a discrete shift after, say, one or two tax years could well perform better than the current approach or my basic proposal. A further possibility to explore would be to incorporate the labor rent explicitly into profit splits. If nothing else, this article likely has demonstrated the range of problems with accurately measuring the labor rent as it dissipates. This calls into dispute the unquestioned fashion in which we tend to see this as clearly a part of "routine" profit. If one packaged the labor rents aspect with other nonroutine returns, this would open the door to allocate this, at least in part, to the jurisdiction of labor supply. This, of course, just brings the measurement issue back to the forefront. This will remain a very difficult problem. Ideally, we would like to base the allocation of the profit split on a factor that tracks diminishing contribution of the labor factor over time. This will be very difficult in practice, but there is at least conceptual space for approaching the correct answer in a way one cannot, if we treat the matter simply as ordinary provision of labor services with segmented markets.

Finally, taking into account the way in which the discretion of the jurisdiction to tax allocated labor rents could offer a powerful answer to the basic measurement problem. At least in the case where there is a single country that makes up a segmented labor market, that jurisdiction will have the incentive not to overtax allocated rents. Suppose rents start off at $\$x$ and a controlled subsidiary is allocated exactly that amount based on the labor cost savings. Over time, imagine that the rent is dissipated to zero but that the jurisdiction of labor supply is still allocated $\$x$ of rent because the labor cost fundamentals across the two segments of the market have remained the same. At this point, if the jurisdiction of labor supply seeks to tax a portion of the "rent" then this should have the effect of driving the labor production to another jurisdiction, as under the standard tax competition model. Thus, the jurisdiction should have proper incentives not to overtax nonexistent rents. This just pushes the informational problem onto the jurisdiction of labor supply, which may be ill-equipped to deal with it. On the other hand, it does mean one is attempting to solve that problem with an additional source of information—actual firm behavior regarding labor outsourcing.

2. Defining the Labor Demand Market

In the initial description of this article's basic proposal, the proposed comparables analysis was described as resting upon examination of the jurisdiction of labor demand instead of the jurisdiction of labor supply. One important issue that has not yet been addressed is that, while the jurisdiction of labor supply will be readily identifiable, this may well not be the case for the jurisdiction of labor demand. In the simple model discussed above, matters were relatively, though artificially, easy because all factors pointed to the United States as the jurisdiction of labor demand.[52] But, clearly, actual implementation of any such approach would need to take account of more complex corporate structures (and the tax planning that might lead to such structures). For example, if in the simple fact pattern above the U.S. parent had some intermediate subsidiary in a third jurisdiction acquire the labor (possibly also in a jurisdiction with low labor costs), then this should not have the effect of treating such third state as the jurisdiction of labor demand. Drafting the correct legal rule will thus involve necessary complexities. This section will set out the basic conceptual framework that could inform the drafting of such rules.

It is important to note that the basic measurement issue at hand regards the labor rent, which in turn is a function of labor cost savings. Such savings arise in virtue of comparison of labor cost in the actual jurisdiction of labor supply and the costs according to some benchmark. Broadly, there are two possibilities

52. *See supra* Part I.A.1.

for assessing that benchmark. Specifically, one could look to alternative own-labor costs or one could look to the labor costs of competitors. In the case of own-labor costs, one is relying on a historical benchmark. This would be the preferred test for market determination where a firm has previously conducted labor in a given jurisdiction, prior to terminating such activity and shifting production to another locale. It would also be the preferred test where a firm continues to produce some output in a relatively high-cost jurisdiction and then expands production into a low-cost jurisdiction. In these sorts of cases, it should be a relatively straightforward matter to identify the correct jurisdiction of labor demand upon viewing all the facts and circumstances. What we seek here is the answer that firm managers would give to the following question: "If you currently realize labor cost savings because of the location of labor supply, these savings arise as compared to labor provision in *which* labor market?" (Recall here that this answer need not refer to a single country but rather only to a single integrated labor market.) It is plausible that managers would be able to answer this question without much difficulty. Translating this into a legal rule with prospective effect, however, will present various drafting challenges, but it is at least clear what target we are aiming for.

The second conceptual possibility is to look at competitor labor costs. If the taxpayer is earning labor rents at all, then it must be the case that competitors are not also operating in the low-labor cost jurisdiction, or at least not to the same extent. This provides another way to identify the conceptually correct jurisdiction of labor demand. Specifically, one would have to examine the final product market (to which the labor inputs relate), identify competitors in that market, and then finally identify the high labor cost markets where such firms source labor inputs. This sort of procedure is clearly more administratively complex than the first and should be favored only in those cases where the taxpayer has no current or prior operating history in relatively high-cost labor markets.

B. Tax Competition

A further set of problems one must think about with respect to this article's proposal relates to the likely effect of tax competition. So far, the problem has been analyzed as if there is a single country that comprises a segmented labor market with low-cost labor inputs. It is likely, however, that to some extent these segmented markets will be regional and transcend national boundaries. Consider a simple case like the one previously analyzed but with two jurisdictions of low-cost labor supply that form a completely integrated labor market (though segmented from the high-cost labor market). If one were to allocate the labor rent to the jurisdiction of labor supply in this sort of case, then it would seem that each of these two jurisdictions might just end up competing down to zero the tax rate on those rents.

Here I would make two observations. First, it is possible that one faces a middle ground in the real world where there are multiple segmented labor markets in developing countries, all of which have cost savings over labor supply in developed countries. In such a case, the jurisdiction with the lowest labor costs really reflects a country-specific rent. That jurisdiction should be able to tax that rent without facing tax competitive pressures from other jurisdictions.

Second, with respect to rents that are available equally across jurisdictions of a particular segment of the labor market, we face a situation of something like a region-specific or segment-specific rent. Here, we do face a problem of tax competitive pressures driving the rent tax down to zero. This is an unambiguously bad result from an efficiency perspective. This is not like the standard tax competition case, which can be read as a general argument against source-based taxation of capital income. In the standard case, we are dealing with distortionary taxes that affect the location of capital and thus are shifted onto local immobile factors. Where one has a segment-specific rent, however, it really is a rent. There is a prospect with coordination of levying non-distortionary rents taxes. That is, there is the possibility of raising additional revenue without distorting the decision to locate labor within the region or segment. Although such coordination will be extremely difficult and infrequently discussed, its normative appeal is compelling.

CONCLUSION

The discrete transfer pricing proposal advanced in this article for a labor-demand comparables test will likely meet considerable resistance. It takes an area (perhaps one of the few) where arm's length transfer pricing seems to work fairly well and instead invites a substantially more complex measurement exercise (which this article fully admits) that runs the risk of being at least partially wrong. The broader source entitlement proposal regarding the scope of source taxation will likewise meet substantial resistance as a fairly radical departure from the extant architecture of international double taxation conventions.

Yet, this article has attempted to illustrate that the current approach, in spite of the appeal of simplicity, is flawed. With its single-minded focus on organizational neutrality, it systematically ignores the fact that labor rents, in the presence of general planning for mobile intangibles, may go largely untaxed.

For the many countries that are capital poor and labor rich, one of the most valuable national attributes is the ability to offer low-cost labor inputs. The extraordinary returns available from such inputs in a world with segmented labor markets are properly taxed in the developing world for a range of reasons. The returns may represent the equivalent of return-to-state investment; the developing countries may be the only ones that can plausibly tax this non-distorting base (as it will be near impossible to break out once comingled with other profit elements, which we already struggle to tax); and the tax revenues would seem to be relatively desirable sources of development finance on the margin.

In summation, such rents should be a prime component of source-based tax. Doctrinally, such source-based tax can be imposed on resident affiliates under the transfer pricing analysis proposed in the article or on nonresident affiliates under the revised conception of the source entitlement that could be put in place through altered versions of Articles 5 and 7 of the typical double taxation convention.

For these reasons, the proposals in this article hopefully will at least invite a broader and more thorough consideration of the particular place of labor rents in the interaction between transfer pricing and source-based taxation.