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I. INTRODUCTION

From the perspective of taxing authorities, the most significant issue raised by global trading is the division (called allocation in tax parlance) of the profits of a multinational corporation among various tax jurisdictions. Taxing authorities focus on the profits of individual market participants. Broader issues, such as trends toward internationalization of capital markets, are important only for understanding the context within which individual firms operate and for developing sound tax policy.

Because of the possibility of double taxation or tax avoidance whenever a firm does business internationally, countries enter into tax treaties that assign taxation rights. The principle by reference to which taxing rights are assigned is called the arm's length principle.[1] It essentially involves two steps: (1) a functional analysis of the activities of a multinational firm within a jurisdiction;[2] and (2) determining the profits attributable to those activities.[3] Thus, it is important for tax authorities to determine the specific economic activities that constitute trading and their economic contribution to the multinational firm.

The term "global trading" refers to the capacity of financial intermediaries to execute customer orders and to take proprietary positions on financial products in markets around the world and around the clock.

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* For a more extensive treatment of this subject, see Plambeck, *The Taxation Implications of Global Trading*, 48 TAX NOTES 1143 (1990).

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1. *See, e.g.*, ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, OECD MODEL DOUBLE TAXATION CONVENTION ON INCOME AND CAPITAL art. 9, para. 1 (1977) [hereinafter OECD MODEL TREATY].

2. ORGANIZATION OF ECONOMIC CO-OPERATION AND DEVELOPMENT, REPORT OF THE OECD COMMITTEE ON FISCAL AFFAIRS, TRANSFER PRICING AND MULTINATIONAL ENTERPRISES para. 17 (1979) [hereinafter 1979 OECD REPORT].

3. *Id.* para. 23.

The financial intermediaries that trade globally are primarily banks[4] and securities dealers.[5]

Many different financial instruments are traded globally. Most currencies, many debt instruments, some equities, and other financial assets evincing ownership in property are traded globally, as are derivative products such as forwards, futures, options, and swaps.

For many products there exists a primary trading market where the bulk of trading in that product occurs. Secondary markets play a vital role when the primary markets are closed, particularly in times of crisis, when volume may swell dramatically. The primary trading markets are often located at centers of large organized exchanges.

II. SOURCES OF GLOBAL TRADING PROFITS

Financial intermediaries profit from global trading in several different ways. They make money by servicing the needs of capital users (*i.e.*, corporate borrowers) and suppliers (usually large institutional investors such as pension fund trustees and plan sponsors). They earn commissions and bid/ask spreads from brokering and dealing globally-traded instruments that evidence ownership in an underlying item. They earn fees and spreads from trading risk in the form of derivative financial products. They also earn fees by providing global custody[6] and research services for investors.

Financial intermediaries also use global trading to satisfy their own portfolio needs. Global trading facilitates asset and liability management.[7] Global trading also facilitates access to a variety of funding sources, thereby diversifying the risk that a bank may be unable to tap a particular source of capital to meet its continuing obligations.

Financial intermediaries also profit in the global markets by trading for their own account. A major source of revenue of a global trading

4. *See Statements to the Congress*, 76 FED. RESERVE BULL. 439 (1990) (statement by Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, Before the Task Force on the International Competitiveness of U.S. Financial Institutions, Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the House Comm. on Banking, Finance and Urban Affairs, Apr. 4, 1990).

5. STAFF OF THE UNITED STATES SECURITIES & EXCHANGE COMMISSION, 99TH CONG., 2D SESS., REPORT TO THE SENATE COMM. ON BANKING, HOUSING & URBAN AFFAIRS AND THE HOUSE COMM. ON ENERGY AND COMMERCE, INTERNATIONALIZATION OF THE SECURITIES MARKETS (Comm. Print 1987).

6. Financial intermediaries may act as custodians of securities for international investors.

7. Moskowitz, *Global Asset and Liability Management at Commercial Banks*, FED. RESERVE BANK N.Y.Q. REV., Spring 1979, at 46-48; Brady, *Dressing Up, Without a Killing*, EUROMONEY, Apr. 1990, at 77 ("A bank with more fixed-rate liabilities than assets can use a swap, in which it pays floating and receives fixed, as a bond or loan substitute.").

operation is from speculating and taking positions with respect to movements in prices (including interest rates and exchange rates).[8] "This means that operating revenues of a global trading operation are largely a function of price movements and the size of positions."[9] Finally, financial intermediaries' access to capital and investment in communications and data processing places them in an advantageous position to capitalize upon arbitrage opportunities, including tax and regulatory arbitrage.[10]

III. ORGANIZATION OF GLOBAL TRADING OPERATIONS

Given differences in management philosophies, investment in technology, market strategy, and other factors, few generalizations are made regarding the way financial intermediaries organize global trading operations. However, there are some generalizations which can be made.

One of these generalizations is that the trading operation is made up of four elements: trading, management, sales, and support. Traders make two critical decisions on behalf of their firms: they quote prices that initiate buy and sell transactions, and they decide whether and how to hedge. Other responsibilities of traders include making orderly markets in products for which the firm acts as a dealer and ensuring proper execution of brokered transactions. Because their performance directly determines the profitability of the firm, traders often are compensated primarily by a bonus (in addition to a base salary) that is based on the profitability of the book as a whole.

Overseeing the trader is the strategist or trading manager, who might be a head trader, a risk manager, or a senior manager. The strategist is responsible for coordinating and implementing the worldwide trading strategy of the firm, and continually attempts to identify market themes. The strategist also is responsible for controlling and monitoring the level of risk to which the institution is exposed.

A salesperson's primary responsibility is to the customers of the firm

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8. *See* Cornish, *When the Trader May Relax*, EUROMONEY, Feb. 1989, at 71 ("Put through business from tame retail clients is not a big feature in today's competitive markets."). *See generally* Glynn, *A Day—and Night—In the Life of the Global Market*, INSTITUTIONAL INV., Apr. 1986, at 293 (mentioning proprietary trading); *Endless Dealing: U.S. Treasury Debt is Increasingly Traded Globally and Nonstop*, Wall St. J., Sept. 10, 1986, at 1, col. 6 (also mentioning proprietary trading).

9. Cornish, *supra* note 8, at 71.

10. COOPERS & LYBRAND, OPPORTUNITY AND RISK IN THE 24-HOUR GLOBAL MARKETPLACE 8 (1987); *Global Traders: How Merrill Lynch Moves its Stock Deals All Around the World*, Wall St. J., Nov. 9, 1987, at 1, col. 6, 21, col. 4 (describing the taking of an arbitrage opportunity).

in connection with their purchases and sales of products. Salespeople obtain quotes for clients from the traders and receive commissions from the firm for transactions procured.

Global trading relies heavily on technology; thus, the support element's primary responsibility is to provide systems that assist the other three elements. In addition to operations staff, financial engineers and economic analysts support a global trading operation.

A second generalization which can be made is that traders are localized in major trading centers.[11] Head traders or strategists usually also are located in those trading centers. Risk managers and more senior management may be centralized in the head office or in the primary trading market for a particular book. Salespeople usually are localized in the geographic area of their customers, while support staff usually are localized where demand is heaviest, with functions that have firm-wide application located in the head office.

A third generalization is that the basic unit of organization is the book, defined essentially as the firm's trading position.[12] A distinctive feature of global trading is passing the book from time zone to time zone around the clock.[13] This feature does not mean that the location of inventory passes; ordinarily there is no transfer of legal title at the end of a trading day in one jurisdiction.[14] It is the location of trading authority

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11. Cornish, *supra* note 8, at 71 ("The classic trading organisation is decentralised."); Makin, *How to Manage a Global Money Manager*, INSTITUTIONAL INV., Apr. 1990, at 69 (quoting fund manager's ideal organizational culture: "You want the greatest degree of laissez-faire *without* chaos.").

12. The positions in the book are tracked electronically. Glynn, *supra* note 8, at 294 ("The firm's trading position is spelled out on the screens of an in-house computer system, which, among other things, enables trading managers to monitor the firm's market exposure, profit and loss and inventory on a real-time basis.").

13. *Endless Dealing: U.S. Treasury Debt is Increasingly Traded Globally and Nonstop*, *supra* note 8, at 1, col. 6 (describing passing the book as "ceaselessly relaying around the globe the responsibility for executing market orders and managing securities holdings, for their own firms and their firms' customers"). *See also* Burgess, *Sun Never Sets on the World's Linked Markets*, Wash. Post, Nov. 1, 1987, at H1, col. 4 (Merrill Lynch & Co. equities); *Round the Globe, Round the Clock*, CORP. FIN., June 1989, at 18 (Alexanders Rouse currency trading); *When the Day Never Ends*, N.Y. Times, Nov. 29, 1987, § 6 (Magazine, Part II) (personal life of a 24-hour trader).

14. *See* R. Gordon, S. Greenberg, & S. Rosen, Global Trading: Tax Issues in Intercompany Pricing of Securities Transactions (paper presented at the American Tax Institute in Europe conference, Intercompany Pricing USA/Europe: Developments, Strategies and Planning, Paris, June 18-19, 1990) [hereinafter GLOBAL TRADING] ("It would be *impossible* to actually pass the formal ownership responsibilities along with trading discretion from entity to entity, because such an approach would require, for example, that the financing obligations and the regulatory capital requirements associated with the securities also be assumed anew by each entity at the beginning of each trading day in that jurisdiction.").

that passes.[15] Most firms operate in one profit center mode, meaning that the trading centers work together as a single economic unit that crosses national boundaries to maximize the worldwide profits of the book.[16] In order to encourage teamwork, traders are compensated based on the profits of the entire book.[17]

IV. APPORTIONMENT OF THE PROFITS FROM GLOBAL TRADING

In the framework of treaties based on the Organization for Economic Co-operation and Development (OECD) Model Treaty, the rights of each nation to tax the profits from global trading are determined by the presence of an enterprise within a jurisdiction and the extent to which the firm's profits are connected with that presence.[18] The two measurements of jurisdictional presence are the existence of an enterprise in a contracting state and the existence within one contracting state of a permanent establishment of an enterprise of another contracting state. The first measurement is generally the place a corporation is organized. The second measurement looks to assets and agency relationships within a contracting state. Dependent agents of an enterprise may create a permanent establishment; independent agents do not create a permanent establishment. Both measurements of jurisdictional presence arise in

15. OFFICE OF TECH. ASSESSMENT, TRADING AROUND THE CLOCK: GLOBAL SECURITIES MARKETS AND INFORMATION TECHNOLOGY—BACKGROUND PAPER 32 (1990).

16. *Global Traders: How Merrill Lynch Moves its Stock Deals All Around the World*, *supra* note 10, at 21, col. 1 ("At the end of each U.S. trading session, the two Americans pass on to Merrill's Tokyo traders the stock positions remaining in their Japanese book as well as whatever market intelligence they pick up. Despite their positions on three continents, all five members of the Japanese stock trading team share a single profit—and loss statement. Another stock book is traded via Hong Kong instead of Tokyo; still others shuttle between only two cities. Most U.S. stocks, for example, are traded largely by the Merrill offices in the U.S. and London because they remain thinly traded in Japan."). *See also Meetings are Shifted by Chase*, N.Y. Times, July 21, 1990, at 29, col. 6, 33, col. 6 ("To improve the performance of the global finance group . . . the practice of measuring bankers' performances by earnings of each profit center would be de-emphasized and replaced by measures of market share, rankings compared with other banks and the total amount of revenues from a corporate client.").

17. Hunter, *The Status and Evolution of Twenty-Four Hour Trading: A Trader's View of International Transactions, Clearance, and Settlement*, 4 B.U. INT'L L.J. 15, 17 (1986) ("One of the earlier mistakes made by American firms was to pass the book out to Tokyo and have a few local people executing who were really interested in only getting volume or production credits because that is how they were paid. So if someone came in and bought the first offering, they would leave the offering there and he would buy twenty more offerings. So by the time you got through your whole offering list you have been picked pretty dry. What we have done is tried to blend the trading motivations with the local desire to do volume.").

18. OECD MODEL TREATY, *supra* note 1, para. 1.

global trading and raise significant interpretation issues.[19]

The extent to which profits are connected with a contracting nation is determined under the arm's length principle described above. The application of this principle to global trading is difficult because of the high degree of global integration of this industry, and because of the outmoded economic assumptions upon which the current rules are based. Among the outmoded assuumptions are the integrity of distinct legal entities and the relevance of national boundaries to capital markets.[20]

V. ALTERNATIVE APPORTIONMENT METHODS

A common aim of the member countries of the OECD is to encourage the positive contributions of multinational enterprises in the promotion of economic and social welfare. With respect to the taxation of global trading, this directive requires the members to cooperate to ensure that the tax rules encourage economic efficiency and fairness. A coordinated solution is necessary to reduce the possibilities of double taxation and tax avoidance.

The approach currently taken by the OECD Model Treaty may be called the realization approach. There are several alternative approaches which would improve the methods of taxing global trading profits.

One alternative to the realization approach may be termed the "mark-to-market" approach. This method would first isolate trading

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19. *See* Frisch, *The Economics of Tax Policy: Some Old and New Approaches,* 47 TAX NOTES 581 (1990) (suggesting that tax policy for the international income of multinationals focuses on harmonization of tax systems). Technological advances enable market participants to surmount tax or regulatory barriers of jurisdictions that are out of step. *See* Marcom, *Welcome to Hauppauge, the World's Next Financial Capital,* FORBES, Oct. 30, 1989, at 143, 166 ("If one country imposes onerous taxes or annoying trading restrictions, in the global electronic market the players just transact their business in a country that is more simpatico."); Bird, *Shaping a New International Tax Order,* 42 BULL. FOR INT'L FISCAL DOCUMENTATION 292, 295 (1988) ("Countries always have the attractive option of doing nothing. Over time, the effective rate of taxation on international business is then likely to fall to the level of the least common denominator among the various countries competing for such investment which means, in practice, something close to zero.").

Tax authorities have recently begun to coordinate. *Compare* de Hosson, *Global Trading—A Worldwide Tax Headache,* INTERTAX, Jan. 1990, at 2-3. For a description of efforts by securities regulators, see Warren, *Global Harmonization of Securities Laws: The Achievements of the European Communities,* 31 HARV. INT'L L.J. 185 (1990); Goelzer, Sullivan & Mills, *Securities Regulation in the International Marketplace: Bilateral and Multilateral Agreements,* 9 MICH. Y.B. INT'L LEGAL STUD. 53 (1988). For a description of efforts by banking regulators, see Hu, *Swaps, The Modern Process of Financial Innovation and the Vulnerability of a Regulatory Paradigm,* 138 U. PA. L. REV. 333 (1989).

20. There are numerous collateral issues of U.S. domestic law; space does not permit a discussion here. For further discussion, see Plambeck, *The Taxation Implications of Global Trading,* 48 TAX NOTES 1143 (1990).

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

A second alternative to the realization approach is a profit split approach, which divides trading profits according to an agreed-upon formula. The first step under this approach is to define the tax base upon which the formula is to be applied. This would be the gains and losses from trades and hedges, less allocable expenses such as interest and commissions to salespeople. The second step would be to apply the apportionment formula to this tax base. Most in accordance with economic theory would be to select factors of production (inputs) as the basis for this formula, on the theory that if unrelated parties in each jurisdiction were to enter into a joint venture to conduct global trading, they might be expected to divide the profits in accordance with each one's relative contribution of inputs.[21] Because human resources (the traders) are usually the most significant input, relative trader compensation probably would be a prominent apportionment factor.[22]

VI. CONCLUSION

In implementing a solution to the tax issues raised by global trading, unilateral approaches are severely constraining.[23] Instead, bilateral and multilateral solutions are preferable.[24] Though heavily in favor of the realization approach, the OECD Model Treaty framework is sufficiently

21. H. Grubert, A Proposed Reinterpretation of the Arm's Length Principle in Transfer Pricing 9-10 (rev. ed. Apr. 1989) (unpublished manuscript, B. Rollinson & D. Frisch, Recent Issues in Transfer Pricing 6-7 (OTA Paper 61, Nov. 1988) (available from the National Technical Information Service, 5285 Port. Royal Rd., Springfield VA 22161; phone: (703) 487-4660).

22. *See* GLOBAL TRADING, *supra* note 14 (suggesting allocation formula based on: (1) relative trader compensation; (2) relative numbers of personnel, including clearance and support; and (3) relative levels of interest and dividends representing costs of risk capital—three factors that indicate economic risk, namely activity, fixed presence, and risk assumed).

23. *See* OFFICE OF TECH. ASSESSMENT, *supra* note 15, at 71.

24. *Id.* at 5, 7, 75.

flexible to accommodate the other two approaches.[25] Harmonized domestic legislation and protocols to treaties may provide a solution in the long term, but an advance determination ruling procedure seems to be the best currently available solution.[26] The process essentially is a flexible and voluntary procedure under which the taxpayer and competent authorities agree to an apportionment methodology and to reporting obligations. Experience with these agreements may lead to principles of general application that can be incorporated into protocols or domestic legislation.

25. *Compare* 1979 OECD REPORT, *supra* note 2, para. 14 ("So-called global or direct methods of profit allocation, or . . . fixing transfer prices by reference to predetermined formulae for allocating profits between affiliates . . . [are] incompatible in fact with articles 7 and 9 of the OECD Model Double Taxation Convention[ ]") *with* OECD MODEL TREATY, *supra* note 1, para. 2 (making it clear that Article 7 was intended to facilitate, rather than prevent, agreement of a set of rules by reference to which the profits of a permanent establishment are to be calculated, and was drafted broadly intentionally in recognition that modern commerce organizes itself with infinite variety).

26. *See Full Text of Draft Revenue Procedure on Advanced Transfer Pricing Rulings*, 2 TAX NOTES INT'L 565 (1990). Respondents of a 1987 survey favored standard provisions in treaties and other agreements. COOPERS & LYBRAND, *supra* note 10, at 15 (1987).