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A Study on the Development of a Global Community from a Legal Perspective

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A STUDY ON THE DEVELOPMENT OF A GLOBAL COMMUNITY FROM A LEGAL PERSPECTIVE

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I. INTRODUCTION

As the process of globalization continues, the world is starting to resemble a single community with a shared economy, culture, and knowledge. However, the effects of globalization do not necessarily translate into positive outcomes. The U.S. subprime mortgage crisis, for example, has driven the entire world into a difficult economic recession. This crisis not only demonstrates how closely integrated the world economy has become, but also demonstrates the need for a global legal system that can promote harmonious co-prosperity.

Every nation has a legal system that reflects its national culture. Historically, most political structures involved some form of monarchy, but democratic political structures are much more common today. In modern democracies, legal systems are designed to reflect the opinion of the nation's people through the mechanism of voting. A democratic legal system, however, is not always reflective of a nation's traditional culture. Indeed, as the culture of a nation changes, its legal system often changes with it. This principle can be observed through the global trend toward democratic governance, which has led many nations to implement democratic processes that are often very different from their traditional political systems. Because a unified legal system facilitates cultural and legal harmony between nations and because such harmony is essential to the development of the global community and economy, it is likely the current trend towards democratic governance will continue in the future.

It is difficult to imagine the development of the global economy without the development of a corresponding global legal system because the two concepts are so interconnected. Accordingly, organizations that facilitate harmony among global legal systems are becoming increasingly important. These international organizations help to unify the global community in a number of areas, and they are likely to be increasingly necessary in the future as a new international legal system emerges. Furthermore, as the global community becomes more economically integrated, it is expected that the need for military power will greatly diminish. As trade barriers between states decrease, enterprises have little, if any, need for military support to conduct business in other states. Below is a table displaying current military expenditures for a host of countries as a percentage of global military spending.[1]

[1] *Military Spending Worldwide*, VISUAL ECONOMICS, http://www.visualeconomics.com/military-spending-worldwide/ (last visited Sept. 26, 2010).

Country	**Spending in Dollars**	**Global Military Spending**
United States	$711 billion	48%
Central and South America	$30 billion	2%
Latin America	$39 billion	3%
Sub-Saharan Africa	$10 billion	1%
Russia	$70 billion	5%
Middle East and North Africa	$82 billion	5%
East Asia and Australasia	$120 billion	8%
China	$122 billion	8%
Europe	$289 billion	20%

As the table shows, countries spend an enormous amount of funds on military expenditures—funds that could be used for other more beneficial purposes. The existence of excessive military power increases the risk of global conflict. Accordingly, the global community should manage world military power under a common legal system. But, for such a system to work, the global community would need to agree on a set of rules to govern the system.

A similar approach should be taken in developing a global economy. While military power was the dominant force of the past, economic power is much more influential today. Thus, because the basis of economic power is cooperation, it is essential that the global community comply with rules established by an international legal system for humankind to prosper in the future. This Article will focus on the creation of a global legal system to promote global economic development. Specifically, the Article will address the following three topics: the development of global organizations, economic and legal systems, and international legislation.[2]

[2] A fourth topic, harmonizing tax treaties and domestic laws, will be discussed in related article anticipated to be published in the Spring 2011 issue of the *Brigham Young University International Law & Management Review*.

II. DEVELOPMENT OF GLOBAL ORGANIZATIONS

Just as every nation has a domestic legal system for its national administration, the international community needs a legal system for its international administration. Since every nation has a different cultural and historical background, it is not easy to create a unified legal system that satisfies each country's needs. Nevertheless, the international community has made an effort to create a legal system that harmonizes the cultural and historical differences between nations, and as a result of these efforts, international organizations like the United Nations, the World Trade Organization, and the Organization for Economic Co-operation and Development have been created. These international organizations are currently performing the global community's most important functions.

A. The United Nations

Military power has historically been the deciding factor in world politics. In the absence of an effective international rule against wars of aggression, it was common for stronger nations to invade weaker nations more or less at will. Indeed, there was little reason for the stronger nations to exercise restraint. This unchecked power resulted in countless tragedies, and eventually the international community realized the importance of a mechanism that could facilitate international cooperation in the pursuit of peace. On June 26, 1945, just such a mechanism was created in the form of the United Nations (U.N.) Charter (U.N. Charter). The U.N. Charter, which consists of a preamble and 111 articles, continues to play an important function in the operation of the international community, and as of January 1, 2009, there are 197 U.N. member states.

Article 1 of the U.N. Charter provides:

> The purposes of the U.N. are
>
> 1) To maintain international peace and security, and to that end: to take effective collective measures for the prevention and removal of threats to the peace, and for the suppression of acts of aggression or other breaches of the peace, and to bring about by peaceful means, and in conformity with the principles of justice and international law, adjustment or settlement of international disputes or situations which might lead to a breach of the peace;

> 2) To develop friendly relations among nations based on respect for the principle of equal rights and self-determination of peoples, and to take other appropriate measures to strengthen universal peace;
>
> 3) To achieve international co-operation in solving international problems of an economic, social, cultural, or humanitarian character, and in promoting and encouraging respect for human rights and for fundamental freedoms for all without distinction as to race, sex, language, or religion; and
>
> 4) To be a centre for harmonizing the actions of nations in the attainment of these common ends.[3]

It seems clear that the U.N. should play an increasingly important role in the international community's efforts toward peaceful coexistence.

B. The World Trade Organization

The World Trade Organization (WTO) was established on January 1, 1995, as a result of the Uruguay Round negotiations between 1986 and 1994. As of January 1, 2009, the WTO has 153 member states. The WTO is the only international organization that deals with "the rules of trade between nations."[4] WTO agreements are negotiated and signed by most of "the world's trading nations and ratified in their parliaments."[5] The goal of WTO agreements is to "help producers of goods and services, exporters, and importers conduct their business."[6]

The global community needs the WTO to assist in creating an open trading system. But what is the value of an open trading system, and why should the global community strive to achieve it? The WTO posits the following argument:

> The economic case for an open trading system based on internationally accepted rules rests largely

[3] U.N. Charter art. 1, *available at* http://www.un.org/en/documents/charter/chapter1.shtml (last visited Oct. 25, 2010).

[4] *What is the WTO?*, WORLD TRADE ORG., http://www.wto.org/english/thewto_e/whatis_e/tif_e/fact1_e.htm (last visited Oct. 25, 2010).

[5] *Id.*

[6] *Id.*

> on commercial common sense and the experience of world trade and economic growth since World War II. Tariffs on industrial products have fallen steeply and now average less than five percent in industrial countries. During the first twenty-five years after World War II, world economic growth averaged about five percent per year, and this high rate was at least partly the result of lowering trade barriers. World trade grew even faster during this period, averaging about eight percent per year. The data show an unmistakable statistical link between lower trade barriers and economic growth, and this link is supported by economic theory. All countries have assets — human, industrial, natural, and financial — that they can employ to produce goods and services for their domestic markets or for export. Economic theory predicts that nations "can benefit when these goods and services are traded."[7]

Thus, the WTO should continue to play an important role in the global economy and the development of a global legal system, especially since the WTO is already established in so many nations.

C. The Organization for Economic Co-operation and Development

The Organization for Economic Co-operation and Development (OECD) describes itself as bringing together "the governments of countries committed to democracy and the market economy from around the world" in order to accomplish the following aims:

1) Support sustainable economic growth
2) Boost employment
3) Raise living standards
4) Maintain financial stability
5) Assist other countries' economic development
6) Contribute to growth in world trade[8]

Since it was established in 1961, the OECD has facilitated the sharing of expertise and the exchange of views between more than 100 countries, including Brazil, China, Russia, and many of the least-developed countries in Africa. For more than forty years, the OECD

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[7] *Understanding the WTO*, WORLD TRADE ORG., http://www.wto.org/english/thewto_e/whatis_e/tif_e/fact3_e.htm.

[8] *About OECD*, ORG. FOR ECON. CO-OPERATION & DEV., http://www.oecd.org/pages/0,3417,en_36734052_36734103_1_1_1_1_1,00.html (last visited Oct. 25, 2010).

has been one of the world's largest and most reliable sources of economic and social data. In addition to collecting data, the OECD monitors trends and analyzes forecasts and economic developments. It researches social changes and evolving patterns in trade, the environment, agriculture, technology, taxation, and more. The organization provides a setting where governments can compare experiences, seek answers to common problems, identify good practices, and coordinate domestic and international policies.

As of January 1, 2009, the OECD had thirty member states. In May 2007, OECD countries agreed to invite Chile, Estonia, Israel, Russia, and Slovenia to open discussions for membership. At the same time, the OECD also offered enhanced engagement with an eye toward future membership to Brazil, China, Indonesia, and South Africa. Because of the OECD's ever increasing and significant role in governance, it should play an equally important role in creating a global legal system.

D. Summary

These organizations have the potential to be important players in the effort to create a legal system that would facilitate the development of the global community. The UN Charter, WTO agreements, and the OECD Model Tax Convention should become a part of any global legal system that may be established. Furthermore, just as a strong democratic society needs a good legal system and popular support in order to guarantee the well-being of its people, the global community needs a strong legal system in order to facilitate prosperity. Before a similarly successful and strong international legal system can be developed, however, it is important to understand how to create such a system.

III. ECONOMIC AND LEGAL SYSTEMS

A. The Economic Efficiency of a Rule

In a society controlled by rules, economic activities are carried out under the auspices of the legal system. That is to say, the economic activities of enterprises and individuals are carried out within the scope of the state's economic policy, and the economic policy of a state is made to be in harmony with the laws of the state. This means that economic activities are governed by rules.

In order to encourage efficiency, rules must be developed from an economic perspective, which means considering the probable social benefit, expense, and corruption effect of a proposed rule. This issue will be discussed further in Chapter IV under the heading, "From the Regulatory Perspective."

In a modern society, where cross-border and local transactions are closely integrated, it is very natural for most economic activities to be performed under an integrated system of domestic and international rules. Cross-border transactions by multinational enterprises are especially affected by the national economic policies of the states implicated in these transactions and by international economic rules—global economic policies—made by international organizations like the WTO and the OECD. Because so many organizations are involved in cross-border transactions, creating economically efficient international rules is vitally important.

B. Role of the Government

Enterprises and governments often have different goals, particularly in an economic context. While enterprises attempt to maximize profits, the primary objective of government is to balance public finances. Nevertheless, governments should make an effort to create economic circumstances that enable enterprises to pursue profit maximization. In a free-market society where economic activities are performed based on consensual transactions, the government needs to create legal rules that facilitate a spirit of fair competition. When fair competition exists, an enterprise's economic activities can contribute to society's development.

To create the best economic circumstances in a democratic society, the legislature, the executive, and the judiciary should coordinate their efforts. The legislature should make rules that produce the best economic circumstances possible. The executive should fairly implement those rules. And, finally, the judiciary should decide whether a violation of those rules has occurred. When the branches of government all work together, rules are created and enforced in a way that allows enterprises to perform their economic activities in accordance with principles of fair competition, without harming the economy.

C. Role of International Organizations

The role of international organizations is becoming increasingly more important as transnational activities increase. Although the international community currently has no political structure comparable to what is found in individual states, international organizations are playing an important role in the international community. For example, agreements and model tax conventions made by the WTO and the OECD significantly affect transnational activities.

Just as tax treaties promote international transactions by smoothing out the differences between the tax laws of contracting states, rules such as the model tax conventions and countless other rules synthesized by international organizations do serve and will serve a similar function. For now, however, legal conflicts between domestic law and international norms often create difficulties for enterprises. Therefore, in order for the global community to develop, the study of legal conflict avoidance is essential.

IV. DRAFTING INTERNATIONAL LEGISLATION

A. Established Purpose of International Organizations

The U.N., the WTO, and the OECD focus on world peace, fundamental human rights, and global economic development. The preamble of the U.N. Charter reads:

> We the peoples of the United Nations determined to save succeeding generations from the scourge of war…and to reaffirm faith in fundamental human rights [and] in the dignity and worth of the human person…to establish conditions under which justice and respect for the obligations arising from treaties and other sources of international law can be maintained, and to promote social progress and better standards of life in larger freedom….[9]

The WTO's General Agreement on Tariffs and Trade (GATT) 1947 states:

> [The parties to this treaty,] [r]ecognizing that their relations in the field of trade and economic endeavour should be conducted with a view to raising standards of living, ensuring full employment and a large and steadily growing volume of real income and effective demand, developing the full use of the resources of the world and expanding the production and exchange of goods, [b]eing desirous of contributing to these objectives by entering into reciprocal and mutually advantageous arrangements directed to the substantial reduction of tariffs and other barriers to trade and to the elimination of discriminatory treatment in international commerce,

[9] U.N. Charter, *supra* note 3, pmbl.

> [h]ave through their Representatives agree [to enter into this treaty].[10]

Furthermore, in Article 1 of the Convention,[11] the OECD committed itself to promoting policies designed to:

> [A]chieve the highest sustainable economic growth and employment and a rising standard of living in member countries, while maintaining financial stability, and thus to contribute to the development of the world economy; to contribute to sound economic expansion in member as well as non-member countries in the process of economic development; and to contribute to the expansion of world trade on a multilateral, non-discriminatory basis in accordance with international obligations.[12]

According to the founding documents of these organizations, they were established to promote world peace, fundamental human rights, and global economic development.

B. Legislative Approach

Economic development, whether domestic or international, is highly emphasized and valued in modern society. Accordingly, economic development has become the primary goal for most states. This section will discuss the importance of Free Trade Agreements (FTAs) and tax treaties to both domestic and international economic development, and will also explore the equity of taxing rights among states. Furthermore, because states and international organizations pursue economic development through a variety of activities that are regulated by a set of corresponding rules and regulations, this section will explore a desirable mechanism for regulation and will emphasize the need for states to consider the negative economic effects of unproductive rules at the time of legislation.

1) FTAs, Tax Treaties, and Taxing Rights

Historically, human society has suffered from war, famine, and disease. Economic development has eased much of this suffering. As

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[10] General Agreement on Tariffs and Trade pmbl., Oct. 30, 1947, *available at* http://www.wto.org/english/docs_e/legal_e/gatt47_e.pdf [hereinafter GATT].

[11] The Convention was signed in Paris on December 14, 1960. *See* Convention on the Organization for Economic Co-operation and Development pmbl., Dec. 14, 1960, *available at* http://www.oecd.org/document/7/0,3343,en_2649_ 20118 51915847_1_1_1_1,00.html.

[12] *Id.* art. 1.

such, society must continue to work toward economic development to alleviate human suffering.

In the past, developed countries often used military power to open new markets in underdeveloped countries and exploit them for economic profit. Today, it is no longer necessary to use military power to open a new market. As voluntary and tax-free international transactions increase, multi-national enterprises can conduct business almost anywhere without commercial barriers. Multi-national enterprises rarely encounter significant oversight from government regarding their business activities in other countries. Instead, these enterprises are primarily governed by the legislative activities of international organizations.[13]

In light of the growing desire to develop an international economy, international organizations should go to great lengths to promote the free cross-border business activities of multi-national enterprises. To do this, international organizations should support the extension of FTAs and tax treaties, as well as equity in taxing rights between nations.

a) Extension of Free Trade Agreements

During the first twenty-five years after World War II, world economic growth averaged about five percent per year—a high rate of growth which was partly the result of lower trade barriers. World trade grew even faster, averaging approximately eight percent during the same period. Because data show a definite statistical link between freer trade and economic growth, the global community should promote free trade to bolster economic development worldwide.[14]

One way to promote free trade is through trade agreements. Trade agreements help open markets and expand opportunities for workers and businesses. In short, they can help enterprises enter and compete more easily in the global marketplace. Trade agreements are also a tool for promoting fair competition and encouraging foreign governments to adopt open and transparent rulemaking procedures as well as non-discriminatory laws and regulations. Trade agreements can enhance the business environment by including terms that resolve issues that are of concern to businesses as well as terms that reduce or eliminate tariffs.

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[13] Since the need for developed countries to use military power to open up new markets has decreased substantially, and international organizations are now strengthening free cross-border transactions, current military power should be used to perform a police function to ensure the peace and well-being of the global community. If this becomes the case, current military expenditures borne by each state will greatly decrease. When economic interchange between states (especially between Islamic and developed states) is enabled, conflicts deriving from cultural differences between these states will decrease significantly.

[14] *See U.S. Free Trade Agreements*, EXPORT.GOV., http://www.export.gov/fta/ (last visited Oct. 25, 2010).

In light of the recent promulgation of Regional Trade Agreements (RTAs) around the world, the WTO stated the following:

> [RTAs] have become a very prominent feature of the Multilateral Trading System (MTS). The surge in RTAs has continued unabatedly since the early 1990s. As of 31 July 2010, some 474 RTAs, counting goods and services notifications separately, have been notified to the GATT/WTO. Of these, 351 RTAs were notified under Article XXIV of the GATT 1947 or GATT 1994; 31 under the Enabling Clause; and 92 under Article V of the GATS. At that same date, 283 agreements were in force.… The overall number of RTAs in force has been increasingly [sic] steadily, a trend likely to be strengthened by the many RTAs currently under negotiations [sic]. Of these RTAs, Free Trade Agreements (FTAs) and partial scope agreements account for ninety percent, while customs unions account for ten percent...[15]

To understand the real economic effect of FTAs, it is helpful to observe the relevant statistics. The chart below reflects the growth from 2007-08 in U.S. exports to its trade agreement partners:[16]

[15] *Regional Trade Agreements*, WORLD TRADE ORG., http://www.wto.org/english/tratop_e/region_e/region_e.htm (last visited Sept. 28, 2008).

[16] *See U.S. Free Trade Agreements*, *supra* note 14 ("The United States is party to many bi-lateral and multi-lateral trade agreements. Countries with which the U.S. has active bi-lateral trade agreements include: Australia, Bahrain, Chile, Israel, Jordan, Morocco, Peru, Oman, and Singapore. The active multi-lateral trade agreements that the U.S. has signed include the North American Free-Trade Agreement and the Central America-Dominican Republic Free Trade Agreement (CAFTA-DR). The U.S. is also party to the General Agreement on Tariffs and Trade (GATT, overseen by the WTO) along with 152 other countries. U.S. trade agreements with Panama, Korea, and Columbia are pending congressional approval. The U.S. is also in negotiations on trade agreements with Malaysia, Thailand, the United Arab Emirates, and the Southern African Customs Union (SACU) which includes Botswana, Lesotho, Namibia, South Africa, and Swaziland.").

As the chart above clearly demonstrates, FTAs can help increase trade between nations. Thus, it is necessary to promote the further extension of FTAs to drive economic development in the global community. To promote FTAs, International organizations should make an effort to build up a system of legal rules that will help break down trade barriers.

b) Extension of Tax Treaties

Presumably, the promulgation of FTAs will result in more cross-border transactions between states and consequently increase global wealth. However, even though states execute FTAs, such execution might result in the taxation of cross-border transactions by each state. In this double taxation scenario, FTAs may not be enough to promote increased cross-border transactions. Thus, to promote global economic development, states and international organizations should attempt to prevent instances of double taxation through tax treaties.

To illustrate how a tax treaty could help prevent double taxation of cross-border transactions, consider the following example:

Assume that a Korean multi-national enterprise (*X*) is doing business worldwide and has a branch (*Y*) in the United States. In Korea, *X* earns the Korean source a taxable income of $200,000 and *Y* earns the U.S. source a taxable income of $200,000. Assume further that the Korean income tax rate is thirty percent and U.S. income tax rate is thirty percent.

Thus, *X* pays a tax of $120,000 [($200,000[17] + $200,000[18]) x 30%] to the Korean government, and *Y* pays a tax of $60,000 ($200,000[19] x 30%) to the U.S. government. So, the total income tax paid by both *X* and *Y* is $180,000 and the net income of both *X* and *Y* is $220,000 [($200,000 + $200,000) – $180,000].

However, if the Korean government allows *X* a foreign tax credit of $60,000 against the income tax paid to the U.S. government by *Y* under the Korea-U.S. Tax Treaty, the total income tax paid by both *X* and *Y* is $120,000 [($200,000 + $200,000) x 30% + $60,000[20] - $60,000[21]], and the net income of both *X* and *Y* is $280,000 [($200,000 + $200,000) - $120,000]. This foreign tax credit of $60,000 against the U.S. source income protects *X* from "double taxation" on the U.S. source income.

As demonstrated above, if this credit were not in place, *X* and *Y* would pay 60% (30% + 30%) of income tax on the U.S. source income of $200,000, and such double taxation would hinder cross-border transactions. Therefore, to drive global economic development, it is crucial that the global community promote the extension of a network of tax treaties to eliminate double taxation of cross-border transactions.[22]

c) Taxing Rights

While extending FTAs, promoting a network of tax treaties, and building up a legal structure to promote growth in the global economy is important, another problem remains. Where free trade increases by eliminating trade barriers, disputes between trading states over taxing rights are likely to become very heated. To solve this problem, the global community should attempt to alleviate taxing rights competition.

The right to tax is generally affected by international tax law, not domestic tax law. Thus, as trade barriers are eliminated, it is expected that each state will enlarge the scope of taxing rights by strengthening its international tax law. Today, most international tax issues (residency, permanent establishment, withholding tax on dividends, interest, royalty, capital gains, other income, etc.) are resolved through standardized tax treaties between related states. The

[17] Korean source taxable income.

[18] U.S. source taxable income.

[19] U.S. source taxable income.

[20] U.S. source tax: $200,000 x 30%.

[21] Foreign tax credit allowed by the Korean government.

[22] Tax treaties prevent both double taxation and fiscal evasion.

provisions in these tax treaties allocate rights to tax based on the type of transaction or income.

However, transfer pricing has always been a significant problem in the field of international tax law. Because tax treaties do not normally address the tax issues related to transfer pricing, states generally rely on their domestic tax law or refer to OECD transfer pricing guidelines to resolve transfer pricing matters. Moreover, because dealing with transfer pricing requires a detailed analysis of many variables (e.g. function, risk burden, market circumstance, and character of goods or services), it is not easy to find a solution that will satisfy both taxpayers and governmental tax authorities. Because of these complexities, transfer pricing is becoming a large-scale problem in the global community. When one state tries to unreasonably exercise its taxation rights to secure additional fiscal revenue, the situation becomes even more aggravated. Thus, it is imperative that global organizations and the global community attempt to address this growing and complex problem.

i) Transfer Pricing Affecting Taxing Rights

States that execute FTAs will likely see their customs revenue gradually decline and eventually disappear. Accordingly, as the level of international trade increases, these states will likely exert greater effort to secure fiscal revenue through strengthening taxation rights. This would result in severe competition among states to tax international transactions. In particular, competition for taxing rights would likely lead tax authorities to increase their scrutiny of transactions between multinational enterprises and their foreign subsidiaries (i.e. transfer pricing). To illustrate why this would be the likely outcome, consider the following example:

Assume that an automobile manufacturing parent company (*A*) located in the U.S. conducts sales activities through a wholly-owned subsidiary (*B*) in Korea. *A* manufactures a model of car (*X*) in the U.S. and sells them to *B* in an arm's length transaction for 40 million South Korean Won (KRW). Further assume that, *A* incurs a cost of 30 million KRW to manufacturer *X* and that *B* sells *X* in Korea for 50 million KRW.

If no other expenses are incurred, *A* and *B* will each realize 10 million KRW in profit from each car sold,[23] and therefore must report this amount to the Korean and U.S. governments. If we assume that the tax rate is 35% in the U.S. and 30% in Korea, *A* must pay the U.S. government a tax of 3.5 million KRW per car (10 million KRW

[23] *A*'s earnings = 40 million KRW – 30 million KRW. *B*'s earnings = 50 million KRW – 40 million KRW.

x 35%), and *B* must pay the Korean Government a tax of 3 million KRW per car (10 million KRW x 30%).

Since *B* was established based on Korean business law, it is an entity legally independent and separate from *A*, which was established pursuant to U.S. business law. However, since *B* deals only with goods manufactured by *A* and is under the control of *A* with respect to business activities in Korea, both can be economically considered as one integrated entity. As such, even if *A* determines to sell the car to *B* at a price exceeding the arm's length price of 40 million KRW, *B* could not object to this determination. Thus, if *A* transacts with *B* at 43 million KRW per car, *A* will realize 13 million KRW of profit on each car whereas *B* will only realize 7 million KRW of profit on each car. Accordingly, for each car sold, *A* will pay 4.55 million KRW in taxes[24] to the U.S. government, while *B* will pay 2.1 million KRW in taxes[25] to the Korean government.

	***A*'s tax payment to the U.S. government**	***B*'s tax payment to the Korean government**
Trade at arm's length	3,500,000 KRW	3,000,000 KRW
Trade at non-arm's length	4,550,000 KRW	2,100,000 KRW
Difference	+ 1,050,000 KRW	- 900,000 KRW

Therefore, at a selling price of 43 million KRW per car, the U.S. government will collect an additional 1.05 million KRW in tax per car, while the Korean government loses 0.9 million KRW in tax per car. Where 100,000 *X* model cars are sold at non-arm's length price, the tax loss of the Korean government would be 90 billion KRW (900,000 KRW x 100,000 cars). Thus, to prevent great financial loss to governments, each state would be highly incentivized to try and secure its taxation rights by scrutinizing intra-company transactions of multinational enterprises.

ii) Equity of Taxing Rights between States

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[24] 13 million KRW x 35%.
[25] 7 million KRW x 30%.

The role of a state's tax authority must change as globalization increases. Although tax authorities traditionally focus on maintaining fairness among individual taxpayers, as globalization increases, tax authorities should also strive to maintain fairness among taxing rights of the states. To aid states with this additional burden, the global community must promote the research and development of a system designed to maintain equity, not only between individual taxpayers, but between states as well. This system will require tax authorities to shift their approach to tax issues, primarily from a micro-perspective to a macro-perspective.[26]

The general principle for determining taxpayer fairness is fairly simple: taxpayers who have the same income bear the same tax burden. However, the general principle for determining fairness between states is slightly more complex: a taxpayer's mixed profit earned by engaging in cross-border transactions with related overseas parties should be allocated to each state based largely on the function performed and risk burden assumed by the taxpayer in each state.[27] Because this is a transfer pricing issue, the market conditions and the character of goods or services can be considered when necessary.

For example, a taxpayer in State *A* engaging in a cross-border transaction with related overseas parties located in States *B* and *C*, realizes 100 million USD of mixed profit in these three states. The taxing rights on this mixed profit should be allocated to *A*, *B,* and *C* on the basis of the function performed and risk burden assumed by the taxpayer in *A*, *B,* and *C*.[28] Otherwise, the door is open for manipulating and infringing upon the taxing rights of each state. Consequently, the global community must pay more attention to the fairness of taxing rights between states by developing more reasonable allocation rules based on function and risk burden.

iii) Abstention from Unreasonable Exercise of Taxing Rights

In cross-border transactions, when one state exercises its taxing rights unreasonably, it infringes upon the taxing rights of another state. To illustrate, recall the transfer pricing example above where

[26] *See* Sung-Soo Han, Strategic Approach toward the Amendment of the Korea-U.S. Tax Treaty 41 (2008) (unpublished Ph.D. Thesis, University of Seoul), *available* at http://works.bepress.com/cgi/viewcontent.cgi?article=1009&context=sung_soo_han (in Korean only).

[27] Every transaction between related parties, including those involving goods, services, interest, royalties, etc., can produce a mixed profit.

[28] Taxpayers normally pay taxes to the government as consideration for protection of their business activities. If a multinational enterprise doing world-wide business realized $100,000 of mixed profit in countries *A*, *B*, and *C*, and it incurred $20,000 in expenses in *A* (reflecting its function and risk burden), $30,000 of expenses in *B*, and $50,000 of expenses in C, it would be reasonable that $100,000 in mixed profits be allocated to *A*, *B*, and *C* based on their expenses as follows: $20,000 [$100,000 x $20,000 / ($20,000 + $30,000 + $50,000)] to *A*, $30,000 to *B*, and $50,000 to *C*.

we assumed that the arm's-length price between A and B for one model X car was 40 million KRW. In that example, what if the U.S. tax authority argued that A should have sold model X cars to B at the greater-than-arm's-length price of 43 million KRW, and then unilaterally exercised its taxing rights on that basis? The likely result would be a unilateral infringement upon the taxing rights of the Korean tax authority.

Additionally, multinational enterprises performing cross-border transactions might manipulate the transaction price with related overseas parties (such as their subsidiaries) to reduce their overall tax burden. Since this type of price manipulation affects the taxing rights of states, tax authorities will generally scrutinize cross-border transactions of multinational enterprises. However, even when multinational enterprises believe that their cross-border transactions were conducted at an arm's-length price, a states' tax authority may not always acknowledge the transaction price determined by these multinational enterprises during a tax audit. Accordingly, multinational enterprises are normally uncertain as to what tax authorities will determine is the arm's-length price.

Thus, states that unreasonably exercise their taxing rights, and consider only their own fiscal revenue, often harm multinational enterprises. Accordingly, states should abstain from the unreasonable exercise of their taxing rights and the global community should promote bilateral or multilateral Advance Pricing Agreements (APAs) and introduce much clearer transfer pricing rules such as "adjustment on the uncontrolled effect of foreign exchange rate," and the "use of multiple year data," discussed below.

iv) Promotion of Advance Pricing Agreements

It is in a taxpayer's best interest to enter into bilateral or unilateral APAs. Entering into APAs with tax authorities can prevent transfer pricing audits and therefore can protect a taxpayer from unreasonable transfer pricing adjustments. However, problems arise where there is no tax treaty between two related states. Without a tax treaty, it is impossible to execute a bilateral APA to prevent unreasonable transfer pricing adjustments from either or both tax authorities. Of course, even in the absence of a tax treaty, it is possible for a taxpayer to execute a unilateral APA with one state's tax authority. Though, a unilateral APA would not protect a taxpayer from a transfer pricing adjustment instigated by another state. Thus, to further the development of the global community, countries must promote bilateral APAs. But, because bilateral APAs are only possible where there is a tax treaty, the global community should first promote the extension of a network of tax treaties.

Nonetheless, transfer pricing is an issue best settled by tax authorities, rather than taxpayers, since transfer pricing affects the taxing rights of each state. From the standpoint of a taxpayer, it does not matter whether one state imposes more taxing rights than another state as long as the taxpayer's overall tax burden is the same. To illustrate, consider the following example:

Assume that a U.S. company (*A*) sells a car (*X*) to its Korean branch (*B*) at 40 million KRW. Its manufacturing cost in the U.S. market is 30 million KRW, and the selling price in the Korean market is 50 million KRW. Also, assume that both the U.S. and Korean income tax rates are 30%. Assuming that there are no other expenses related to this transaction, *A* would realize 10 million KRW (40 million KRW – 30 million KRW) in income and *B* would realize 10 million KRW (50 million KRW – 40 million KRW) in income. The combined income tax paid by both *A* and *B* would be 6 million KRW [(10 million KRW + 10 million KRW) x 30%].[29]

Now suppose that *A* sells *X* to *B* at 45 million KRW. As a result, *A* would realize 15 million KRW (45 million KRW – 30 million KRW) in income, and *B* would receive 5 million KRW (50 million KRW – 45 million KRW) in income. Here, the total income tax paid by both *A* and *B* is 6 million KRW [(15 million KRW + 5 million KRW) x 30%], which is the same as the above example.

Thus, if the total tax burden is the same, there is no reason a taxpayer would manipulate the transfer price between related parties. Nevertheless, this issue is still relevant for taxpayers because they could face unreasonable transfer pricing adjustments where two tax authorities have different tax arrangements. This serves to support the concept illustrated above that transfer pricing is an issue that should be managed and resolved by the relevant states' tax authorities rather than by taxpayers. In other words, tax authorities should pay more attention to the transfer pricing issue than taxpayers and should actively seek out and execute, at its own expense, bilateral or multilateral APAs with other contracting states.

The APA statistics for Korea, which introduced a transfer pricing regime in 1996, are as follows[30]:

[29] For simplicity, an explanation of foreign tax credits is omitted.

[30] S.Kor. Nat'l Tax Serv., APA ANNUAL REPORT (2008) (on file with author).

	Unilateral APA			Bilateral APA			Total		
	Received	Processed	Pending	Received	Processed	Pending	Received	Processed	Pending
2002	9		9	24	10	14	33	10	23
2003	3	2	10	4	3	15	7	5	25
2004	6	7	9	10	3	22	16	10	31
2005	15	4	20	10	3	29	25	7	49
2006	12	8	24	12	16	25	24	24	49
2007	19	13	30	13	7	31	32	20	61
2008	13	16	27	22	14	39	35	30	66
Total	77	50		95	56		172	106	

The APA statistics for Japan, which introduced a transfer pricing regime in 1986, are as follows[31]:

	By 2004	By 2005	By 2006	By 2007	By 2008
Applied	51	76	92	93	111
Completed	34	32	72	70	70
Carried-over	160	204	224	247	288

Considering the number of APA renewals and the number of multinational enterprises in existence, the APA statistics above indicate that administration and utilization of APAs is now more important than ever.

v) Uncontrolled Effect of Foreign Exchange Rate

Every cross-border transaction is affected by foreign exchange rates. Foreign exchange rates can affect the appropriateness of transfer pricing methodologies. Because transfer pricing affects the taxing rights of each state, and the appropriateness of transfer pricing

[31] Data provided by Kazufumi Limori in presentation at IFA China, Japan and Korea Tax Conference, in Seoul, Korea (May 19 - 20, 2010) (on file with author).

between related parties is determined by an arm's-length price, it is necessary to determine an arm's-length price. If an arm's-length price could be accurately determined, it would not be difficult to maintain fair taxing rights between related states.

The 2009 OECD transfer pricing guidelines describe various transfer pricing methods, including traditional transaction methods and transactional profit methods. Traditional transaction methods include the "comparable uncontrolled price method" (CUP), "resale price method," and "cost plus method." Transactional profit methods include the "profit split method" and "transactional net margin method" (TNMM).[32]

According to the OECD guidelines, in order to use any of the traditional transaction methods, one of the following two conditions must be met: "(1.) none of the differences (if any) between the transactions being compared or between the enterprises undertaking those transactions [can] materially affect the price in the open market; or (2.) reasonably accurate adjustments can be made to eliminate the material effects of such differences."[33]

Conversely, the transactional profit method does not require any conditions to be met. The transactional profit method, as mentioned above, is divided into two methods: (1) the profit split method and (2) the transactional net margin method. "One strength of the profit split method is that it generally does not rely directly on closely comparable transactions, and it can therefore be used in cases when no such transactions between independent enterprises can be identified."[34] The strength of the transactional net margin method is that "net margins (*e.g.* return on assets, operating income to sales, and possibly other measures of net profit) are less affected by transactional differences than is the case with price, as used in the CUP [m]ethod."[35]

In reality, it is practically impossible to compare companies doing identical or substantially similar transactions in terms of function, risk burden, and character of goods or services. For this reason, the transactional profit method is used more frequently than the traditional transaction method to allocate the taxing rights of each country. In addition, because the transactional profit method normally allows a certain level of taxing rights, tax authorities tend to

[32] *See* ORG. FOR ECON. CO-OPERATION & DEV., TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS 52-65, 68-81 (2009), http://browse.oecdbookshop.org/oecd/pdfs/browseit/2309111E.PDF [hereinafter 2009 TRANSFER PRICING GUIDELINES].

[33] *Id.* at 53, 55, 60.

[34] *Id.* at 69.

[35] *Id.* at 75.

prefer this method, unless, of course, the traditional transaction method allows for more taxing rights.

Although each state's tax authority prefers the transactional profit method for the more convenient transfer pricing administration that it provides, changes in foreign exchange rates, which cannot be controlled by a taxpayer, can negatively affect the appropriateness of this method unless a proper foreign exchange rate adjustment is made. Foreign exchange rates can, of course, also affect the appropriateness of using other transfer pricing methodologies, such as the comparable uncontrolled price method, the resale price method, and the cost plus method. In other words, since foreign exchange rates affect every cross-border transaction, it must be studied very closely and objectively in order to prevent arbitrary taxation. Since the transactional net margin method (TNNM) is perhaps the most frequently used method, the effects of foreign exchange rates under this method as well as a reasonable approach to countering these effects are discussed below.[36]

(1) Change of Import Price and Profit

As stated above, a change in foreign exchange rates can greatly affect the international price of goods. Furthermore, because a private enterprise cannot control changes in the foreign exchange rate, it faces unexpected profits or losses when the foreign exchange rate changes substantially. To illustrate this concept, consider the following example:

Assume that in the second half of 2007, a German company (*X*) made a business decision to sell its product (*Z*) to its Korean distributor (*Y*) at the price of 20 Euros in 2008, and that the forecasted average foreign exchange rate for 2008 is 1200 KRW per one Euro. Thus, if the foreign exchange rate does not change between 2007 and 2008, the import price paid by *Y* to *X* in the year 2008 will be 24,000 KRW (20 Euros x 1200 KRW).

However, if the foreign exchange rate increases to 1500 KRW per 1 Euro in the year 2008, the import price paid by *Y* to *X* in the year 2008 becomes 30,000 KRW (20 Euros x 1500 KRW). Thus, *Y* will pay an additional 6000 KRW (30,000 KRW – 24,000 KRW) for the goods because of the change in foreign exchange rates. Accordingly, *Y*'s operating profit decreases by 6000 KRW. Thus, variations in foreign exchange rates can greatly affect an enterprise's profit.

(2) Adjustment of Foreign Exchange Rate

[36] The same approach would be applied to other TP methodologies.

The table below shows trends in foreign exchange rates from 2002 to 2008.[37]

Foreign Exchange Rate Trend (Average Buyer's Rate / Euro: KRW)

Unit: KRW

	2002	2003	2004	2005	2006	2007	2008
Jan.	1189.69	1276.03	1522.63	1390.87	1218.58	1241.18	1413.79
Feb.	1169.53	1308.65	1503.20	1360.45	1182.77	1249.52	1423.19
Mar.	1181.80	1357.41	1458.46	1355.06	1196.16	1274.23	1549.75
Apr.	1191.46	1365.47	1408.77	1344.79	1193.16	1282.67	1585.99
May	1183.91	1419.96	1440.27	1297.13	1255.56	1279.06	1646.67
June	1192.68	1421.00	1435.31	1253.51	1232.73	1269.69	1633.60
July	1199.38	1372.22	1449.01	1274.36	1230.21	1285.10	1638.70
Aug.	1193.02	1340.64	1440.17	1279.45	1255.08	1297.71	1592.63
Sept.	1208.37	1334.89	1428.87	1287.21	1239.03	1316.88	1659.93
Oct.	1241.91	1392.66	1457.08	1283.02	1226.37	1329.20	1800.44
Nov.	1237.96	1413.08	1444.46	1253.47	1229.30	1372.38	1804.09
Dec.	1254.77	**1439.15**	1436.62	1238.19	1247.12	1382.21	**1882.82**
% Change		**19.0%**	-0.2%	-13.82%	0.7%	10.8%	**36.22%**

The table above shows that the foreign exchange rate increased 19% from 2002 to 2003. Applying these real world numbers to our hypothetical would mean that the import price of *Y* in 2003 increased 19%, resulting in a significant decrease in *Y*'s operating margin.[38] Accordingly, if *Y*'s operating margin decreases solely because of an increase in the foreign exchange rate, bringing it out of an arm's-length range under TNMM, the negative effect on operating margin

[37] KOREA EXCHANGE BANK, http://www.keb.co.kr/IBS/goContents.jsp?co (last visited Feb. 18, 2011). Note that the fluctuation rate is based on the rate in December of the previous year.

[38] Since the foreign exchange rate increased 36.22% in 2008 compared to 2007, it would result in a larger decrease in *Y*'s operating margin.

caused by the change of foreign exchange rate should be adjusted through transfer pricing. To illustrate, consider both the above and the table below, which lists the operating margins for a hypothetical target company as well as the arm's-length range for operating margins of several comparable companies:[39]

	2002	**2003**	**2004**	**2005**	**2006**	**Average**
Upper quartile	8.385%	9.683%	3.823%	6.658%	8.613%	**7.726%**
Median	5.004%	8.076%	3.501%	4.555%	6.673%	**6.056%**
Lower quartile	2.928%	5.648%	2.095%	3.053%	4.558%	**3.223%**
Target company	4.136%	3.170%	4.622%	8.017%	7.275%	**5.444%**

In 2003, for example, the foreign exchange rate increased 19% and affected the import price and thus the operating margin of the target company. In fact, the target company's operating margin in 2003 (3.170%) is lower than the arm's-length range during that same year (5.648%~9.683%). If the foreign exchange rate had not increased 19% in 2003, the target company's operating margin would have been within the arm's arm's-length range.

Furthermore, observe that the target company's operating margins in fiscal years 2004 and 2005 exceeded the upper quartile of an arm's-length range. It would be very unreasonable and unfair if a tax authority only made a transfer pricing adjustment in 2003. Accordingly, in terms of transfer pricing, a tax authority should adjust the operating margin of the target company in each year by eliminating the amount of profit/loss caused by fluctuations in foreign exchange rates that are beyond the arm's-length range.

Of course, if fluctuations in foreign exchange rates affect the operating margins of a target company and comparable companies to the same degree, it would not be necessary to adjust the operating margin of the target company. The foreign exchange rate should be adjusted only when it would lead to a more reasonable result.[40] Adjusting transfer pricing without adjusting the foreign exchange

[39] The statute of limitations on tax audits is normally five years in Korea. Thus, the tax authority scrutinizes five-year data at the time of a TP audit.

[40] Since the facts and circumstances surrounding each company's transactions differ, the foreign exchange adjustment should be made in the most reasonable way—on a case-by-case basis.

rate would result in an arbitrary double taxation. Because OECD transfer pricing guidelines do not currently have a clear rule pertaining to the effects of foreign exchange rate fluctuations, the OECD should consider introducing such a transfer pricing rule to prevent unilateral and arbitrary TP adjustment.

(3) Use of Multi-Year Data

Information pertaining to foreign exchange rate adjustments is often not available because there is no readily accessible data showing the effect of foreign exchange rates on comparable companies. Under such circumstances, it is best to use multiple year data to determine the appropriateness of transfer pricing. Furthermore, foreign exchange rates are often cyclical—that is, they move up and down over the years. A portion of the table above, entitled "Foreign Exchange Rate Trend (Average Buyer's Rate / Euro: KRW)," has been inserted below to show the cyclical nature of exchange rates.

	2002	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**
% Change		**19.0%**	-0.2%	-13.82%	0.7%	10.8%	**36.22%**

The Foreign Exchange Rate Trend table excerpt above shows that, although the target company's operating margin in the year 2003 is below the arm's length range, its operating margins in the year 2004 and the year 2005 exceed the arm's length range. As a result, its five-year average operating margin is within the arm's length range, and therefore it would not be reasonable to make an additional adjustment in 2003. Thus, because foreign exchange rates are often cyclical, it is crucial that tax authorities us multi-year data when reviewing the appropriateness of transfer pricing arrangements.

OECD Transfer Pricing guideline 3.44 states:

> Multiple year data should be considered in the transactional net margin method for both the enterprise under examination and independent enterprises to the extent their net margins are being compared, to take into account the effects on profits of product life cycles and short term economic conditions. For example, multiple year data could show whether the independent enterprises that engaged in comparable uncontrolled transactions had suffered from the effects of market conditions in the same way and over a similar period as the

> associated enterprise under examination. Such data could also show whether similar business patterns over a similar length of time affected the profits of comparable independent enterprises in the same way as the enterprise under examination.[41]

Unfortunately, the abstract nature of this rule makes it hard to apply or understand, and leads to controversy regarding its construction. Moreover, the tendency of some tax authorities to treat this rule merely as a non-mandatory guideline further complicates the issue. Thus, the OECD should clarify this rule to make it more effective.

vi) Prevention of Tax Avoidance Through Roundabout Transactions

As discussed earlier, the competition for taxing rights between related states could increase once trade barriers are eliminated. The global community should take a systematic approach to prevent the discouragement of cross-border transactions that can result from competition over taxing rights between states. In addition, to prevent double taxation and tax avoidance tactics, each state should actively create new tax treaties or supplement existing tax treaties.

A large part of the problem occurs when taxpayers engaged in cross-border transactions infringe upon the taxation rights of related states by shopping for loopholes in tax treaties. Treaty shopping is performed through roundabout transactions, which frustrate the intended equality of taxing rights between partners. Thus, it is imperative that the global community establish a common set of rules to prevent these kinds of roundabout transactions.

Comments to Article 1 of the 2008 OECD Model Tax Convention on Income and on Capital recommend various rules to prevent the improper use of the Convention.[42] These rules include:

i) provisions aimed at conduit companies,
ii) provisions aimed at entities benefiting from preferential tax regimes,
iii) provisions aimed at particular types of income,
iv) anti-abuse rules dealing with source taxation of specific types of income, and

[41] 2009 TRANSFER PRICING GUIDELINES, *supra* note 32, at 80.

[42] ORG. FOR ECON. CO-OPERATION & DEV., MODEL TAX CONVENTION ON INCOME AND ON CAPITAL (CONDENSED VERSION) 45-63 (2008), http://www.oecd.org/dataoecd/14/32/41147804/pdf [hereinafter COMMENTARY TO MODEL TAX CONVENTION].

v) provisions aimed at preferential regimes introduced after the signature of the convention.

The global community should pay special attention to roundabout transactions performed through "conduit companies." Roundabout transactions result in an infringement of the taxation rights of treaty partners not intended by the parties to the treaty. Every state should implement a legal system to prevent such tax avoidance strategies.

(1) Example of Roundabout Transactions Used for Tax Avoidance[43]

[Issue]: Does the recipient of interest (*X*) in the following scenario qualify as a "beneficial owner of interest"?

[Facts]: Due to the Korean financial crisis in 1997, a Korean multinational company (*A*) decided to sell its Korean subsidiary (*B*), Chinese subsidiaries (*C* and *D*), and a U.S. subsidiary (*E*) to a U.S. fund.

The U.S. fund established *X* corporation in Hungary, *Y* corporation in Luxembourg, *Z* corporation in the British Virgin Islands and then provided the funding necessary for the operation of these corporations.

Z borrowed $300 million from a U.S. investment bank and loaned or invested it as follows:

- Capital investment to *X*: $29 million
- Capital investment to *Y*: $15,000
- Loan to *Y*: $116 million
- Loan to another British Virgin Islands company: $121 million
- Loan to *C* and *D*: $34 million

Subsequently, *Y* loaned the $116 million borrowed from *Z* to *X*, and *X* loaned $145 million ($116 million borrowed from *Y* with the $29 million invested from *Z*) to *B* (the Korean subsidiary)—the above transactions taking place almost simultaneously.

According to the loan agreement between *X* and *B*, *B* paid 11.72% of interest to *X*, whereas *X* paid 11.47% of interest to *Y*. Thus, *X* realized the 0.25%[44] difference as profit. Altogether, *X* realized i) $3,398,800[45] in income by loaning its own capital to *B*,

[43] *Id.*
[44] 11.72% less 11.47%.
[45] $29,000,000 x 11.72%.

and ii) $290,000[46] in income by loaning the funds borrowed from *Z* to *B* every year. *X* paid a 3% corporate tax on its income to the Hungarian government.

[Position of Korean tax authority]: Since *X* is a mere conduit company, *X* cannot enjoy the benefit of Article 11 of the Korea-Hungary Tax Treaty[47]. Therefore, Article 13 of the Korea-U.S. Tax Treaty should apply where a beneficial owner of interest resides, and *B* is obligated to withhold a 12% tax from the interest amount paid to *X*.[48]

(2) Anti-avoidance Rule

If there is no clear anti-avoidance rule preventing roundabout transactions, taxpayers will continue to exploit this loophole in tax treaties to avoid taxes. Further, the absence of a clear anti-avoidance rule greatly increases the likelihood of tax disputes between taxpayers and tax authorities due to the ambiguity of the rule. Thus, if anti-tax avoidance rules are not universally applied, it will be impossible to prevent tax avoidance through roundabout transactions.

- Introduction of Anti-avoidance Rules into Domestic Tax Law -

As illustrated above, tax avoidance through roundabout transactions is possible by taking advantage of loopholes in tax treaties with third party states. In other words, even if a treaty signed between two states has no loophole that would permit tax avoidance tactics, an enterprise may still avoid payment of taxes and circumvent the treaty by exploiting loopholes extant in other treaties with third party states. Therefore, a state that wants to prevent tax avoidance should insert an anti-avoidance rule in its tax treaty with every related and third party state. Even if only one tax treaty has a loophole, this loophole can circumvent every other tax treaty that does not have one.

For example, although Korea has executed seventy-three tax treaties to date, if there is a loophole in one tax treaty (such as in the Hungary example above), this loophole can incapacitate the Korea-U.S. Tax Treaty as well as other Korean tax treaties. Therefore, as illustrated by this example, the Korean tax authority needs a unified

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[46] $116,000,000 x 0.25(11.72-11.47).

[47] *See* Korea-Hungary Tax Treaty art. 11, para. 1, Kor.-Hung., Mar. 29, 1989 (providing that "Interest arising in a Contracting State and paid to a resident of the other Contracting State shall be taxable only in that other State.").

[48] *See id.* at art. 11, para 1, 2. ("Paragraph 1: Interest derived from sources within one of the Contracting States by a resident of the other Contracting State may be taxed by both Contracting States. Paragraph 2: The rate of tax imposed by one of the Contracting States on interest derived from sources within that Contracting State by a resident of the other Contracting State shall not exceed 12 per cent of the gross amount.").

tax treaty policy in order to prevent tax avoidance through roundabout transactions. However, because it is not practical to amend all existing tax treaties at the same time, it is necessary to introduce anti-avoidance rules into domestic tax laws. The OECD has stated that anti-tax avoidance provisions in international tax treaties allow for such domestic anti-avoidance rules.[49]

- Beneficial Owner Rule of the U.S.-Japan Tax Treaty -

Anti-avoidance rules must be drafted clearly for both tax authorities and taxpayers. If not, unnecessary disputes between tax authorities and taxpayers can arise. The U.S.-Japan Tax Treaty, revised on November 6, 2006, introduced the "clear beneficial owner" rule to prevent roundabout transactions in relation to the payment of dividends (Article 10), interest (Article 11), royalties (Article 14), and other income (Article 21).[50] Paragraph 11, Article 11 of the U.S.-Japan Tax Treaty provides:

> A resident of a Contracting State shall not be considered the beneficial owner of interest in respect of a debt-claim if such debt-claim would not have been established unless a person:
>
> (a) that is not entitled to benefits with respect to interest arising in the other Contracting State which are equivalent to, or more favorable than, those available under this Convention to a resident of the first-mentioned Contracting State; and
>
> (b) that is not a resident of either Contracting State; held an equivalent debt-claim against the first-mentioned resident.[51]

[49] *See* COMMENTARY TO MODEL TAX CONVENTION, *supra* note 42, at 49, 58 (Commentary 9.2 provides, "[T]o the extent these anti-avoidance rules are part of the basic domestic rules set by domestic tax laws for determining which facts give rise to a tax liability, they are not addressed in tax treaties and are therefore not affected by them. Thus, as a general rule, there will be no conflict between such rules and the provisions of tax conventions." Commentary 9.4 provides, "Under both approaches, therefore, it is agreed that States do not have to grant the benefits of a double taxation convention where arrangements that constitute an abuse of the provisions of the convention have been entered into." Finally, commentary 22.1 provides, "Such rules are part of the basic domestic rules set by domestic tax laws for determining which facts give rise to a tax liability; these rules are not addressed in tax treaties and are therefore not affected by them.").

[50] *See* Convention between the Government of the United States of America and the Government of Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.-Japan Tax Treaty, U.S.-Japan, arts. 10, 11, 14, 21, Nov. 6, 2006, http://www.irs.gov/pub/irs-trty/japan.pdf [hereinafter U.S.-Japan Tax Treaty].

[51] U.S.-Japan Tax Treaty, *supra* note 50, at art. 11, para. 11. *See also* U.S. DEP'T OF THE TREASURY, TECHNICAL EXPLANATION OF THE CONVENTION BETWEEN THE UNITED STATES

The operation of this rule can be illustrated by the following example:

A, a U.S. resident, holds a debt-claim against *X*, a Japanese company which entitles *A* to interest of 10x each year. *B*, a resident of a third country that does not have a tax treaty with Japan, holds a debt-claim against *A* that entitles *B* to interest of 10x each year and otherwise has terms that are equivalent to the terms of the debt-claim held by *A*. Furthermore, *A* would not have an established debt-claim against *X* if *B* did not hold a debt-claim against *A*. *X* pays interest of 10x to *A*, who then pays interest of 10x to *B*. Under paragraph 11, *A* will not be considered the beneficial owner of the interest from *X*, and is therefore not entitled to treaty benefits with respect to the interest from *X*.[52]

If this kind of clear anti-avoidance rule is introduced into all tax treaties or domestic tax laws, it is possible to prevent tax avoidance activities through roundabout transactions. For instance, if this rule was applied to the Hungary example above, *X* would not be a beneficial owner of interest since *X* just passed on to *B* the $116 million borrowed from *Y*.

- Limitation on Beneficial Owner Rule of the U.S.-Japan Tax Treaty -

In addition to the beneficial owner rule, the U.S.-Japan Tax Treaty, revised on November 6, 2006, introduced the "limitation on benefits" (LOB) rule.[53] Paragraph 1, Article 22 of the U.S.-Japan Tax Treaty provides:

AND JAPAN FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME AND ON CAPITAL GAINS, SIGNED AT WASHINGTON NOVEMBER 6, 2003 55 (2004), http://www.irs.gov/pub/irs-trty/japante04.pdf.

[52] *See* Technical Explanation of the Convention Between the United States and Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains, U.S.-Japan, art. 11, para. 11, Nov. 6, 2003. [hereinafter Technical Explanation Between the U.S. and Japan], http://www.ustreas.gov/press/releases/reports/tejapan04.pdf.

[53] *See* U.S.-Japan Tax Treaty, *supra* note 50, at art. 22 and Technical Explanation between the U.S. and Japan, *supra* note 52, at art.22, para. 1 (explaining the purpose of limitation on benefits provisions such as Article 22 of the U.S.-Japan Treaty to be as follows: "The United States views an income tax treaty as a vehicle for providing treaty benefits to residents of the two Contracting States. The proper operation of a treaty requires that it apply to those that are *bona fide* residents of one of the Contracting States for the purpose of being granted treaty benefits. This principal [sic] has long been recognized. For example, the Commentaries to the OECD Model authorize a tax authority to deny treaty benefits, under substance-over-form principles, to a nominee in one Contracting State deriving income from the other on behalf of a third-country resident. In addition, although the text of the OECD Model does not contain express anti-abuse provisions, the Commentary to Article 1 contains an extensive discussion regarding the appropriateness of such provisions in tax treaties in order to limit the ability of third state residents to obtain treaty benefits. The United States holds strongly to the view that tax treaties should include provisions that specifically prevent misuse of treaties by residents of third countries. Consequently, all recent U.S. income treaties contain comprehensive Limitation on Benefits provisions.").

> Except as otherwise provided in this Article, a resident of a Contracting State that derives income from the other Contracting State shall be entitled to all the benefits accorded to residents of a Contracting State for a taxable year by the provisions of other Articles of this Convention only if such resident satisfies any other specified conditions for the obtaining of such benefits and is either:
>
> (a) an individual;
>
> (b) a Contracting State, any political subdivision or local authority thereof, the Bank of Japan or the Federal Reserve Banks;
>
> (c) a company, if:
>
> (i) the principal class of its shares, and any disproportionate class of its shares, is listed or registered on a recognized stock exchange specified in clause (i) or (ii) of subparagraph (b) of paragraph 5 and is regularly traded on one or more recognized stock exchanges; or
>
> (ii) at least 50 percent of each class of shares in the company is owned directly or indirectly by five or fewer residents entitled to benefits under clause (i), provided that, in the case of indirect ownership, each intermediate owner is a person entitled to the benefits of this Convention under this paragraph.[54]

[54] U.S.-Japan Tax Treaty, *supra* note 50, at art. 22 (explaining further that the remainder of U.S.-Japan Treaty Article 22 limitation on benefits provision reads, "(d) a person described in subparagraph (c) of paragraph 1 of Article 4;

> (e) a pension fund, provided that as of the end of the prior taxable year more than 50 percent of its beneficiaries, members or participants are individuals who are residents of either Contracting State; or (f) a person other than an individual, if: (i) residents that are described in subparagraph (a), (b), (d) or (e), or clause (i) of subparagraph (c), own, directly or indirectly, at least 50 percent of each class of shares or other beneficial interests in the person, and (ii) less than 50 percent of the person's gross income for the taxable year is paid or accrued by the person in that taxable year, directly or indirectly, to persons who are not residents of either Contracting State in the form of payments that are deductible in computing its taxable income in the Contracting State of which it is a resident (but not including arm's length payments in the ordinary course of business for services or tangible property and payments in respect of financial obligations to a

What happens if the Korean tax authority introduces this LOB rule into all tax treaties and domestic tax laws? If we assume that the Korea-Hungary Tax Treaty has this LOB rule and it can be applied to the Hungary case above, *X* falls within the definition of a corporation provided in Subparagraph (c), Paragraph 1 of Article 22. However, since the shares of *X* are owned 100% by *Y* and are not listed or registered on a recognized stock exchange, it cannot satisfy the requirements of (c)(i). In addition, it cannot satisfy the requirements of (c)(ii) since *X*'s shares are not directly or indirectly owned by five or fewer Hungarian residents. Therefore, *X* is not entitled to the benefits of the Korea-Hungary Tax Treaty. Therefore, to prevent tax avoidance through roundabout transactions, it is necessary to introduce clear anti-avoidance rules into all tax treaties or domestic tax laws.

2) From the Regulatory Perspective

The global financial and economic crisis of 2008 was a result of the U.S. subprime mortgage loan debacle that drove many financial institutions to bankruptcy and crippled the global economy. To revive a badly ailing economy, the U.S. Democrat-controlled House of Representatives approved a historically large $819 billion stimulus bill on January 28, 2009, which focused on increased spending and tax cuts. Some commentators now say that the U.S. government should have instead focused on regulating the reckless economic practices that led to the disaster.[55]

Today, the economic activities of the global community are more closely integrated than ever. Thus, an ailing economy in one state can easily spread to other states—the larger the economic ailment, the larger the global effect. The U.S. subprime mortgage loan crisis is an excellent example of the degree to which the global economy is connected. Thus, the global community has a responsibility to pay close attention to the issue of global economic integration when considering economic development.

From a legal perspective, there should not be a substantial difference between regulating the global community and regulating an individual state in terms of preventing undesirable business activities. The section below will discuss the topic of global economic regulation from Korea's perspective. However, instead of taking a case-by case approach to global regulatory analysis (which is the approach recommended for global regulators since different

commercial bank, provided that where such a bank is not a resident of a Contracting State such payment is attributable to a permanent establishment of that bank situated in one of the Contracting States.").

[55] *See* Anthony Faiola et al., *What Went Wrong?*, WASH. POST, Oct. 15, 2008, at A01.

business areas require individually tailored rules), this Article will focus on general principles for establishing regulation. For this reason, the discussion of global economic regulation below is focused on ascertaining and regulating problematic activities in terms of social benefit, social expense, and corruption.

a) Regulation and Policy[56]

Our society is filled with regulation and the amount of regulatory oversight seems to increase as society develops. Because regulatory laws affect individuals and their activities, they make up a large and essential part of national policy. The Korean Basic Law for Administrative Regulation, Subparagraph 1, Paragraph 1, Article 2, explains that the term "administrative regulation" refers to what is provided in laws, municipal ordinances, and rules to restrain the rights of the people and to impose responsibility upon the people so that a nation or a local autonomous authority may achieve a specific administrative purpose. Thus, according to the Korean Basic Law for Administrative Regulation, everything that has an effect on the lives of the people comes under the term "regulation."

To illustrate how regulations affect the lives of people, consider the following example: A person wanting to work in the intercity bus transportation business needs to receive a license from the Minister of Transportation. Moreover, a person who wants to engage in other bus transportation related business must receive a license from the Governor, according to Article 6 of the Automobile Transportation Business Law and Article 13 of the Enforcement Ordinance of the same law. The government has placed such a regulatory burden on the passenger transportation business in order to increase its impact on the national economy and to secure a certain level of safety. However, in reality, since these regulations endow an administrative agency with significant discretion, they have distorted the market economy and have caused many problems.

Consider another example from the construction business: Pursuant to Article 5 of the Construction Business Law, the Korean government classifies construction projects as general construction, specific construction, or technical construction projects and also directly manages licensing of the construction business. From 1975 through the latter half of 1989, granting new licenses in the general construction category was prohibited. After that time, new licenses were issued every three years, removing a significant restraint on

[56] The following three sections are excerpted and adapted from SUNG-SOO HAN, ROAD TO DEMOCRATIC STATE WITHOUT CORRUPTION: REPORT BASED ON THE SYNTHETIC ANALYSIS OF LAW, TAX AND ECONOMY 50-51 (Istory Inc., 2003), http://works.bepress.com/cgi/viewcontent.cgi?article=1004&context=sung_soo_han.

competition. However, problems arose when large construction companies began setting up related companies to receive general construction licenses from the government to avoid bottom-line limitations established by the construction contract limitation system. These related companies would, in turn, participate in small scale construction to stay below the limitation.[57] Thus, as can be seen by this example, when the government retains the right to issue licenses, the market does not maintain a perfectly competitive situation and imperfect competition results. Also, the natural flow of the markets is disrupted and many problems can occur as a result.

In a perfectly competitive market, each enterprise competes with other enterprises, thus consumers can purchase goods or services at lower prices. However, governmental intervention in a market, while useful in preventing unnecessarily excessive competition, can negatively affect a market by creating imperfect competition. A government deciding whether to regulate could obtain the information necessary to establish an effective policy by comparing the economic benefits obtained through imperfect competition with those obtained through perfect competition. It is worth noting that in the early stages of economic development, imperfect competition can be economically more beneficial than perfect competition. Thus, some nations might consider setting up imperfect competition policies.

b) The Effect of Regulation[58]

This section discusses the various effects regulation may have on a society. For the purposes of this section, the term "policy" is generally defined as a set of ideas or plans that is used as a basis for making decisions, especially in politics, economics, or business. Also, for the purposes of discussion, assume that a regulation can produce three kinds of effects: (1) a "policy effect" when it produces social benefit, (2) a "non-policy effect" when it incurs social cost,[59] and (3) a "corruption effect" when it leads to corruption.[60]

Effect of Regulation	
Policy Effect: 60%	Non-policy effect: 40%

[57] JI-HONG KIM, THE COMPETITION PROMOTION OF CONSTRUCTION BUSINESS AND IMPROVEMENT OF GOVERNMENTAL REGULATION (1990) (on file with author).

[58] *See* SUNG-SOO HAN, *supra* note 56, at 51-53.

[59] This thesis evaluates "social cost" in terms of the economic efficiency of a rule and distinguishes it from corruption in terms of connection to a bribe.

[60] The following discussion assumes that the three kinds of effects can be quantified from an economic perspective.

A regulation positively influences society and becomes "good policy" where its "policy effect" (social benefit) is greater than its "non-policy effect" (social cost), as shown in the table above. Conversely, a regulation negatively influences society and becomes "bad policy" where the government decides to maintain the regulation even when its "non-policy effect" (social cost) start to outweigh its "policy effect" (social benefit).

However, in economic terms, one of the biggest regulatory consequences is corruption that results in the course of licensing. Since the right to issue a license is left to the discretion of an administrative agency, if there is no mechanism to control such discretion, the administrative agency will inevitably abuse its discretion. Moreover, where the standards for licensing become obscure, the possibility for corruption increases because administrative agencies can exert more even greater discretion. In fact, world history provides many examples of instances where illegality and corruption have damaged the fundamental structure of a national economy. Korea is one example.

Effect of Regulation		
Policy Effect (30%)	Non-policy Effect (40%)	Corruption Effect (30%)

As seen in the table above, where the non-policy effect of a regulation is 10% larger than the policy effect and its corruption effect is 30%, the aggregate negative effect on the national or global economy is 40% (10% non-policy effect + 30% corruption effect).[61] Thus, even where a regulation has a large policy effect, if the non-policy and corruption effect together are greater than the policy effect, the regulation is not desirable because the non-policy and corruption effect completely offset the policy effect.

Effect of Regulation		
Policy Effect(45%)	Non-policy Effect (25%)	Corruption Effect (30%)

[61] In reality, it would be difficult to quantify each effect. However, to facilitate discussion, each effect is stated here as a percentage.

In another example above, although the policy effect of a particular regulation is 20% greater than the non-policy effect, the regulation has an overall negative effect on society because the corruption effect is at 30%. Thus, to make the regulation desirable for society, it is necessary to strengthen the policy effect and weaken the non-policy and corruption effects. To accomplish this, the policy effect must be strengthened by thoroughly reviewing the content of a regulation and removing factors that can cause non-policy effects and the corruption effect must be weakened by bolstering the internal control system of an administrative agency.

As mentioned above, in Korea, after 1989, the government allowed new construction licenses to be issued every three years, which removed restraints on competition that existed under the old regulatory scheme. However, since then, large construction companies have illegally set up related companies to avoid the bottom-line limitation established by the construction contract limitation system and now participate in small-scale construction to stay below the limitation. In this example, if the removal of restraints on competition produces social benefits, the regulation permitting such licensing does have a policy effect. Furthermore, because large construction companies illegally participate in small-scale construction, there is a corruption effect. The Korean government could reduce this corruption effect by strengthening the internal control system of the licensing agency to strictly monitor and eliminate corrupt activities.

If a regulation has an adverse effect on society because its non-policy effect is greater than its policy effect, the problem can be solved by reducing factors producing the non-policy effect and increasing factors producing the policy effect. An additional and perhaps better option is to simply abolish the regulation altogether. However, what if a regulation, such as the one related to construction licensing, has policy, non-policy, and corruption effects all at the same time? Even if a regulation produces some corruption effect, it may not be desirable to abolish it without considering its policy effect. If a regulation has both a policy effect and a corruption effect, the government could strengthen the policy effect by merely removing the corruption effect. However, when a regulation has no policy effect and only a corruption effect, it may be best for society if the regulation were completely abolished. Finally, where the non-policy effect is greater than the policy effect and there is also a corruption effect, the policy effect can be increased by removing the corruption and non-policy effects.

How can a regulation's corruption effect be removed? Regulation-based corruption can be divided into two types. The first type is where an administrative agency has too much discretion due to the regulation's obscurity. In other words, vagueness allows for excessive discretion which ultimately leads to corruption. In this situation, discretion must be reduced to the greatest extent possible by establishing detailed and elaborate administrative rules. The second type of regulation-based corruption occurs when an administrative agency receives a bribe in violation of a regulation. In this case, an internal control system under which administrative actions can be supervised and checked must be implemented.

c) The Need for a Systematic Mechanism[62]

In Korea, when people want to engage in business, they must meet the requirements of the Fire Service Law, the Public Health Law, and any related presidential decrees and enforcement ordinances that apply to their particular place of business. These rules function as prerequisites to obtaining a business license. If these related rules are not satisfied, a business license cannot be obtained.

Naturally, because employees spend much of their time in their workplace, the safety conditions of the workplace can greatly influence the course of their lives. If an administrative agency does not properly supervise and guide the economic activities of businessmen, the possibility of dangerous conditions (e.g. fire) occurring in the workplace increases, thereby increasing the potential risk of injury or death. For this reason, administrative agencies often actively intervene in the economic activities of the people to prevent accidents from occurring.

In general, governments implement a regulation under the assumption that they will benefit people. However, problems arise when an administrative agency misuses the regulation causing the social expense of the regulation to become larger than its social benefit. When social expenses become larger than social benefits, regulations lose their value. Korea provides yet another example to illustrate this concept. In Korea, it is easier to meet the licensing requirements to conduct business for a general saloon than it is for a luxury saloon. Because of this, saloon business owners often obtain a license for a general saloon but conduct their business as a luxury saloon. Moreover, agency officers who are aware of this practice often demand bribes from the business owners in exchange for allowing their business to continue in this illegal manner. Thus, corruption often occurs in situations where a person seeking a business license does not meet the licensing requirements established by law and is thus tempted to collude with an agency officer to obtain the license. In addition, there are also instances where corruption occurs merely because regulations are so obscure that they provide

[62] *See* SUNG-SOO HAN, *supra* note 56, at 53-54.

administrative officers with significant wiggle room to arbitrarily construe licensing requirements.

Although this portion of the Article has discussed the topic of economic regulation using examples from Korea, the regulatory mechanisms and concepts discussed above can and should be applied to other countries as well as the global community at large. To effectively alleviate regulatory problems in the global community, it is imperative that the global community establish a common regulatory mechanism that will increase social benefit, decrease social cost, and eliminate corruption.

V. CONCLUSION

As the world becomes increasingly integrated through the process of globalization, it has become increasingly important and crucial to promote a global legal system and drive global economic development. To do so, countries and international organizations should promote the extension of FTAs and tax treaties, and find ways to cooperatively deal with international tax issues, such as taxation rights surrounding transfer pricing arrangements. Furthermore, economic development is best achieved by conducting business activities under a set of corresponding rules and regulations, states and international organizations should strive to establish a common regulatory mechanism that takes into account the social benefits and costs of regulatory measures, as well as the potential for corruption. The result of an international global economic and legal structure is an environment in which nation states and their citizens can enjoy economic prosperity and avoid the pitfalls of poor regulation and governance.[63]

[63] A related article written by this author will be published in the Spring 2011 issue of the *Brigham Young University International Law & Management Review.* It will focus on the role of domestic law and tax treaties in creating a global community and explore a mechanism for harmonizing legal conflicts between tax treaties and domestic tax law.