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NOTE

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The term "country" as used in this study also refers, as appropriate, to territories or areas; the designations employed and the presentation of the material do not imply the expression of any opinion whatsoever on the part of the Secretariat of the United Nations concerning the legal status of any country, territory, city or area or of its authorities, or concerning the delimitation of its frontiers or boundaries. In addition, the designations of country groups are intended solely for statistical or analytical convenience and do not necessarily express a judgement about the stage of development reached by a particular country or area in the development process.

The following symbols have been used in the tables:

Two dots (..) indicate that data are not available or are not separately reported. Rows in tables have been omitted in those cases where no data are available for any of the elements in the row;

A dash (-) indicates that the item is equal to zero or its value is negligible;

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A slash (/) between dates representing years, e.g. 1994/95, indicates a financial year;

Use of a hyphen (-) between dates representing years, e.g. 1994-1995, signifies the full period involved, including the beginning and end years.

Reference to "dollars" ($) means United States dollars, unless otherwise indicated.

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IIA Issues Paper Series

The main purpose of the UNCTAD Series on issues in international investment agreements is to address key concepts and issues relevant to international investment agreements and to present them in a manner that is easily accessible to end-users. The series covers the following topics:

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Preface

The United Nations Conference on Trade and Development (UNCTAD) is implementing a work programme on a possible multilateral framework on investment, with a view towards assisting developing countries to participate as effectively as possible in international investment rule-making at the bilateral, regional, plurilateral and multilateral levels. The programme embraces capacity-building seminars, regional symposia, training courses, dialogues between negotiators and groups of civil society and the preparation of a series of issues papers.

This paper is part of this series. It is addressed to government officials, corporate executives, representatives of non-governmental organizations, officials of international agencies and researchers. The series seeks to provide balanced analyses of issues that may arise in discussions about international investment agreements. Each study may be read by itself, independently of the others. Since, however, the issues treated closely interact with one another, the studies pay particular attention to such interactions.

The series is produced by a team led by Karl P. Sauvant and Pedro Roffe, and including Victoria Aranda, Anna Joubin-Bret, John Gara, Assad Omer, Jörg Weber and Ruvan de Alwis, under the overall direction of Lynn K. Mytelka; its principal advisors are Arghyrios A. Fatouros, Peter T. Muchlinski and Sanjaya Lall. The present paper is based on a manuscript prepared by Susan Borkowski. The final version reflects comments received from Antonio Carlos Rodrigues do Amaral, Dali Bouzoraa, Bernard Damsma, Sylvain Plasschaert and Constantine Vaitsos. The paper was desktop published by Teresita Sabico.

Funds for UNCTAD's work programme on a possible multilateral framework on investment have so far been received from Australia, Brazil, Canada, the Netherlands, Norway, Switzerland, the United Kingdom and the European Commission. Countries such as India, Morocco and Peru have also contributed to the work programme by hosting regional symposia. All of these contributions are gratefully acknowledged.

Rubens Ricupero
Secretary-General of UNCTAD

Geneva, February 1999

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Executive summary

As the global integration of the world economy proceeds, more transnational corporations (TNCs) are considering new or increased foreign direct investment (FDI) and the establishment of affiliates abroad. This expansion necessitates the transfer of tangible and intangible assets (including services) between parent corporations and their foreign affiliates. One issue that arises in this context is how to establish prices for these cross-border transfers. Transfer pricing frameworks can, in principle, promote reasonable tax revenues for the countries involved and, at the same time, establish a fair tax liability on corporations. For these reasons, transfer pricing issues raise important and often contentious policy questions for host and home governments, as well as for TNCs, as transfer pricing methods directly affect the amount of profit reported in host countries by corporations, which in turn affects the tax revenues of both host and home countries.

International tax and other arrangements can address transfer pricing issues, including mutually acceptable transfer pricing methods, compensating adjustments to avoid double taxation, competent authority issues, and clauses for limitations on benefits and exchange of information. Such arrangements can also provide corporations with some assurance of dispute settlement and the elimination of double taxation while safeguarding countries' tax revenues and capital stock. Also, increased financial, accounting and tax disclosure by corporations can occur concurrently with the implementation of a transfer pricing framework to ensure the transparency of transactions and to deter income shifting and evasion of tax liabilities.

As the international operations of TNCs grow in developing countries, the issue of effective transfer pricing regulation becomes more pressing for them. Given the more limited skills and resources of such countries in the field of transfer pricing, it becomes increasingly important to consider to what extent international investment agreements can address this imbalance through, for example, increased transparency, information sharing, co-operation and technical assistance provisions, thereby ensuring that developing countries derive full benefits from FDI without exposure to a potentially harmful diversion of revenues through transfer pricing practices.

INTRODUCTION

An important issue resulting from the globalization of economic activity and the associated increases in the international transactions of TNCs and the internationalization of a good part of international trade is how to establish prices for goods, services, know-how and intellectual property transferred across borders within corporate networks and especially between foreign affiliates and parent corporations. The prices at which such items are transferred determine the incomes for both parties and therefore the tax base of the countries involved. In theory, a properly calculated transfer price allocates profits from the transferred items reasonably to all involved parties so that tax authorities in the countries concerned receive their fair shares of the tax revenues from those profits.

In principle, therefore, transfer pricing frameworks should promote reasonable tax revenues for all countries involved while assessing a fair tax liability on TNCs. These two objectives highlight the desirability for each country's tax authority to develop and enforce appropriate transfer pricing regulations and treaty provisions that, among other things, mitigate double taxation, income shifting and tax avoidance. Understanding a TNC's FDI strategy is also important "because appropriate transfer pricing policies can sustain and guarantee the original investment decision" (Emmanuel, 1996, p. 3); inappropriate policies can discourage new or continued FDI in host countries.

Transfer pricing is one of the most important tax issues facing TNCs today (Ernst and Young, 1997) due to its direct effects on both TNC profits and host and home countries' tax revenues. There are also specific factors going beyond tax-related transfer pricing considerations that can motivate a TNC to manipulate transfer prices in a manner that adversely affects host or home countries, including the level of customs duties; repatriation policies; the extent of exchange risk; asset capitalization policies; anti-monopoly charges; dumping charges; and cost-sharing concerns (Plasschaert, 1994). As cross-border transactions are increasing in number, size and scope, more TNCs are engaging in transfers involving larger monetary amounts with affiliates located in more and more countries, as well as among these affiliates. The effects of transfer pricing are therefore increasingly important to both TNCs' profits and to each country's tax base. Developing countries, for example, "have long relied on corporate income taxes as a principal means of revenue. These taxes account for up to a third of revenue in some developing countries" (Cohen, 1995, p. 11). [1]

Indeed, transfer pricing methods can directly affect the amount of profit reported in a country by a TNC, which in turn affects the tax revenues of that country (box 1). However, many developing countries (and especially least developed countries) do not have administrative frameworks that adequately codify and enforce

Box 1. How income can be shifted across borders

Scenario A: The parent TNC in the example is domiciled in a relatively high-tax (34 per cent) country, and it has a foreign affiliate in a lower-tax (10 per cent) host country. A component is produced by the affiliate in the host country at a cost of $400, and sold to the parent in the home country at the (transfer) price of $550, which becomes part of the parent TNC's cost of goods sold. The home country parent firm incurs an additional $300 to complete the product which contains the transferred component. The product is sold at $2000. Tax liabilities are calculated using the host affiliates's and parent firm's pre-tax income, resulting in total tax liabilities of $226.

Transfers to income statement	Affiliate in low-tax country (10 per cent tax rate)	Parent in high-tax country (34 per cent tax rate)	Total TNC income
Revenue	$550	$2,000	$2,000
Less costs of goods sold	$400	($550* + $300)	$700
Gross margin =	$150	$1,150	$1,300
Less operating expenses	$100	$500	$600
Income before taxes =	$50	$650	$700
Less tax expense	$5	$221	$226
Net income	$45	$429	$474

(Box 1, concluded)

Scenario B: Income is shifted from high-tax to low-tax country when the component produced by the affiliate in the host country is sold by the parent in the home country at the (transfer) price of $700. The result is that there is no effect on total revenues, costs and pretax income of the TNC. There is a net reduction of $226-$190=$36 in the TNC's overall tax liability, resulting in $36 increase in consolidated net income. When the results are consolidated, the affiliate's selling price cancels out $550 of the parent firms' costs of goods sold. The net effect of any transferred good or service on a company's pre-tax profits is zero.

Transfers to income statement	Affiliate in low-tax country (10 per cent tax rate)	Parent in high-tax country (34 per cent tax rate)	Total TNC income
Revenue	$700*	$2,000	$2,000
Less costs of goods sold	$400	($700* + $300)	$700
Gross margin =	$300	$1,000	$1,300
Less operating expenses	$100	$500	$600
Income before taxes =	$200	$500	$700
Less tax expense	$20	$170	$190
Net income	$180	$330	$510

* Because this amount is revenue for the affiliate but a cost for the parent company, it is calculated into the parent company's cost of goods but neutralized in the calculation of the total cost of goods which remains the same for the total TNC income.

Source: UNCTAD.

regulations governing TNCs' transfer pricing practices. In addition, non-existent, unfair or ambiguous transfer pricing legislation can be a factor that discourages FDI inflows due to concerns about tax risks and legal protection. To avoid this outcome, countries can implement and enforce a transfer pricing framework that has broad support in the international community, from both the governmental and the corporate side. Its application needs to be flexible, but its effective implementation can be assured by a penalty system that distinguishes between good-faith errors and deliberate manipulations by firms to shift income and evade tax liabilities.

Note

1 A further, related, issue concerns the fact that transfer pricing may be used as a means of redistributing profitability entitlements among business partners as in the case of joint ventures or of other business arrangements with profit sharing implications. This may require a reallocation of revenues to ensure that a true and fair amount of profit is distributed to the non-TNC partner. This may be a particular problem in developing countries where local partners may not have the capacity or resources to identify the profit-shifting effect of transfer pricing manipulations.

Section I

EXPLANATION OF THE ISSUE

A. Transfer pricing in transnational corporations

For an understanding of the transfer pricing issue, it is important to describe briefly the use of transfer pricing by TNCs. Only then can the meaning of the regulatory standards employed in international agreements and national laws be fully grasped.

The pricing of transfers of goods, services or other assets within a TNC network creates considerable management and accounting problems. This can be explained by the fact that, while the management of individual plants and divisions is often carried out on a decentralized basis, and accounts are made out for each "profit centre", the group enterprise as a whole may require a centralized financial strategy, to ensure an efficient co-ordination of the group's transnational business operations. In order to achieve this, a TNC sets the transfer pricing of intra-firm flows of goods, services or other assets on a centralized basis, thereby taking control over pricing policy away from individual profit centres. This requires a mechanism for setting prices in a rational way that ensures the setting of optimal prices and which avoids the misallocation of resources or distortions in the final prices of products (Muchlinski, 1995, pp. 283-284; Plasschaert, 1994, pp. 6-7).

The achievement of optimal prices can be very difficult. One, seemingly straightforward, approach is to apply open market prices to intra-firm transactions. However, such prices may be inapplicable -- or even non-existent -- to the realities of TNC operations. First, profit centres may not be free to purchase inputs from the open market. Second, the relevant inputs may not be available on the open market. Indeed, the specialized productive technology or managerial know-how of a given TNC may be unique to the enterprise. The very advantage that the firm possesses may negate any alternative source. Thus an internally determined transfer price may be the best approximation of the value of the input concerned (Muchlinski, 1995, p. 285; Kaplan and Atkinson, 1994, pp. 134-135).

Accordingly, TNCs have developed mechanisms to determine internal transfer prices. Two basic methods are used, though with many variations. The first is the “cost-plus” method. This uses the basic cost of the item transferred, calculated according to one of a number of possible costing criteria, to which a percentage mark-up is added allowing a margin of profit to accrue each seller in the chain. The second is the “sales minus” or “resale price” method. Here, the price of the finished product is the starting point. From this, a percentage discount is subtracted, leaving the buyer with a margin of profit on the transfer based on the assumption that the affiliated buyer will add value to the product prior to resale at the final price (Muchlinski, 1995, p. 284; OECD, 1995). These methods are in themselves imperfect. Significant problems continue with the allocation of costs to different parts of a TNC’s system of production. Moreover, the sales minus approach may introduce distortions where the final resale price may reflect the monopolistic position of a TNC on its market, if applicable.

From the above, it is clear that the setting of transfer prices between the affiliates of a TNC is no easy matter. There is much uncertainty which, in turn, creates complexity for regulators who must balance between, on the one hand, ensuring a reasonable return to revenue from the operations of TNCs located in their territory and, on the other, allowing that the legitimate pricing practices of integrated business groups are not undermined as this could lead to the penalization of the efficiency gains of integrated international production systems.

B. Transfer pricing methods in tax regulation

Most developed countries derive their transfer pricing regulations from the Organisation for Economic Co-operation and Development (OECD) transfer pricing guidelines (OECD, 1995; 1996) and from the United States regulations in Section 482 of the Internal Revenue Code (hereinafter referred to as United States Section 482).[1]

Transfer pricing methods which are currently acceptable to most tax authorities are based on the arm's-length principle. In non-technical terms, this principle means that a transaction should be valued at what company A would have charged company B in the market, if company B were an independent company not connected in any way with company A. (See box 2 for an example of a provision that applies the principle to taxation measures.)

Box 2. Applying the arm's-length principle to taxation

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

Source: OECD, 1997a, article 9.

The use of the arm's-length approach is not without difficulties. Critics of this approach point to the fact that such an enquiry is likely not to achieve useful results where the transaction under review occurs between affiliates of an internationally integrated TNC. It fails to meet the reality of such an enterprise's activity especially in relation to transfers of technology, whether as intellectual property or know-how, or other firm-specific sources of value. Yet, national tax authorities and the OECD continue to prefer the arm's-length method, in part, because it accords better to a world of territorially based national tax jurisdictions. In practice, however, tax authorities have been pushed to recognise the realities of TNC transfer-pricing activities by using profit-based allocation methods. This, in turn, has led to lively debates on the nature and future of the arm's-length principle particularly between the United States, which is at the forefront of developing profit-based allocation methods, and the OECD, the principal supporter of the arm's-length principle (Muchlinski, 1995, pp. 293-295; Plasschaert, 1994, pp. 9-10; United States, Department of the Treasury, 1988; OECD, 1995).

Cross-border transfers may be priced using any of several traditional *transactional* and *transactional profit* methods, all of which adhere to the arm's-length principle. The methods can apply to both “tangibles” and “intangible property”.

Tangibles include any goods, whether finished products or intermediate inputs, such as raw materials or components, that are transferred between affiliated enterprises. Intangible property includes such diverse categories as:

- patents, inventions, formulas, processes, designs or patterns;
- copyrights, literary musical or artistic compositions;
- trademarks, trade names or brand names;
- franchises, licenses or contracts;
- method programmes, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists or technical data; and
- other intellectual property not listed above.

The definitions of transfer pricing methods used in this section are derived from the transfer pricing guidelines of the OECD (1995; 1996) and from the United States Section 482 transfer pricing regulations (United States, Internal Revenue Service, 1994).

1. Transactional methods

The *comparable uncontrolled price* (CUP) method, also known as the market price method, compares the price for tangible goods transferred in a controlled transaction to the price charged for property or services transferred in a *comparable uncontrolled transaction* (CUT) in comparable circumstances, i.e. the market price. This comparison verifies that the comparable price for the product transferred between TNC entities is the same as would have been charged if the product had been sold to a customer unconnected with that TNC, i.e. an arm’s-length transaction. The difficulty for both tax authorities and (as noted above) TNCs lies in identifying an exact comparable product upon which to base the market price; hence, an adjusted, or inexact comparable market price, is more commonly used.

In an elaboration from the accounting practices of TNCs, the *resale price* method uses the price at which a product, that has been purchased from an associated enterprise (a TNC entity), is resold to an independent enterprise (an independent customer).

The resale price is reduced by the resale gross margin. What is left after subtracting the resale price margin can be regarded, after adjustment for other costs associated with the purchase of the product (e.g. customs duties), as an arm's-length price. The *cost plus* method uses the costs incurred by the supplier of a tangible product in a controlled transaction between TNC entities. An appropriate cost plus mark-up is added to this cost to allow for an appropriate profit in light of the functions performed and the market conditions, again arriving at an arm's-length price.

2. Transactional profit methods

The *profit split* method identifies the combined profit to be split for the associated enterprises from a controlled transaction (between TNC entities). Those profits are then split, or allocated, between the TNC entities based upon an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm's-length with an independent customer.

The *transactional net margin* method (TNMM) examines the net profit margin relative to an appropriate base (e.g. costs, sales, assets) that a taxpaying TNC realizes from a controlled transaction with its affiliate(s). This method operates in a manner similar to the cost plus and resale price methods. The TNMM must therefore be applied in a manner consistent with the way in which the resale price or cost plus method is applied (OECD, 1995, paragraph 3.26).

The *comparable profits* method (CPM) determines an arm's length result using the amount of operating profit that the tested party (a TNC entity) would have earned on related party transactions with other TNC entities if its profit level indicator were equal to that of an uncontrolled comparable transaction, i.e. the comparable operating profit the TNC entity would have earned in a transaction with an independent customer.

3. Formulary apportionment methods

Some tax authorities have suggested determining transfer prices based on the *global formulary apportionment* method. This approach "allocate(s) the global profits of a multinational enterprise group on a consolidated basis among the associated enterprises [TNC entities] in different countries on the basis of a predetermined formula" (OECD, 1995, p. G-4). It is, arguably, a method that more closely relates to the realities of international business integration by TNCs. To date, however, this method has not gained much support because it does not meet the arm's-length principle. The practical application of formulary apportionment involves multiple tax authorities, guidelines, regulations, tax rates and tax bases in arriving at the tax revenues apportioned to each country. Reaching a global consensus on a so-called "predetermined formula" that would be required to allocate a TNC's total profits to the countries involved is difficult to obtain. Such a formula would *inter alia* have to take account of the special economic situation of developing countries. Existing methods of formula apportionment may be unsuitable in view of their emphasis on economic criteria that result in higher proportions of taxable revenue being allocated to more economically developed taxing jurisdictions (Muchlinski, 1995, p. 307).

C. Cost-sharing arrangements

A cost-sharing arrangement is an agreement whereby two or more persons agree to share the costs and risks of research and development of new intangible property as these are incurred in exchange for a specified interest in any such property that is developed. Such arrangements can be used as a vehicle for the reallocation of costs and risks in the most tax-efficient way. Consequently, where such arrangements are entered into by affiliated enterprises, tax authorities have monitored them to ensure that they are not used simply as tax-avoidance devices. Thus only genuine allocations of costs and risks will be acceptable. The OECD (1997b) guidelines re-emphasize the arm's-length nature of any cost-sharing allocations, and the requirement of definite prospective benefits in order to participate in a cost-sharing arrangement.

D. Advance pricing agreements

Advance pricing agreements (APAs) are concluded between taxpayers, including TNCs and host and/or home country tax authority(ies); they can be unilateral, bilateral or multilateral. Their purpose is to reduce uncertainty and conflict among taxpayers and tax authorities. An APA "determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparables and appropriate adjustment thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time" (OECD, 1995, p. G-1). Multilateral APAs reduce significantly the risk of transfer pricing audits, penalty assessments and double taxation when the tax policies of two countries differ regarding corresponding adjustments and acceptable transfer pricing methods. A shortcoming of unilateral APAs is that they are ineffective in resolving double taxation issues.

Note

1 Harmony between the OECD and United States approaches is assumed unless otherwise specifically noted. Differences between, and the relative impact of, OECD and United States regulations are discussed below.

Section II

STOCKTAKING AND ANALYSIS

A. Transfer pricing legislation: a historical perspective

A comparison of countries with well-developed transfer pricing legislation shows the influence of OECD guidelines and/ or United States tax policy on those countries' regulations. Further, most other transfer pricing legislation is based on concepts drawn from either or both sources. A discussion of both approaches is therefore necessary to understand their similarities and differences, and to analyse the conflicts between the two approaches and their effects on current global transfer pricing policies.[1]

While both the OECD and the United States tax authority fully support and are committed to the arm's-length principle, they diverge in several important areas: the methods that are preferred, the profit-based methods that are acceptable, the depth of documentation requirements, the entity that bears the burden of proof, and the type and severity of penalties. These differences are clarified and illustrated below.

- **OECD guidelines as implemented by selected developed countries.** The OECD began a substantive assessment of transfer pricing issues in its publication Transfer Pricing and Multinational Enterprises (OECD, 1979), which was supplemented by additional guidance in Transfer Pricing and Multinational Enterprises: Three Taxation Issues (OECD, 1984) and again in Thin Capitalization (OECD, 1987). Given the continuing relevance of this issue and multiple revisions of the United States regulations, the OECD responded to the needs of member countries for updated transfer pricing guidance relevant to the expanding globalization of TNC activity. The OECD revised transfer pricing guidelines (OECD, 1995; 1996; 1997) are designed to assist tax authorities and TNCs "by indicating ways to find mutually satisfactory solutions to transfer pricing cases, thereby minimizing conflict" and therefore costly litigation (OECD, 1995, p. P-5).

The purpose of the updated guidelines is twofold: they are meant to serve as the foundation of a country's transfer pricing regulations, and to provide direction to TNCs in choosing a transfer pricing method in accordance with the arm's-length principle. They are characterized by flexible application, moderate documentation requirements, avoidance of double taxation and a non-adversarial relationship between tax authorities and the TNCs. Currently, the OECD guidelines are the source of most countries' transfer pricing legislation, where such legislation exists (box 3). Transactional methods are preferable to transactional profit methods, according to these guidelines. The latter are to be used only as methods of last resort.

Box 3. Transfer pricing legislation based on the OECD guidelines

- **Canada.** Transfer pricing is regulated by Revenue Canada in Section 69 of the Canadian Income Tax Act. These regulations require that the method employed meet the arm's-length standard in accordance with the OECD guidelines. While the application of Section 69 is flexible, Revenue Canada follows the OECD preference for transactional and then transactional profit methods, such as TNMM and profit split, but excluding the comparable profits method. In cases where a CUP cannot be determined, a functional analysis should be undertaken to identify the appropriate transfer pricing method.

- **Japan.** The Japanese National Tax Administration regulates transfer pricing through Article 66-5 of the Special Taxation Measures Law and the Special Taxation Law relating to a Tax Treaty. These regulations are based on the OECD guidelines and are flexibly applied to eliminate income shifting and double taxation while easing the reporting burden of TNCs. The regulations also protect

/...

Box 3, concluded)

Japanese TNCs from audits and penalties assessed by the United States tax authority, as a result of enforcement of Section 482. Due to increasing audits of its TNCs, the Japanese tax authority has become more active in its own audits of non-Japanese TNCs.

- **United Kingdom.** The Inland Revenue controls transfer pricing transactions through Sections 770-773 of the 1988 Income and Corporation Taxes Act. These regulations are based on OECD guidelines and assume a flexible interpretation of the arm's length principle for both tangible and intangible transfers. The regulations have been strengthened by recently enacted legislative changes. These changes include a shift of some of the burden of proof for compliance with the arm's-length principle to TNCs from the tax authority, and adoption of documentation requirements similar to OECD guidelines. At this time there is no formalized APA programme, although informal APAs will be considered.

- **United States.** The United States Internal Revenue Service (IRS) regulates transfer pricing through Section 482, which has been repeatedly revised during the last two decades, with significant changes occurring with almost every revision (United States, Internal Revenue Service, 1996). The most recent changes in 1994 allow a TNC the choice of any approved transaction-based or profit-based method to price transferred tangibles or intangible property. These methods include CUP, CUT, resale price, cost plus, profit split and CPM. Under this "best method" rule, however, the IRS can challenge a TNC's choice, placing the burden of proof on the TNC. Section 482 mandates that TNCs maintain extensive contemporaneous documentation, while Section 6662 provides for penalties in cases of understatement of taxable income, with no distinction between good faith errors made by TNCs and deliberate income manipulation.

Some developing countries have based their regulations on the OECD guidelines and variations thereof. The Republic of Korea and Mexico, for example, have relatively well-developed transfer pricing regimes. The Republic of Korea regulates transfer pricing through Article 20 of its Corporation Income Tax Law and administrative regulations and guidelines issued by the Office of National Tax Administration in 1990. The arm's-length principle is upheld, with the CUP, resale, and cost-plus methods preferred. If these methods are not appropriate, only then can other reasonable methods be considered. Documentation may be requested from a TNC to check the correctness of the chosen transfer pricing method and application. The tax authority may audit TNCs that do not provide documentation when requested; these documentation requirements, updated in 1996, are more burdensome to TNCs than those suggested by the OECD. The tax authority may also recalculate profits by applying its own choice of an arm's-length method, and is actively pursuing TNCs which shift profits and avoid taxes (Lee, Lee and Donaldson, 1996).

Mexico addresses transfer pricing issues in the Tax Reform Act of 1992, and again in 1997 with its tax reform package adopting the revised OECD guidelines. The *Secretaria de Hacienda y Credito Publico* reviews transfer pricing transactions between related parties, using the arm's-length principle. Income adjustments may be made if a TNC is deficient in maintaining or providing pricing documentation, and multi-year APAs will be available. In order to follow OECD guidelines, existing safe harbour provisions will be gradually eliminated (Leavey and Amante, 1997).

B. Status of related tax treaty articles

Most tax treaties[2] contain several articles related to transfer pricing issues. In most cases, it is not the articles themselves that pose problems for transfer pricing, but the fact that they appear in a patchwork of bilateral, multilateral and/or regional treaties, each of which may address one or all of the issues.

The United Nations Model Double Taxation Convention between Developed and Developing Countries (UNCTAD, 1996a, vol. I), originally adopted in 1979 and currently under revision, is very similar to the OECD Model Tax Convention (OECD, 1997a). Any differences are due to the former taking into account the specific needs of, and conditions in, developing countries, and addressing them in the Convention articles. The United Nations Model stresses source taxation, and is therefore favoured by capital-importing countries. The OECD Model is preferred by capital-exporting countries because it emphasizes residence taxation.

The OECD Model Tax Convention on Income and on Capital, originally developed in 1963 (OECD, 1963), has undergone periodic revisions during the past 35 years. It is the basis of most existing tax treaties, and the origin of many of the articles related to transfer pricing issues. Recently, the United States Department of the Treasury released its Model Income Tax Convention (1996), which is based on several models, including the OECD Model Convention, the prior 1981 United States model treaty, and existing United States tax treaties.

The following discussion of articles relevant to transfer pricing is drawn from both model conventions. The principle issues covered by these provisions are:

1. *The application of the arm's-length principle*

Article 9 (Associated enterprises) of the OECD Model Tax Convention (1963) is the source for the widely-accepted definition of the arm's-length principle upon which all acceptable transfer pricing methods are based, and is similar in both the OECD and United States models. This article also provides for the use of corresponding adjustments by competent authorities to eliminate or mitigate double taxation situations which may arise when cross-border transfers occur. This problem arises where the home tax administration of a TNC, in the exercise of its powers of re-allocation under transfer pricing regulations, increases the taxpaying enterprise's liability to home country tax. Unless the host country tax administration involved agrees to adjust downwards the amount it has already charged to tax from the local affiliate of the TNC, there will be an element of unrelieved double taxation. To avoid this eventuality, Article 9 (2) of the OECD Model Tax Convention recommends that the host country tax administration makes the necessary adjustment to the tax charged on the local affiliate's profits. However, this procedure is not compulsory and so no duty to adjust arises on the part of the host country.

To deal with such cases, both model treaties contain provisions on relief from double taxation (article 23) to address situations which may arise due to differences in host and home country transfer pricing regulations and requirements. Article 25 of the OECD Model (Mutual agreement procedure) allows for the use of a competent authority to try mutually to resolve tax disputes and instances of double taxation between a TNC and a host country tax authority. The United States model sets no time limits within which a transfer pricing dispute may be brought to the competent authority, while the OECD model sets a three-year time limit beginning from the first notification of the dispute. The United States model also allows the use of advance pricing agreements as a means of settling transfer pricing disputes.

2. Deterrence of "treaty shopping"

The United States model treaty contains strong provisions in Article 22 (Limitation on benefits). This article is designed to deter treaty shopping, which is an attempt "by a third-country resident to obtain benefits from an income tax treaty for which it was not intended to qualify" (Brandt and French, 1995, p. 224). The OECD model does not specifically address this issue, but does contain language that allows a tax authority to deny benefits when a third country treaty is used to shift profits from one country to another. This article prevents a TNC from using an affiliate in a third country -- that is not involved in the transfer pricing transaction -- to act as a conduit for profits shifted between the involved TNC entities in the host and home countries.

3. Exchange of information

In its Article 26 (Exchange of information), the United States model treaty, while similar to the OECD Model, contains provisions which allow the tax authority access to usually inaccessible banking or financial information. The United States model is also explicit about the obligation of a contracting State to comply with requests for information, while this obligation is implied in the OECD Model. The United States Model reflects the trend towards increased international cooperation between governments in sharing tax and other information to prevent income shifting and tax evasion.

In addition to the routine exchange of information provisions contained in many tax treaties, the OECD (Owens, 1997) suggests that other non-routine exchanges be explored, including a simultaneous examination agreement between two tax authorities. Such a coordinated enforcement programme allows for both host and home tax authorities to concurrently examine a TNC in whom they share a mutual interest, and share information. In addition, some countries, particularly Canada, are actively advocating the increased use of simultaneous examinations. Simultaneous examination agreements are included in many tax treaties based on Article 26 of the OECD Model Tax Convention, in bilateral advance pricing agreements, and in the joint Council of Europe/OECD Convention on Mutual Administrative Assistance in Tax Matters.

Other avenues for gathering information include bilateral Tax Information Exchange Agreements (TIEA) with the United States, or such multilateral agreements as the Nordic Convention on Mutual Assistance and the EC Directive on Mutual Assistance. General industry-wide exchanges of information can be set up between the United States tax authority and other tax authorities under the Industry Specialization Programme. Data are limited to a particular industry, rather than specific TNCs.

C. Status of arbitration venues

Until recently, the competent authority as defined in existing tax treaties was a major factor in any settlement of double taxation and other transfer pricing disputes. However, this approach is very time-consuming and may require several years to reach a settlement, if indeed one is reached. In some cases, settlements are never reached, because, as noted above, the OECD and United States Models do not require that a binding decision be made, only that an attempt to reach settlement be made. On the other hand, the Arbitration Convention (on the Elimination of Double Taxation with the Adjustment of Profits of Associated Enterprises) agreed to by European Community countries (EEC, 1990), which entered into force on 1 January 1995, ensures the elimination of double taxation by forcing any disputes to arbitration if the competent authorities have not reached a settlement within two years. The arbitration commission then has six months to render a binding decision, after which the competent authorities either reach an alternative agreement within the next six months, or accept the Commission's settlement.

D. Potential conflicts around procedural issues

While there is much agreement that the arm's length principle is appropriate when pricing tangibles and intangible property, there are differences of opinion on other issues, such as documentation requirements, penalties, burden of proof, and preferences concerning the TNMM versus the CPM methods.

Some tax authorities now require detailed documentation on how a TNC's transfer pricing method was chosen and how the transfer price was calculated in order to assess its compliance with the arm's length principle. The OECD guidelines suggest a flexible approach, recommending the maintenance of a level and detail of documentation that allows verification of compliance while not burdening firms with excessive time and cost demands. A more demanding approach is required by United States Section 6038, which sets forth the documentation and reporting requirements for TNCs: documentation should be contemporaneous and include all relevant information, including that discovered after the transaction has occurred. The level of detail, and the types of documentation required, are often considered onerous by TNCs in terms of detail and quantity. Assuming good-faith compliance, such detailed documentation is required by the tax authority for TNCs to escape penalties if there has been a significant under-reporting of tax liabilities due to pricing adjustments.

As with documentation requirements, the assessment and severity of penalties varies by tax authority. OECD guidelines do not suggest specific penalties to be applied at certain thresholds of tax liability in response to misstatements of liability by TNCs. The recommendation is for each country to set penalties, whether criminal or civil, such that "tax underpayments and other types of non-compliance are more costly than compliance" (OECD, 1995,

p. IV-7). The other viewpoint is observed in United States Section 6662, which imposes transactional and net adjustment penalties for misstatements, even those resulting from good-faith errors. The specific accuracy -- and fraud -- related penalties are applicable at certain thresholds for under-reported profits.

Differences regarding burden of proof are highlighted by the divergence between the OECD and United States approaches to documentation and penalties (box 4). This difference may lessen due to recent calls by the United States Congress for reform of the United States tax authority. These reforms include shifting the burden of proof from TNCs to the United States tax authority.

Based on OECD guidelines, some tax authorities (for example in Canada and Germany) have reservations and/or are strictly opposed to CPM as an acceptable transfer pricing method. In other countries, such as Japan, transactional methods are clearly the methods of choice, although the profit split and TNMM methods may be acceptable in certain specific circumstances. Recently, Japanese

Box 4. Burden of proof

The following summarizes the philosophical differences between the United States and the OECD approaches to the issue of the burden of proof:

"In the United States, the burden of proof lies squarely with the taxpayer, who must prove that his prices are charged at arm's length. In Europe, conversely, the burden of proof lies with the tax administration, which must prove that the prices are not arm's length [...] In the United States, the relationship [of TNCs with their respective tax authorities] is often adversarial, whereas in Europe corporations are more used to working in close cooperation with tax authorities to arrive at compromise solutions [...] The OECD guidelines concentrate on how prices are set (a subjective test that focuses on behavior), whereas the U.S. regulations require an arm's length result (an objective test that focuses on taxable income). The IRS's main concern is whether the tax base is correct."

Source: Tax Analysts, 1996, p. 2 and p. 8.

officials were said to have warned that "if the US insists on using the CPM too aggressively, it could provoke a 'taxation war' with Japan" (Coopers and Lybrand, 1997, p. 1). Opposition stems from the perception that "transfer pricing is a pricing issue, not an income issue, and TNMM deals with pricing, whereas CPM deals with income" (*Tax Analysts*, 1997, p. 4). TNMM is applied only to individual transactions and groups of transactions, while CPM can be applied not only to specific transactions, but to results of a TNC on a company-wide basis. If the latter occurs, then CPM is no longer considered a "transactional" method, and is unacceptable to most tax authorities in countries adhering to the OECD guidelines.

When the source of FDI is a TNC based in an OECD country, that country's transfer pricing regulations are generally based on the OECD guidelines and are characterized by flexibility and an assumption of good faith by both the TNC and the tax authority. If developing countries implement their own transfer pricing legislation using similar approaches, disputes about double or unfair taxation and the frequency of arbitration, of audits and penalty assessment, and of income shifting, would all be minimized, provided sufficient resources are available for the effective operation of such laws.

Notes

1 Lorraine Eden (1997) provides an in-depth discussion of OECD guidelines as implemented by Canada -- versus United States regulations -- and their relative effects on corporate income taxation and on TNC strategy.

2 For a discussion of the growth of tax treaties, see UNCTAD (1998).

Section III

INTERACTION WITH OTHER ISSUES AND CONCEPTS

Several issues included in international investment agreements are related to transfer pricing (and are discussed in other papers of this series and in previous sections of this paper (table 1):

Table 1. Interaction across issues and concepts

Concepts in other papers	Concepts in this paper: Tangibles	Intangible property	Advanced pricing arrangement
Scope and definition	+	+	+
Admission and establishment	+	+	+
Incentives	+	+	+
Investment-related trade measures	++	0	++
National treatment	+	+	+
Most-favoured-nation treatment	+	+	+
Fair and equitable treatment	+	+	+
Taxation	++	++	++
Competition	++	++	+
Transfer of technology	+	++	+
Employment	0	0	0
Social responsibility	0	0	0
Environment	0	0	0
Home country measures	++	++	++
Host country operational measures	+	+	+
Illicit payments	0	0	0
Taking of property	0	0	0
State contracts	0	0	0
Funds transfer	++	++	++
Transparency	++	++	++
Dispute settlement (investor-State)	++	++	++
Dispute settlement (State-State)	++	++	++
Modalities and implementation	+	+	+

Source: UNCTAD.

Key: 0 = negligible or no interaction.
+ = moderate interaction.
++ = extensive interaction.

- **Investment-related trade measures (IRTMs).** Firms' transfer prices also become an issue in their relations with governments because of their implications for tariff revenues. Transfer pricing issues thus interact with IRTMs. In fact, for firms' individual transactions, there are sometimes conflicts in the incentives created by the relative magnitudes of the tax rates and the tariffs in the importing country. For example, if the tax rate is relatively high, compared with the exporting country, firms have an incentive to set the transfer price high to shift income out of the importing country and into the exporting country. However, if the importing country also has a high tariff rate on the imported item, then a high transfer price will of course mean a higher tariff. The interaction of transfer pricing issues with tariffs as IRTMs, therefore, can be compounded by the interaction between transfer prices and taxes -- and the relationship between taxes and tariffs.

- **Taxation.** Tax issues are obviously relevant to transfer pricing issues; indeed, as this paper makes clear, transfer pricing is in substantial measure a tax issue. Although firms would need to set prices for intra-firm international transactions for their own internal financial and control purposes, their transfer pricing practices become such an important and contentious issue in their relations with host and home governments because of the tax implications of the prices. The sums at stake are substantial for all parties involved.

- **Competition.** Competition issues and transfer pricing can interact significantly. One of the major "internalization" advantages of TNCs over domestic firms is their ability to manipulate transfer prices across tax jurisdictions offering a higher saving to tax than a domestic competitor can enjoy. This may figure as part of a strategy to drive weaker domestic competitors out of the market. Equally, abuses of transfer price manipulations can lead to the creation of barriers to entry as a result of the greater market power enjoyed by the TNC through its greater profitability (Muchlinski, 1995, p. 393).

- **Transfer of technology.** The transfer of intangible property, which includes technology transfers under the OECD guidelines, should be addressed by transfer pricing regulations. However, in many developing countries, such transfers are not addressed. This is a deterrent to TNCs which need assurance that such transfer will not be unduly taxed.

- **Home country measures.** Transfer pricing regulations administered by the TNC's home country tax authority affect the distribution of income among the TNC and its subsidiaries, and therefore the tax revenues of the host and home countries. Inequitable distribution may lead to TNCs avoiding investment in certain countries whose tax authorities disagree with the distributions imposed by the home country authorities.

- **Funds transfer.** There are also extensive interactions with funds transfer issues -- precisely because transfer prices inevitably affect the amounts of funds that are transferred between related entities of a TNC. Thus, if a host government imposes restrictions on funds transfers in the form of an affiliate's profit remittances, a firm can raise the transfer prices of the goods and services being imported by the affiliate from the parent firm or affiliates in other countries, in order to circumvent the restrictions and thus move funds out of the host country. Of course, there can be serious legal consequences and other problems in relations with the host government if these practices are detected by the exchange control or other authorities of the government.

- **Transparency.** Because of the potential for manipulating transfer practices in contravention of government tax and tariff regulations and because of the potential for using transfer prices to move funds internationally in circumvention of government restrictions on funds transfers, questions of transparency interact with transfer pricing issues. The transparency issues include not only the transparency of the firms' practices but also the transparency of the governments' tax, tariff and funds transfer policies. Furthermore, given the possibility of bribery in these domains of government policy, there are often serious issues about the transparency of TNC-government relations associated with transfer pricing practices.

- **Dispute settlement.** Provisions for the settlement of transfer pricing disputes provide TNCs with some assurance that an avenue exists to deal fairly with such issues. These provisions are often included as articles in bilateral tax treaties. When such provisions are lacking, or fail to succeed, arbitration procedures are the next approach available to TNCs.

CONCLUSION:

ECONOMIC AND DEVELOPMENT IMPLICATIONS AND POLICY OPTIONS

There is widespread concern about transfer pricing issues among policy makers in both developed and developing countries, but especially in the latter group. This was reflected in the answers from respondents from developing countries who completed the 1995 UNCTAD *Questionnaire on current developments in the field of accounting and reporting by transnational corporations and other enterprises* (box 5).[1] The following issues are particularly important.

A. Issues

1. Deficiencies in transfer pricing legislation

For 41 per cent of the developing countries in the UNCTAD survey noted above, their existing transfer pricing regulations, guidelines and/or administrative requirements did not address the issue of services. Furthermore, technology transfers were not addressed in the transfer pricing regulations of two-thirds of the developing countries. The effects of such non-existent or incomplete transfer pricing regulations in some developing countries are debatable. Some experts argue that the presence of transfer pricing policies is a disincentive to FDI in that such policies unnecessarily restrict a TNC's freedom to structure its FDI to protect itself in a risky environment. Others argue that the lack, rather than the presence, of transfer pricing policies is the true disincentive. It may be that TNCs "weight profit allocations towards countries with aggressive transfer pricing policies, so as to minimise tax risk" (Price Waterhouse, 1997, p. 1).

If regulations are based on globally acceptable principles, such as the arm's-length principle, and are uniformly implemented by competent and knowledgeable tax authorities, TNCs should welcome the certainty of the investment environment, especially if this certainty is reinforced by tax treaties and APAs. As has been observed: "only formal public agreements can provide both the framework needed for systematic cooperation and a clear incentive to taxpayers to comply with the law" (Cohen, 1995, p. 23). In some developing countries, the existence of tax incentives, such as tax holidays and tax credits, has postponed the need for transfer pricing policies. Other countries have relied on customs valuations in place of transfer pricing valuations to generate revenues.

In developing countries with basic transfer pricing regulations, problems arise from the lack of experience and/or expertise of accountants and auditors in analyzing complex transfer pricing situations. A lack of administrative experience may allow firms to take advantage of the situation and shift income, or to be unfairly taxed due to a misapplication of the regulations. The existence of monopolies within a country may affect the tenor of tax regulations so that those monopolies are protected from competition by TNCs wishing to tap into a captive market share. In some countries, "entry is arbitrarily regulated -- often from regulatory authorities with vested interests in screening" (Bergsman and Shen, 1996, p. 346).

Box 5. Transfer pricing policies: views from a developing country perspective

Because most TNCs are based in developed countries, and developing countries are mostly host countries, inequitable transfer pricing shifts wealth and resources from the latter to the former. The following are observations obtained in response to the UNCTAD questionnaire from one government official, observations that echoed those of many other respondents:

"* Recognize the right of governments of importing countries to question the pricing policies of TNCs.
* Ensure an appropriate taxable profit is posted in the end consumer country, keeping in view the risk/reward criteria which propel multinational investment.

/...

(Box 5, concluded)

* Recognize all taxes paid by the TNC in a host country including state or local authority taxation and withholding taxes, in determining the reward criteria for transfer price fixation.
* Recognize the research and development costs of products and services, and the necessity of their recovery from product or service sales.
* Recognize the relative cost base differentials between countries when determining profit splits between territories on any transfer pricing issues.
* Recognize the validity of patents and trademarks, more specifically to develop different price fixation criteria for products under patent."

Source: Borkowski, 1997, p. 333.

2. Income shifting

The extent and significance of income shifting by national and foreign TNCs in developing countries was assessed by the UNCTAD survey. Of the developing countries with sufficient evidence to make an assessment, 61 per cent estimated that their own national TNCs were engaging in income shifting, and 70 per cent deemed it a significant problem. The income-shifting behaviour of foreign-based TNCs was also appraised. Eighty-four per cent of the developing countries felt that the affiliates they hosted shifted income to their parent companies to avoid tax liabilities, and 87 per cent viewed the problem as significant.

Even in countries with sophisticated transfer pricing legislation designed to subvert income shifting and transfer pricing manipulations, the success of the tax authorities in these areas has to be weighted against the effort involved. In 1994 alone, the United States tax authority made income adjustments of $2 billion and $1.5 billion for 236 non-United States-controlled and 156 United States-controlled TNCs respectively (United States, GAO, 1995), based on the application of Section 482. Other countries, most notably Japan, are increasing the frequency and size of TNC income adjustments resulting from the misapplication or manipulation of transfer pricing. In the twelve month period ending June 1997, the National Tax Administration of Japan made 78 adjustments to reported income due to transfer pricing assessments totalling $330 million (Hielscher and Kaneko, 1998).

Income shifting is encouraged by cross-border tax and tariff differentials, and may lead to distorted competitiveness between resident and non-resident TNCs. Capital flight may occur via the opportunity for non-resident TNCs to withdraw funds from emerging market economies which could otherwise have been used for re-investment in those countries. Tax underpayments caused by the movement of profits out of a country can result in shortfalls in government revenue and in foreign exchange reserves. Income shifting also leads to an undue reduction of the tax base in one country with a corresponding undue tax base increase in another. The curtailment of income shifting is hampered by the difficulty in obtaining physical evidence of transfer pricing manipulations. This situation has led many developed countries to include stricter documentation requirements and penalties in their transfer pricing regulations.

3. Repatriation of profits

While some developing countries set some limits on the outflow of funds, repatriation policies can sometimes be so stringent as to deter FDI. Such limitations are often considered part of the negotiations when encouraging major TNCs to commence or increase FDI. However, reservations can often be made for situations in which there are severe trade imbalances. Repatriation policies can be included in new tax and investment treaties and agreements. An analysis of 19 existing regional, bilateral and multilateral FDI instruments by UNCTAD (1996b) shows that the transfer of funds and the repatriation of investment by TNCs are explicitly addressed in nine of those instruments.

4. Double taxation of profits

Double taxation of a TNC's profits may arise when there are differences in the transfer pricing policies of the countries involved. For example, the OECD guidelines mandate the use of TNMM only by transaction, or for a group of controlled transactions, and only as a last resort. The United States tax authority, however, allows CPM, its supposed counterpart, to be applied to a broader, and therefore less rigorous, range of transactions, and with no restrictions, only requiring documentation that it is the "best method" for the firm. These differences create the current situation where a tax authority using OECD-based transfer pricing regulations may reject a TNC's use of CPM and assess additional taxes and penalties. (The potential for double taxation and/or transfer pricing audits is detailed in table 2).

Table 2. Transfer pricing method matrix of selected countries

Country	Transaction-based methods			Profit-based methods			Other methods
	CUP/ CUT	Resale	Cost Plus	Profit Split	CPM	TNMM	Formulary apportionment
Brazil	Yes	Yes	Yes	No	No	No	Possible
Canada	Yes	Yes	Yes	No	No	Last resort	No
China	Yes	Yes	Yes	Deemed profit	No	Yes	No
Germany	Yes	Yes	Yes	Last resort	No	Last resort	No
Japan	Yes	Yes	Yes	Yes	No	No	No
Mexico	Yes	Yes	Yes	Yes	No	Yes	No
Korea, Rep. of	Yes	Yes	Yes	Last resort	No	Last resort	No
United Kingdom	Yes	Yes	Yes	Last resort	Last resort	Last resort	No
United States	Yes	Yes	Yes	Yes	Yes	No	No
OECD Guidelines	Yes	Yes	Yes	Last resort	No No	Last resort	No

Source: Adapted from *Tax Management Transfer Pricing Report*, 1997, p. 18; and *Tax Notes International*, 17, 16 (10 October 1998), p. 1159.

Such situations may be resolved by use of the competent authority procedure described in the OECD Model tax treaty. However, some developing countries do not have corresponding adjustments in their tax treaties, while others do not even have a tax treaty with the relevant home country. The competent authority process has been characterized as "too costly ... time consuming ... simply inadequate" from a TNC perspective (Ernst and Young, 1995, p. 2). In addition, the use of the competent authority procedure does not guarantee the elimination of double taxation. From the viewpoint of tax authorities, there is concern that the current competent authority process is perceived by TNCs as inadequate to protect them against double taxation, and that the time factor to settle a case is excessive. The latter problem is important because the caseload for competent authorities is expanding, and will only increase the already considerable time delay in resolving cases.

Recent research (Borkowski, 1996) found that United Kingdom and United States TNCs experienced transfer pricing audits by both home and host country tax authorities significantly more often than Canadian, German or Japanese TNCs. One-half of TNCs from the United Kingdom with affiliates in the United States had been audited by the United States tax authority, while 29 per cent of those same TNCs had been audited by their home tax authority in the United Kingdom. Most audits of TNCs, regardless of home country, are conducted by the United States tax authority (table 3).

Table 3. Double transfer pricing audits of TNCs in selected countries [a]

(Percentage)

TNC home country	**TNCs** audited by United States tax authority	**TNCs** audited by home country tax authority [b]
Canada	4	14
Germany	11	6
Japan	18	6
United Kingdom	50	29
United States	56	33

Source: UNCTAD, based on Borkowski, 1996, p. 30.

a 347 TNCs were covered in the study.

b Host country in the case of the United States.

5. Customs valuations

Conflicts of interest may arise between valuing a transferred good using an arm's length method, such as CUP, and valuing the same good for purposes of customs duties. Cogent arguments have been made for and against uniform valuation. Proponents of one valuation cite the value derived at arm's-length as objective; the need for one standard to avoid taxpayer confusion; the consistent use of the arm's length standard in all tax situations; and problems if TNCs use one value to minimize tax liabilities while tax authorities use another value to maximize tax revenues. Opponents argue that the valuations serve different purposes; TNCs are not adversely affected; and the expectation that both TNCs and the tax authorities would choose the optimal valuation to maximize their positions (Masui, 1996).

In reality, complete uniformity is improbable given the complexities of the tax-trade cross-border relationships and regulations (Masui, 1996), and that transfer pricing valuations usually include costs that are omitted in customs duties valuations. By including an exchange of information provision in tax treaties, tax authorities and customs officials can ensure that differences in the declared values are indeed justified, and do not represent an attempt to evade either income taxes or customs duties. Such information exchange is supported by OECD guidelines.

6. Cost sharing

Cost sharing arrangements for the development of intangibles require careful monitoring to ensure that TNCs are not passing on undue costs of developing intangible property to their affiliates in developing countries which may receive minimal benefit from that property. Cost sharing techniques can be used to allocate research, development and other costs, leading to these advances, to developing countries on a basis disproportionate to the benefits actually enjoyed by those countries. However, in certain cases, in particular those of high R&D costs, including new product development, headquarters salaries and other corporate overheads, the affiliate concerned, often the parent firm, may be unable to meet all of the cost incurred. Yet, the overall benefit to the corporate group may require a degree of shifting in the overall distribution of costs across and among affiliates. Thus, legitimate cost sharing arrangements must be distinguished from those with a primary aim of tax avoidance.

7. Tax havens

Transactions performed in tax havens pose some problems to tax authorities, as do payments of interest through loan agreements entered into by related parties. These issues are discussed in more detail in the Issues Paper on Taxation in this Series.

8. Advance pricing agreements

APAs might help to alleviate some transfer pricing problems for developing countries. However, TNCs typically appear uninterested in participating in APA programmes. One survey (Borkowski, 1996) found that, depending on the home country, the percentage of TNCs with no plans to pursue APAs with either their home or host country tax authorities ranged from 71 per cent to 96 per cent (table 4). Canadian TNCs cited the volume of information and/or documentation required and the cost of APAs exceeding their benefits. German TNCs ranked volume of information required and the difficulty of concluding multilateral APAs as the most important deterrents. Japanese TNCs were concerned with volume of information and confidentiality concerns, while United Kingdom TNCs cited cost and confidentiality concerns. United States TNCs ranked cost and volume of information required as the chief drawbacks to APAs.

Table 4. Advance pricing agreements in selected countries[a]

(Percentages)

Home country	Have/plan to have APA with the United States	Have/plan to have APA with home country[b]
Canada	7	11
Germany	17	6
Japan	18	5
United Kingdom	29	21
United States	10	4

Source: UNCTAD, based on Borkowski, 1996, p. 30.

[a] 347 TNCs were covered in the study.
[b] Host country in the case of the United States.

While the United States tax authority has been a leading proponent of the APA programme, TNCs based in the United States seem to be wary of the programme. Only 10 per cent of these TNCs have or plan to pursue an APA with their own United States tax authority, while only four per cent are considering APAs with host country tax authorities

B. Enhancing the development dimension

As noted above, developing countries have, and will continue to, experience significant direct and indirect effects from transfer pricing transactions. This is true not only in cases of wholly-owned subsidiaries operated by TNCs. Other types of business organization employed by TNCs and which involve local investors, whether as minority shareholders or as partners in joint ventures, will also generate transfer pricing problems. Any resulting income diversion from local investors and/or, more generally, from the local economy may need to be regulated.

In responding to such matters developing countries face particular problems. Many such countries lack adequate financial resources and sufficient numbers of experts to administer an effective regulatory system. A related problem exists with the retention of experts after training-developing countries may be unable to compete with TNCs over terms and conditions of employment for such skilled personnel.

In addition, while laws regulating transfer pricing can be adopted, and, as shown above, significant models already exist for these, their practical application may create further issues. In particular the practical skills and resource needs in administering a regime for transfer pricing adjustments have to be met. These concern principally mechanisms for obtaining and sharing information, both internally among national regulators as well as regionally and internationally.

These dual concerns, skills and resources and information gathering and sharing, could be operationalized in international investment agreements through specialized clauses. In the first place, a transparency clause could be included that requires disclosure by TNCs of their transfer pricing practices. For example, the draft United Nations Code of Conduct on TNCs required, in paragraph

44, that TNCs should "disclose to the public in the countries in which they operate, by appropriate means of communication, clear, full and comprehensible information on the structure, policies activities and operations of the transnational corporation as a whole". Listed among the non-financial information to be disclosed are "policies applied in respect of transfer pricing" (UNCTAD, 1996a, volume I, pp. 170-171). Similarly the OECD Guideline on taxation states:

> "Enterprises should:
>
> 1. Upon request of the taxation authorities of the countries in which they operate provide in accordance with the safeguards and relevant procedures of the national laws of these countries, the information necessary to determine correctly the taxes to be assessed in connection with their operations, including relevant information concerning their operations in other countries" (UNCTAD, 1996a, volume II, p. 160).

Increased disclosure could serve to discourage income shifting by making transfer pricing activity more transparent to tax authorities in both developed and developing countries (box 6).

Box 6. Improving transparency

Considerable energy has already been expended on increasing disclosure, resulting in the International Accounting Standards Committee's 1997 revision of IAS 14, "Reporting financial information by segment" (IASC, 1997) and the United States Financial Accounting Standards Board's Statement 131, "Disclosures about segments of an enterprise and related information," issued on 30 June 1997 (United States, FASB, 1997). Detailed recommendations for improved reporting have been suggested by UNCTAD (1996c), including increased disclosure about transfer pricing methods, tax liabilities, segment financial reporting, and related party transactions. In further standardizing reporting and allowing for comparisons of TNCs based in various countries, the IASC standards about depreciation, research and development, allowable expenses and related issues could help to improve comparable cross-border analyses.

Source: UNCTAD.

Notwithstanding an increase of transparency, problems concerning skills, resources and regulatory systems will continue for developing countries in particular. Here, technical assistance and co-operation clauses may help to ensure that positive assistance is given to developing countries, in particular by developed countries that have the resources and experience necessary to deal with transfer pricing practices effectively. An analogous technical assistance clause can be found in the TRIPS agreement (box 7). Such a clause could include assistance on information sharing (Lall, 1979), co-operation in the control of transfer pricing and advice and information on the development of effective regulatory frameworks.

Box 7. The TRIPS technical assistance clause

Article 67
Technical Cooperation

In order to facilitate the implementation of this Agreement, developed country Members shall provide, on request and on mutually agreed terms and conditions, technical and financial cooperation in favour of developing and least-developed country Members. Such cooperation shall include assistance in the preparation of laws and regulations on the protection and enforcement of intellectual property rights as well as on the prevention of their abuse, and shall include support regarding the establishment or reinforcement of domestic offices and agencies relevant to these matters, including the training of personnel.

Source: UNCTAD, 1996a, volume I, p. 368.

Furthermore recommendations for establishing a workable transfer pricing framework based on international guidelines have been made by a number of tax experts from developing countries (box 8). These indicate how special clauses aimed at assistance to developing countries could evolve.

Box 8. Establishing a workable transfer pricing framework for developing countries

Below are suggestions adapted from a resolution of tax experts from Latin American countries which were approved at an international event, the "II Jornada Tributária do Mercosul" (Sao Paulo, 1997):

1. National laws, notably of the Southern Common Market (MERCOSUR) member-states, must be compatible with one another, so that the principle of tax coordination among the various jurisdictions involved prevails and harmful fiscal competition is avoided.

2. In view of the necessity of retaining international investment and to keep MERCOSUR member-states attractive for foreign capital, the rules for transfer pricing to be established by the respective domestic laws should follow the basic lines adopted by the OECD countries, taking into account national realities. The member-states should also adopt the interpretative orientation given under the OECD rules.

3. The economic methods to obtain a transfer price must be used in a consistent form and should be compatible with the applicable rules to the customs and VAT valuations.

4. For transfer pricing rules to be compatible with internationally adopted practices, fixed profit margins should not be established, nor should there be any utilization of legal fictions or absolute presumptions other than the "arm's-length" method in the identification of the market value of a transaction.

5. The national tax authorities must bear the burden of proof that the prices adopted by the taxpayers do not reflect the applicable legal standards.

6. The rules for transfer pricing relating to intangibles (such as the rendering of services, utilization of rights, brands and patents, transfer of technology, technical assistance and cost-sharing agreements) must be fair and efficient and adopted in a realistic form, so that the economic methods adopted are adequately defined by the relevant legislation.

/...

(Box 8, concluded)

7. The network of international agreements should be increased to avoid double taxation and to allow for the exchange of information between the fiscal authorities from the various jurisdictions. It is recommended that the MERCOSUR countries establish a multilateral treaty, i.e. signed jointly by the member-states, to avoid double or multiple taxation.

8. The MERCOSUR member countries should adequately examine the structure of their respective taxes over the income and profit of taxpayers, including identifying tax havens and examining their taxable basis, rates and fiscal administration.

9. To apply adequately the rules of transfer pricing in the MERCOSUR countries, the establishment of a supranational organization to organize a large database (statistics) on economical activities relevant for international transactions is of importance, as long as the necessary commercial secrecy is preserved about the operations and business practices of taxpayers.

10. Due to relevant administrative and compliance costs arising from the application of transfer pricing rules, national legislation should allow for the possibility of advance pricing agreements, the existence of deviation margins, excluding methods of transfer pricing from operations that do not materially show outstanding taxes, and safe harbours.

11. It is essential to establish efficient channels of communication between public authorities and taxpayers, so that the introduction and application of pertinent rules on transfer pricing is done in a fair, adequate and reasonable way.

12. It is essential that the tax authorities of the MERCOSUR member-states act in a consistent form, in order to minimize the possibilities of starting expensive litigation between nations, because of diverging interpretations over transfer pricing rules in each of the jurisdictions, including the efficient application of the so-called corresponding or appropriate adjustment to avoid double or multiple taxation of the same income.

Source: do Amaral, 1998.

Some more technical aspects of transfer pricing issues could also be addressed in relevant provisions of international tax agreements. These could include specific arbitration measures to settle disputes when the competent authority fails (box 9), and limitation-on-benefits clauses to prevent or deter treaty shopping (box 10). Tax treaties could also be a vehicle through which APAs are reached, allowing developing countries and TNCs a respite from annual tax audits, deficiency assessments and tax disputes.

Box 9. Dispute settlement

Tax disputes and double taxation situations arising from transfer pricing disagreements are, to a certain extent, unavoidable, given the nature of rules in this area and their application. Mutual agreement procedures with competent authorities can help, but these are cumbersome. Perhaps competent authorities can utilize international APAs as part of tax treaties to settle current and avoid future transfer pricing disputes with TNCs. Article 25 of the OECD Model Tax Convention allows for the use of competent authorities, but does not set time limits on reaching a settlement, and does not require that a solution be reached to avoid double taxation. Treaties could include a binding arbitration clause similar to that in the European Community Arbitration Convention (text box).

Expansion of arbitration clause

"Article 25 [on dispute settlement] should be expanded to include mandatory arbitration to settle disputes within a reasonable time frame if mutual agreement procedures fail ... When competent authorities fail to settle the dispute, it should be sent to an independent arbitration board whose decision is binding on all participants. The board should consist of transfer pricing, trade law, and tax experts from countries not involved in the particular dispute, or currently involved with one of the parties in another dispute. Board members should not be part of any tax authority or governmental unit. The integrity and independence of the arbitration board must be guaranteed in order for tax authorities and TNCs from the countries involved to accept the board's decision as binding."

Source: UNCTAD, 1996c, p. 21.

/...

(Box 9, concluded)

In some countries, TNCs use litigation in the tax courts to seek redress in instances of transfer pricing disputes. Litigation could be structured so that it is seen as the last, rather than first, resort of dispute settlement. Access to voluntary binding arbitration could be simplified and its cost-effectiveness stressed. While arbitration costs are less than litigation costs, total costs may be even lower if limits are set on discovery and on the use of expert witnesses.

Source: Sansing, 1997.

Box 10. Benefits clause

A limitation-on-benefits clause could be included in tax treaties to help curb transfer pricing abuses and prevent the pass-through of profits through a third party country. Treaties could also provide for compensating adjustments to avoid double taxation of TNCs, such as those presented in the OECD Model. In certain cases, such adjustments are not necessarily desirable because they may harm, rather than help, a developing host country, depending on its tax structure vis-à-vis a developed home country. An exchange-of-information clause, based on Article 26 of the OECD Model, could be included in treaties and identify relevant types of information, whether routine, specific or spontaneous. Language could be based on existing Tax Information Exchange Agreements.[a]

Source: UNCTAD.

[a] If such correlative adjustments are desired, the United States Model does not guarantee protection from double taxation.

By way of conclusion, it can be seen that transfer pricing practices require a specialized and flexible regime based on co-operation both within and between countries, and especially between developed and developing countries, if a development friendly regime for regulating transfer pricing is to be realized.

Note

1 For detailed country-specific comments, see Borkowski (1997).

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