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Multinationals and the Third World - Issues Related to Transfer Pricing

Marcia A. Wiss

A. NATURE OF THE PROBLEM

Transfer pricing is the transfer of anything of value between related enterprises at a price other than that determined through arm's-length negotiations. The affiliated or related enterprises within a multinational enterprise ("MNE") typically use transfer pricing in the sale of goods, data and services and the licensing of technology, patents and trademarks among the members of the MNE. The prices charged to related enterprises may reflect the free play of market forces. However, since the MNE generally is in a position to adopt whatever pricing principle it determines to be convenient to it as a group, prices for such transactions may vary considerably from arm's-length prices, which are the prices which would have been agreed upon by unrelated parties engaged in the same or similar transactions in the open market ("arm's length prices").

MNE's can be predicted to be more concerned normally with their total net earnings after taxes, rather than with the form those earnings take or the taxing authority which receives the higher percentage of those taxes. Artificial arrangements between the various members of the MNE can generate substantial benefits to it, without directly disadvantaging corporations outside the MNE, since transactions with non-members would be on an arm's length basis. However, some taxing jurisdictions are the victims of transfer-pricing practices and others the beneficiaries.

Since national tax authorities need to determine the proper level of taxable profits of affiliated enterprises operating within their respective jurisdictions, the transfer pricing policies of MNEs are of great importance to them, particularly where there are grounds to believe that the taxable profits reported by a member of such a group are unduly low. In such a case, the relevant national tax authority may have to examine the possibility that this is due to the transfer-pricing policy applied by the group.

It is generally acknowledged that, in taxing the profits of an enterprise which engages in transactions with affiliated enterprises outside the jurisdiction of the relevant taxing authority, the profits should be calculated on the assumption that the prices charged in these transactions are arm's length prices. The arm's-length approach has been endorsed by the United Nations Group of Experts on Tax Treaties between Developed and Developing Countries. It is the underlying assumption in Article 9 of the OECD Model Double Taxation Convention on Income and Capital (1977). The Internal Revenue Code of the United States uses the arm's-length concept to allocate income among related enterprises under Section 482 of the Internal Revenue Code of the United States ("Section 482"). Modern bilateral double taxation conventions between many nations have adopted the arm's length-principle.

The MNE uses transfer pricing to achieve the following benefits:

1) To reduce total MNE tax liabilities by shifting income to countries with low income taxes and deductions to high tax jurisdictions;

2) To reduce customs taxes by decreasing the customs value of an item;

3) To reduce profits in countries in which outside shareholders, sometimes including worker employees, own a substantial portion of the local entity; and

4) To shift profit outside a developing country to minimize the impact of restrictive foreign exchange and currency controls or to remove profits as soon as possible in the expectation that expropriation might occur and terminate profits.[1]

Although MNEs have reasons or incentives such as those mentioned above for engaging in transfer pricing, it is not always possible for them to do so. Often units of MNEs have considerable autonomy so that they can, and often do, bargain with each other in a manner similar to that of independent entities. For example, local management may want to demonstrate a good profit record and therefore may resist central management's directives to depress their profits artificially . In addition, the tax considerations which are normally paramount reasons for engaging in transfer pricing may be offset against other pressures from minority shareholders or local governmental entities such as customs authorities, exchange or price control offices. They may therefore charge arm's-length prices, or even prices distorted in a manner counterproductive to tax savings, in order to recognize alternative benefits or to respond to alternative pressures. Therefore, it should not always be assumed that prices among related entities are not arm's-length prices.

In addition, it should be kept in mind that transactions within MNEs may not be directly comparable with those which take place between independent enterprises, so that allowances have to be made when comparing transfer prices with the prices charged by independent enterprises. For example, frequently a wide range of technical, managerial and research and development support is provided to members of an MNE in connection with the sale of goods, a phenomenon which is less frequently found in the sale of goods to unrelated entities. Also, often the production facilities of a related group are largely integrated with divisions responsible for research and development, transportation, marketing, advertising, design, and distribution. These functions are rarely integrated when are performed by unrelated entities.

In addition to the interest of taxing authorities to assure that an appropriate tax is paid to each, the MNE has a corresponding interest in

avoiding double taxation. These corresponding interests in assuring that a fair, non-duplicative tax is paid to the tax authorities facilitate problem resolution through negotiation and resolution on a bilateral or multilateral basis.

B. ACCOUNTING CONCEPTS

In determining an arm's-length price, three principal accounting methods have been used: (1) the comparable uncontrolled or independent price method; (2) the resale price method; and (3) the cost-plus method. Under Section 482 these three methods are listed in this order of priority in determining which would be the most appropriate allocation of prices among related enterprises. The Report of the OECD Committee on Fiscal Affairs (1979) favors use of the comparable uncontrolled price method if possible; however, it recognizes that there may be cases where the evidence of retail profit markups, production costs or other data may be more complete, more conclusive and more easily obtained than an undisputed evidence of open market prices and therefore one of the other two methods would be preferable.

The comparable uncontrolled price, or independent price, method uses the uncontrolled market price for the same or similar goods sold to independent third parties. The resale price method takes the price at which the goods are sold by the connected purchaser to its independent customers and subtracts an assumed markup to arrive at the arm's-length price for sale by the original vendor. The cost-plus method uses the original vendor's cost and adds an appropriate markup to arrive at the arm's-length price for the sale by the original vendor and thus for the purchase by the reseller.

1. Comparable, Uncontrolled Price Method

The comparable uncontrolled price, or independent price, method can be applied if a comparable uncontrolled sale, i.e., one in which neither the buyer nor the seller are members of the same controlled group, can be identified. Comparability exists if the physical property and circumstances involved in the uncontrolled sales are identical to the physical property and circumstances involved in the controlled sales. If the differences have a definite and reasonable impact on the price, the differences can be reflected by adjusting the price. Differences which may affect the price of property include quality of the product, the time and terms of the sale, associated intangible property, the size of the market and the geographical market in which the sale takes place.

It is also possible to use the comparable uncontrolled price method when viewing sales made by the MNE to unrelated customers and purchases made by the MNE from unrelated sellers in addition to sales between totally unrelated parties. Section 482 provides that this method can be used if substantially the same products are sold under substantially the same circumstances where differences either have no effect on prices or

can be measured and eliminated with a "reasonable number of adjustments."

2. Resale Price Method

The resale method is designed principally for transfers to sales subsidiaries that, without additional processing, sell the product to unrelated customers. The arm's-length price is obtained by subtracting an appropriate markup for profit from the uncontrolled selling price. The markup is obtained by reference to similar transactions between unrelated parties. The appropriate markup is equal to the gross profit from uncontrolled sales of similar products or under similar circumstances. In determining the appropriate markup, the similarity or dissimilarity of resale must be considered with reference to: (1) the product line involved; (2) the functions performed by the reseller with respect to the property; (3) the effect on price of any intangible property utilized by the seller, e.g., patents, trademarks, trade names; and (4) the geographic market in which the functions are performed by the reseller.

3. Cost-Plus Method

The cost-plus method is designed primarily for exports of components or unfinished goods that will have substantial value added to them by the purchasing subsidiaries. In determining an arm's-length price under the cost-plus method, an appropriate markup for profit is added to the seller's total cost of product. The resultations under Section 482 provide that the gross profit percentage is to be determined if possible by reference to sales made by the seller to unrelated parties, or in the absence of such sales, by reference to sales between unrelated parties under comparable circumstances. The determination of the gross profit percentage should take into account such matters as: (1) the type of property involved; (2) the functions performed by the seller; (3) the effect of any intangible property used by the seller in connection with the property sold; and (4) the geographic market in which the functions are performed by the seller.

C. INTERNAL REVENUE CODE SECTION 482

To the best of my knowledge, the United States has exercised the right of a taxing authority to reallocate prices charged between related parties for a longer period of time than any other country and, consequently has a large body of regulations, revenue rulings and cases interpreting this right of the Internal Revenue Service to reallocate. Therefore, frequent reference will be made in this paper to the United States' policy and history with respect to transfer pricing in order to shed light on appropriate systems that might be created by developing countries in an attempt to combat transfer pricing. Both Germany and the United Kingdom more recently have adopted procedures with respect to transfer pricing that are similar to those of the United States.

Obviously many developing countries lack the administrative and enforcement mechanisms and trained personnel to implement a complex tax-reallocation system. References to U.S. tax policy are, therefore, provided as a guide only, to be adapted to local conditions as appropriate.

Since the U.S. is frequently one taxing authority in intercompany transactions, effective U.S. enforcement of §482 should minimize transfer pricing problems for U.S. trading partners. The same should obtain as other efficient taxing authorities adopt similar arm's-length rules. Effective enforcement of these rules by the industrialized nations should benefit Third World trading partners.

A recent study by Burns [2] illuminates the actual usage by the IRS of the three accounting methods. Those U.S.-based MNEs responding to the survey state that 80% of all exports to their subsidiaries were products which were also sold to unrelated customers. Therefore, if circumstances surrounding sales to related and unrelated customers were the same or substantially the same, 80% of the transfer prices should or could have been based on the comparable uncontrolled price method. The remaining 20% of all exports to subsidiaries were products which were not also sold to unrelated customers. Approximately one third of these exports were finished goods and two thirds were components or semi-finished goods. Therefore, if an appropriate markup could be determined for those goods sold only to subsidiaries, 7% of the transfer prices should have been based on the resale method and 13% should have been based on the cost-plus method.

Although 80% of exports to subsidiaries would seem to have qualified for comparable uncontrolled price treatment, only 43% of the executives surveyed believed that it was reasonable to use the comparable uncontrolled price method for their firms' intercompany exports. Although 7% of the exports to the subsidiaries would seem to qualify for the resale price method, 30% of the executives polled thought this method reasonable. The cost-plus method was shown to be overwhelmingly favored by the MNE executives. Although only 13% of the exports to subsidiaries would seem to qualify for the cost-plus method, 64% of the executives consider this method to be reasonable.

The participants in this study reported that for intercompany exports audited since 1965, the Internal Revenue Service calculated 24% of the additional tax assessments by using a comparable uncontrolled price, 14% by using a resale price, 30% by using the cost-plus price, and 32% by using some other measure.

An earlier study by Duerr[3] revealed this same lack of use of the supposedly preferred comparable uncontrolled price method. In Duerr's study, which examined IRS audits of intercompany sales, the respondents stated that IRS reallocations during a ten-year period were based on the comparable uncontrolled price method only 28% of the time, on the resale method 13% of the time, on the cost-plus method 23% and on some other procedure the remaining 36% of the time.

Even the U.S. Treasury's own study[4] revealed the same minimal use of the comparable uncontrolled price method, which the statute declares to be the preferred method. That study revealed that IRS agents considered adjusting 591 U.S. tax returns for transfer pricing reasons and actually adjusted 174, assessing $313 million in additional taxes. Only 21% of the assessments were based on the comparable uncontrolled price method; 11% were based on the resale price method; 27% on the cost-plus price and another method was used 41% of the time.

This failure to use the comparable uncontrolled price method by the IRS and the corresponding preference of the executives of MNEs that other methods be used should be reviewed and considered by developing countries when fixing priorities of accounting methods for combating transfer pricing.

It should also be noted that respondents to the Burns survey reported that 40% of all Section 482 assessments paid involved exports to subsidiaries taxed at rates equal to or greater than United States tax rates. Also, the Burns respondents reported that 52% had been subjected to double taxation as a result of a Section 482 reallocation. This occurred because the companies were unable to obtain a refund from foreign governments to offset the increased taxable income established by the U.S. audit. Respondents stated that refunds could not be obtained because (1) the foreign government disagreed with the assessments (57%); (2) the period set by the statute of limitations had elapsed (42%); (3) there was no procedure for a refund claim (29%); and/or (4) the procedure for a foreign claim was too costly (29%). Increased use of reallocation audits by countries in which U.S.-taxed MNEs do business can be predicted to further exacerbate this problem.

U.S. taxpayers might receive relief from double taxation resulting from a Section 482 audit through application of the foreign tax credit when the foreign subsidiary's profits are paid to the parent. Prior to 1965, the U.S. taxpayer was allowed to offset against the increased tax liability caused by the Section 482 adjustment an amount by which foreign taxes were overstated by reason of the improper treatment of such transactions. In effect, a foreign tax credit was available without the U.S. parent corporation having received a profit distribution from the foreign subsidiary. Since 1965 a direct offset has not been allowed against tax liability as a relief from the double taxation which sometimes arises from a Section 482 audit. However, under Rev. Proc. 65-17, a tax-free repatriation procedure has been substituted. This repatriation procedure is only available where the underlying transactions giving rise to the Section 482 allocation did not have as one of their principal purposes the avoidance of United States federal income tax. The factors which the United States Government uses to determine this are as follows:

1) The amount of dividends received from the controlled entity;

2) Whether the taxpayer attempted in good faith to comply with the Section 482 regulations then in existence;

3) The extent to which the rejected transfer pricing arrangement contravened the regulations; and

4) The amount of any income tax levied by a foreign country which resulted from the transaction.[5]

Several other aspects of Section 482 are worth noting. It gives the U.S. Internal Revenue Service the authority, if necessary, to apportion gross income, deductions, credits or allowances between related entities, to prevent evasion of taxes or clearly to reflect the income of any such businesses. Section 482 applies only to corporations owned or controlled by the same interests and "control" includes any kind of direct or indirect control. The reality of the control is decisive, not its form or the mode of its exercise.[6]

Central to many of the problems under Section 482, and between MNEs and taxing authorities generally, is that Section 482 is based on the premise that a subsidiary can be constructively treated as if it were economically separate from the parent. However, only 41% of the U.S. respondents to Burns' study state that their organizations actually operate this way. Although composed of legally separate entities, 49% of the respondents stated that their companies make most of their intercompany pricing decisions as though the MNE were one economic unit.

D. PROBLEM AREAS

Specific problem areas for proper allocation are treated by regulations promulgated under Section 482 and by the Report of the OECD Committee on Fiscal Affairs as follows: (1) loans or advances,[7] (2) performance of services,[8] (3) use of tangible property and leasing,[9] (4) transfer or use of intangible property[10] and (5) sales of tangible property.[11]

1. Loans or Advances

Since debt may be disguised as equity or vice versa, most jurisdictions set forth tests to determine which transactions fall into which category. This distinction is particularly important for the country of the borrower, especially if a transaction is portrayed as a loan, but is in fact equity. If this occurs, the country of the borrower will ordinarily disallow the deduction of interest and will treat it as a dividend payment, possibly attracting a different rate of withholding tax.

Countries have different approaches as to how to distinguish an equity contribution from a loan. Some will only or principally look at the debt equity ratio. However, since the debt equity ratio typically varies significantly between industries, such variations have to be taken into account. Other countries look at a number of additional factors, such as whether there is an unconditional written promise to pay a fixed

amount of principal at a fixed maturity date; whether the loan is subordinated to the rights of other creditors; whether the debt is convertible into stock or shares of the debtor company; whether the shareholders of the company hold the alleged debt instruments pro rata in relation to their shareholdings; whether the debtor is in default in the event of a failure in the payment of interest; and whether or not parties intended to create a debtor-creditor relationship.

One country adopts a flexible approach and generally looks at the acts and circumstances of each individual case to determine whether the transaction demonstrates "unusual financing." Loans are frequently given to subsidiaries by parents during the start-up years, but most countries' taxing authorities will not accept an interest-free transaction simply because the enterprise is in a developmental phase.[12] The rate of interest occasionally also poses problems, although tax authorities normally will require an adjustment only if the rate significantly deviates from the market rate. Should allocation be necessary, factors to be reviewed in determining a comparable or similar rate would be; amounts and maturities; the nature or purpose of the loan (trade credit, general purpose loan, real estate credit, etc.); the currency or currencies involved (strong or weak currencies); the exchange risks of the taxpayer lending or paying in a particular currency; the security involved and the credit standing of the borrower.[13]

2. Services

Services in a group of associated enterprises are often performed in a different manner and on a different cost basis than those performed for unrelated enterprises. In highly integrated groups of enterprises, normally services are performed which are different in quantity and form from those provided between independent entities and therefore allocation between members of the group may be difficult.

The general formula used by the OECD is that the enterprise receiving the benefit should pay for the service.[14] Therefore, if the parent is providing services in which it is acting in its capacity as a shareholder, the subsidiary should not be required to pay for such services. In addition, expenses incurred by a parent company in providing administrative services to subsidiaries, e.g., arranging meetings of its own shareholders, consolidating the results of performance of members of the group, or in providing financial assistance to extend the scope of the group should not be chargeable to the members of the group. However, when a real benefit has been conferred upon one or more of the associated enterprises, a fee should properly be charged by the parent.

In determining whether such a benefit has been conferred, it might also be relevant to answer the question whether a member would have bought the service had it been offered by an independent third party. Examples of services in which a benefit is conferred might be detailed planning services for particular operations, emergency management or technical advice (troubleshooting), centralized accounting and legal

services and even, in some cases, assistance in day-to-day management. Since payment is often made by way of a flat rate fee, questions of allocation must often be decided by taxing authorities. Again, reference to outside transactions, with full recognition of the importance of avoiding double taxation must be the guide. If the open market value of services rendered is difficult to determine, it may be necessary to look at prices charged by the parent for similar services to unrelated companies. Normally all charged, direct and indirect, and a profit should be included. The OECD suggests that if a comparable open market price cannot be found and if the cost method does not seem appropriate, other methods might be used by tax authorities, based, for example on the examination of the overall performance of the relevant associated enterprise.[15] Of course, satisfactory documentary evidence must be provided by the associated enterprise as evidence of costs incurred, time expended, and services performed.

It is the view of the OECD that when countries levy withholding taxes on service fees and contributions to central management costs, such payments should not be taxed in the country of source unless they enter into the computation of the profits of a permanent establishment in the providing enterprise.[16]

3. Leasing and Use of Tangible Property

If property is leased for the full period of its projected economic life, the transaction is essentially the same as a sale. Tax regulations in the United States provide that when tangible property is leased by one member of a controlled group to another member of that group without charge, or at a charge which is not equal to an arm's-length rental charge, the tax authorities may make an appropriate allocation to reflect an arm's-length charge.[17] Those regulations go on to define an arm's length rental charge to be the amount of rent which would have been charged for the use of the same or similar property during the time it was in use in independent transactions with or between unrelated parties under similar circumstances considering the period and location of use, the owner's investment in the property, rent paid for the property, expenses of maintaining the property, the type of property involved, its condition, and all other relevant facts.[18]

The U.S. tax regulations provide different treatment for the leasing of tangible property when the lessor is in the business of leasing. If the lessor is in the trade or business of renting property, the appropriate price is to be determined by reference to the usual price structure.[19]

However, U.S. tax regulations provide that if neither the lessor nor the lessee is engaged in the trade or business of renting property, then the arm's-length charge shall consist of: (1) the amount of straight line depreciation claimed by the lessor for U.S. tax purposes; (2) an addition of 3% of the depreciable basis of that property; (3) all direct and indirect expenses paid for accrued) by the owner of the property during the year (including real estate and personal property taxes and

maintenance and management expenses); and (4) the amount of expenses directly and indirectly connected with the possession, use or occupancy of the property by the user paid (or accrued) by the owner during the taxable year. If the taxpayer wishes to establish a more appropriate charge than the prescribed arm's-length standard, which in essence permits a safe haven, it is permitted to do so.[20]

4. Transfer or Use of Intangible Property

Transfers of intangible property between related enterprises present particular problems of allocation. Under Section 482, intangible property is defined to include:

1. Patents, inventions, formulas, processes, designs, patterns and similar items;

2. Copyrights, literary, musical or artistic compositions, and other similar items;

3. Trademarks, trade names, brand names, and other similar items;

4. Franchises, licenses, contracts and other similar items; and

5. Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, technical data, and other similar items.[21]

In applying an arm's-length standard to intangible property which is transferred, the U.S. tax authorities first look to transactions involving unrelated parties; however, if these cannot be found, recourse is had to the following factors:

1) Prevailing rates in the same industry or for similar property;

2) Offers and bids made by competitors;

3) The terms of the transfer, including geographical limitations and the exclusive or non-exclusive character of the rights transferred;

4) The uniqueness of the property and the period for which it is likely to remain unique;

5) The degree and duration of protection afforded to the property under the laws of the relevant countries;

6) Prospective profits to be realized or costs to be saved through the use or the subsequent transfer of the property; and

7) Costs incurred in developing the property.[22]

a. Research and Development

Industrial groups must devote considerable resources to research, both basic and applied, and development to remain competitive. The actual size of research and development budgets depends on a variety of factors, including competition, corporate philosophy, anticipated profits from the R & D activity and the general level of company profits. The manner in which research and development expenditures are recovered varies according to circumstances. Generally, these expenditures are recouped only after intangible property such as patents or know-how is developed. However, some MNEs have utilized cost contribution or cost funding arrangements by which research and development expenses are assessed among members regardless of the products.

The OECD Model Double Taxation Convention in Article 12 makes a distinction between a know-how contract, under which one of the parties agrees to impart to the other his special knowledge and experience which is unknown to the public at large so that the receiver can use them for his own account, as opposed to a contract for the provision of services, in which one of the parties undertakes to use the customary skills of his calling to execute work himself for the other party. For example, in the United States a charge reflecting fair market value would be required for transfers of intangible property, whereas only cost has to be charged for the rendering of services generally. In several countries, a withholding tax is not levied on payments of fees for services to non-residents; however, it is for royalties paid for the use of intangible property. Although in determining the amount of an arm's-length consideration for the use of intangible property, the standard to be applied is the amount that would have been paid by an unrelated party for the same intangible property under the same circumstances, in many cases it will be difficult to find a satisfactory comparable open market price since the owner of intangible property, and particularly the owner of a patent, often will not make it available to an unrelated enterprise. One common approach employed by tax authorities to test the validity of licenses is to appraise the trend of an enterprise's profits over a long period of time in comparison with those of other unrelated enterprises engaged in the same or similar activities which are operating in the same way. It is generally not useful to employ the cost method since costs are amortized over both successful and unsuccessful research.

b. Cost Contribution Arrangements

A phenomenon rarely seen in unrelated enterprises is a cost contribution arrangement, whereby research and development costs are financed by assessing unrelated enterprises at the time the R & D expenditure is incurred, rather than at the time the patent or know-how has been successfully developed. This is useful for financing concurrently with expenditure and regardless of the success of the research.

A distinction may be made by tax authorities, when analyzing cost-sharing methods since generally only net costs of R & D are allocated to the participants of the cost-sharing arrangement. Therefore, in some countries, such as the United States, no profit markup need be added to receipts of the entity providing the research and development.[23] Correspondingly, double taxation principles would indicate that an enterprise receiving the benefit of the research and development would only be allowed to deduct the actual cost contributed to the R & D, without a profit markup to the provider. Since it is not typical for a withholding tax on royalties to be levied against entities that have concluded a cost-contribution arrangement, there is an incentive for MNEs to use such arrangements.

MNEs using the cost sharing or cost funding method generally allocate the aggregate costs of research and development on the basis of each affiliate's proportion of worldwide customer sales. The United States tax regulations provide that in order for the arrangement to qualify as a "bona fide cost-sharing arrangement," it must reflect a good faith effort by the participating members to bear their respective share of all costs and risks of development on an arm's-length basis.[24]

c. Patents and Trademarks

Determining an arm's-length price for patent rights is different from doing so with respect to trademark or tradename rights. Patent rights normally require a major expenditure prior to the time the patent is received, whereas, a trademark generally costs very little prior to receipt. However, it is generally costly to maintain a trademark or tradename since the costs of advertising and quality control may be significant.[25]

Cooperation between the licensee and the licensor is a feature of trademark licensing, since preserving standards and aiding in the promotion of a trademark are important. Often complicated contracts such as cross-licensing agreements or licensing pools may be used by associated enterprises for trademarks and patents. Often "package deals" are used by MNEs which include licensing of trademarks, tradenames, patents, and other intangible property developed by various members of the group, where responsibility for promotion and technical assistance on the use of the intangible property is assured by other members of the group.[26]

The essential question in determining an arm's-length price for both trademarks and patents is determining which party receives the benefit transferred. The cost incurred by a licensee under a license agreement for promotion and technical services fee will affect the amount of any trademark royalty. In arriving at an arm's-length price, it may be possible to use the comparable uncontrolled price method if a trademark is licensed to unrelated enterprises; however, as with patent royalties, generally there will not be significant licensing to unrelated enterprises, and moreover, the value of a trademark in one market may vary significantly from that in another. Generally, it will not be very

helpful to refer to the costs of developing a trademark as a foundation for determining proper allocation; however, the cost of maintaining the value of a trademark may often be helpful.

E. STATE AND LOCAL EXPERIENCE IN THE UNITED STATES

Transfer pricing problems arise within the United States when state and local jurisdictions try to collect taxes from MNEs. Lessons and models from their experience can be used by developing countries with similar problems.

In an effort to enforce an equitable taxation system, some states have enacted the Multistate Tax Compact[27] which is designed to promote uniformity and compatibility of the state tax systems as applied to multistate-multinational businesses. This Compact, which has been held valid by the Supreme Court of the United States[28] contains uniform legislation including the Uniform Division of Income for Tax Purposes Act ("UDITPA") which allows MNEs to elect UDITPA for allocation and apportionment of income to prevent potential double taxation. The Compact has a governing body of tax administrators from member states who are empowered to promulgate uniform advisory regulations to conduct joint audit programs and to carry on various administrative activities to otherwise promote ease in compliance, bettern enforcement, uniformity and compatibility in state tax systems as applied to MNEs.

An organization known as COST (Committee on State Taxation of the Council of States Chambers of Commerce) which is composed of over 120 MNEs has been organized in the U.S. to combat the Multistate Tax Compact.

Five major issues have been identified by Corrigan, Schoettle and Dexter which divide the states of the United States and the MNEs.[29] The first is the income controversy. The MNEs take the position that the manner in which they separately account for their income should be controlling for tax purposes. However, it is the position of the states that the income of the total unitary trade or business of the MNE should be subject to taxation, whether carried out under a single corporate umbrella or under many. The MNEs hold to the "separate-accounting" approach by which the corporate form and organization which are chosen by business management determine taxation. The states' "unitary" approach stresses the economic or business substance of the activities which the MNEs are pursuing.

The second issue is the "source" concept as applied to the income of MNEs derived from investments in intangible properties, particularly dividends and interest from subsidiaries and affiliates. MNEs typically take the position that such income should be attributed to the state of the receiving corporation's commercial domicile, where the corporate headquarters are located. Typically this state is a tax haven. It is the position of the states that income which is closely associated with, arises out of, and is used in connection with the MNE's unitary business, should be attributable to those jurisdictions or "sources" in which it

carries on its underlying business activities. Under the UDITPA, income is apportioned under a formula if it is "business" income. Utilizing the separate corporate identity approach and a commercial domicile in a low or zero taxation state, frequently MNEs in the United States are subject to negligible state taxation. A large number of states in the United States allow MNEs to escape state taxation through these two mechanisms.

The third issue concerns apportionment of income. Under the UDITPA, business income is attributable to the source of a corporation's tangible properties, payroll and sales. Frequently the apportionment formulas used to attribute income to one state or another varies, and, therefore, double taxation or undertaxation is predictable. Through use of the Multistate Tax Commission, attempts are being made to achieve uniformity.

The fourth major issue is uniform enforcement because most states have inadequate programs for in-depth, substantiated audits of complex multinational businesses. The states have traditionally been forced to rely upon the information provided by the MNEs. They lack adequate audit staffs, properly trained lawyers and business analysts. Therefore, inequitable tax treatment has resulted. This experience is especially relevant to Third World lawmakers and public servants.

The fifth issue deals with United States federal intervention because the MNE community believes that Congress should enact restrictive legislation curtailing the taxing powers of the state and local authorities. Although no legislation has, at the writing of this paper, been enacted, hearings were held in 1980. Senator Mathias has introduced s.655, which would prohibit the states from applying the unitary accounting concept. It would also exempt certain classes of income from state taxation altogether, such as dividend income and so-called "foreign source" income and would arbitrarily assign other income to the commercial domicile of the MNE. At the time of this writing, this legislation has been delayed pending several Supreme Court decisions, especially Chicago Bridge & Iron Co. v. Caterpillar Tractor Co.,[30] mentioned below.

Several recent United States Supreme Court decisions have been decided against the MNE's. In Mobil Oil Co. v. Commir of Taxes of Vermont[31] the Supreme Court of the United States held that the due process clause of the fourteenth amendment of the United States Constitution did not preclude Vermont from including dividends from overseas operations in apportionable income. In Exxon Corp. v. Wisconsin Dept. of Rev.[32] the Supreme Court dealt with the vertically integrated petroleum and petroleum-related businesses of Exxon. The Supreme Court disagreed with Exxon's assertion that only the income attributable to its "separately-accounted-for" activities in Wisconsin could be apportioned in part to Wisconsin. It had been Exxon's contention that since it "separately-accounted-for" its marketing income apart from its exploration and production and refining income, only its marketing income could be subject to apportionment in Wisconsin under the due process clause of the United States Constitution.

The question of unitary "combined reporting" was again before the

Supreme Court in Chicago Bridge & Iron Co. v. Caterpillar Tractor Co.;[33] Woolworth Co. v. New Mexico Taxation and Revenue Department[34] and Asarco v. Idaho State Tax Commission.[35] In the latter two cases, the MNEs successfully challenged the unitary method as a violation of the due process and commerce clauses of the United States Constitution. In Chicago Bridge & Iron[36] the Supreme Court dismissed the appeal, thereby affirming the Illinois Supreme Court's decision upholding Illinois law providing that taxes paid by foreign subsidiaries are not deductible on Illinois State tax returns.

It is hardly surprising that several recent cases before the United States Supreme Court concerning transfer pricing involve petroleum companies, because transfer pricing has been used by petroleum companies for quite some time. By the use of consolidated returns, sources of profits and losses have been concealed. One of the techniques used by petroleum companies to disguise profits has been the attribution of profits or losses as desired to a tanker company that is shipping petroleum.[37]

F. ENFORCEMENT

Due to lack of coordination among taxing jurisdictions, lack of adequate information from the MNEs and frequent unavailability of auditors, attorneys and others expert in analyzing profit and loss flows from associated enterprises, enforcement of national or regional tax codes is frequently difficult. In the United States, if a taxpayer does not observe the Section 482 allocation rules, the Internal Revenue Service will make an adjustment to its income on an arm's-length basis. This will produce an income tax deficiency for the year under audit and other more drastic results might occur. For example, the allocation may result in the loss of DISC treatment or could cause a U.S. shareholder to be taxed currently on income earned abroad under Subpart F of the Internal Revenue Code. Allocations could also affect the foreign tax credit or could result in the declaration that a corporation is a personal holding company, which could have negative tax implications to the U.S. corporations. Furthermore, a collateral consequence of a Section 482 allocation might be the application of constructive dividend treatment.[38]

Obviously, each taxing jurisdiction can impose penalties on local entities affiliated with MNEs when those entities fail to allocate income and losses in a manner which the local jurisdiction deems acceptable. Ideally, most taxing jurisdictions would also seek to minimize the double taxation upon related entities within their jurisdiction. Frequently a foreign tax credit will offset double taxation when a foreign subsidiary's profits are paid to the parent. However, often those profit distributions are not anticipated until the future. The United States Treasury has developed a Model Income Tax Convention which covers, *inter alia*, associated enterprises. (Attachment A). This provides for appropriate adjustments to the tax of one associated enterprise when already taxed by another taxing authority. This model U.S. Income Tax

Convention has been incorporated into many of the modern bilateral tax treaties to which the United States is a party. It also provides for the arm's-length standard to be observed in transactions between related entities. Furthermore, there is provision for consultation between "competent authorities" of the contracting states with respect to tax issues for allocation of income and deductions. The 1977 Model United States Income Tax Convention under Article 25 entitled "Mutual Agreement Procedure" sets forth the procedures which are followed under most of the modern United States treaties against double taxation. (Attachment B).

G. CODES OF CONDUCT FOR MNES

Many in the Third World have challenged the size and power of MNEs and have sought to set standards of conduct for their operations in various fora. One of the suggestions has been the regulation of transfer pricing. For example, the U.N. Commission on Transnational Corporations has been working on a proposed code of conduct since its Second Session in 1976. In 1967 the OECD proposed a code for the protection of foreign private investment and in June 1976 it adopted a "Declaration," "Guidelines" and three "Decisions" for MNEs that establish a standard of conduct which is "voluntary." In 1979 the OECD Council made specific recommendations on the determination of transfer prices between associated enterprises. (Attachment C). UNCTAD's Conference on an International Code of Conduct on the Transfer of Technology has not yet concluded an agreed upon text as a result of a conflict over the principles of "applicable law" to be invoked in settling disputes. However, one of the issues which also remains to be resolved includes the scope of the Code's application, particularly whether the Code should apply to transactions between affiliated enterprises.[39]

The International Chamber of Commerce in 1972 adopted the "Guidelines for International Investment," which were not designed to be a "rigid code of conduct." They contain rules for investors, home countries and host countries of investors.

H. CONCLUSION

The magnitude of the transfer pricing problem is significant. For example, in the United States a special Department of Commerce survey found that in 1970, 22.4% of all export sales of U.S. manufactured goods and services were made to U.S. MNEs, subsidiaries and affiliates abroad.[40] A subsequent survey of twenty corporations, representing 5% of U.S. industrial activities, showed that 29.5% of their manufactured goods and services were export sales to their manufacturing subsidiaries and affiliates abroad.[41] Similar patterns exist for other industrialized countries.

In order to reach fair and equitable allocation of taxes among taxing jurisdictions, including both developing countries and developed

countries, it is appropriate and helpful that further study, understanding and negotiation of the problem of transfer pricing be conducted within appropriate international fora and international standards be adopted which have the consensus of the major participants in the problem. Transfer pricing clearly is an issue which properly and advantageously can be discussed and resolved in international fora at which representatives of host countries, home countries and MNEs have full participation.

Awareness of the nature of the problem faced by developing countries in recognizing, reallocating and enforcing reallocation of transfer prices is an important step towards resolution. This paper has attempted to outline the nature of the problem; the motivations and limitations on MNEs engaging in transfer pricing; the problem areas for developing countries' taxing authorities in properly allocating transfer prices; the experience and guidance of other taxing authorities such as the U.S. and the individual states within the United States and the OECD's analysis of the problem. Unilateral, bilateral and multilateral actions are called for to achieve an orderly, equitable and enforceable system for treating transfers among related enterprises. This paper has attempted to illuminate some aspects of the issue, which will allow each of us more fully to understand the problem so that we might most effectively seek a solution.

ATTACHMENT A

Treasury Department's Model Income Tax Property
Article 9
ASSOCIATED ENTERPRISES

1. Where
   a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or

   b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

   and in either case 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.

2. Where a Contracting State includes in the profits of an enterprise of that State, and taxes accordingly, profits on which an enterprise of the other Contracting State has been charged to tax in that other State, and the profits so included are profits which would have accrued to the enterprise of the first mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other.

3. The provisions of paragraph 1 shall not limit any provisions of the law of either Contracting State which permit the distribution, apportionment or allocation of income, deductions, credits or allowances between persons owned or controlled directly or indirectly by the same interests when necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such persons.

ATTACHMENT B

Article 25 entitled, "Mutual Agreement Procedure" of the 1977 Model U.S. Income Tax Convention provides:

1. Where a person considers that the actions of one or both of the Contracting States result or will result for him or her in taxation not in accordance with the provisions of this Convention, he or she may irrespective of the remedies provided by the domestic law of those States, present his or her case to the competent authority of the Contracting State of which he or she is a resident or national.

2. The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with the Convention. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States.

3. The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. In particular the competent authorities of the Contracting States may agree:

   (a) to the same attribution of income, deductions, credits, or allowances of an enterprise of a Contracting State to its permanent establishment situated in the other Contracting State;

   (b) to the same allocation of income, deductions, credits, or allowances between persons, including a uniform position on the application of the requirements of paragraph 8 of Article 24 (non-discrimination);

   (c) to the same characterization of particular items of income;

   (d) to the same application of source rules with respect to particular items of income; and

   (e) to a common meaning of a term.

ATTACHMENT C

Annex
RECOMMENDATION OF THE COUNCIL on the determination of transfer prices between associated enterprises (Adopted by the Council on 16th May, 1979)

The Council,

Having regard to Article 5(b) of the Convention on the Organisation for Economic Co-operation and Development of 14th December, 1960;

Having regard to the Declaration of 21st June, 1976 adopted by the Governments of OECD Member Countries on International Investment and Multinational Enterprises and the Guidelines annexed thereto;

Having regard to the Report of the Committee on Fiscal Affairs of 12th March, 1979 on the determination of transfer prices between associated enterprises;

Considering that transactions between associated enterprises (i.e. between parent and subsidiary enterprises or enterprises under common control) may take place under conditions differing from those taking place between independent enterprises;

Considering that the prices charged in such transactions between associated enterprises (usually referred to as transfer prices) should, nevertheless, for tax purposes be in conformity with those which would be charged between independent enterprises (usually referred to as arm's length prices) as provided in Article 9(1) of the OECD Model Double Taxation Convention on Income and on Capital;

Considering that problems with regard to transfer prices in international transactions arise mostly between the various entities of multinational enterprises and assume special importance in view of the substantial volume of such transactions;

Having regard to the considerations in the Report referred to above regarding the methods to be followed for the correct determination of transfer prices for goods, technology, trademarks and services and of interest rates on loans between associated enterprises;

Having regard to the need to achieve consistency in the approaches of tax authorities, on the one hand, and of associated enterprises, on the other hand, in the determination of transfer prices for the purposes of ensuring correct taxation of profits and avoidance of double taxation;

I. RECOMMENDS to the Governments of Member countries:

1. that their tax administrations take into account, when reviewing, and if necessary, adjusting transfer prices between associated enterprises for the purposes of determining taxable profits, the considerations and methods set out in the Report referred to above for arriving at arm's length prices when goods, technology, trademarks and services are provided or supplied or loans granted between associated enterprises;

2. that they give the Report referred to above publicity in their country and have it translated, where appropriate, into their national language(s);

3. that they develop further co-operation between their tax administrations, on a bilateral or multilateral basis, in matters pertaining to transfer pricing;

II. INSTRUCTS the Committee on Fiscal Affairs:

1. to pursue its work on issues pertinent to transfer pricing and to the assessment of taxable profits of associated enterprises in general;

2. to report periodically to the Council on the results of its work in these matters together with any relevant proposals for improved international co-operation.

FOOTNOTES

1. W. Streng, International Business Transactions Tax & Legal Handbook 145 (1977).

2. Burns, How I.R.S. Applies the Intercompany Pricing Rules of Section 482: A Corporate Survey, 52 J. Tax'n 308 (1980).

3. Duerr, Tax Allocations and International Business, The Conference Board Inc. (1972).

4. Treasury Department, Summary Study of International Cases Involving Section 482 of the Internal Revenue Code (1973), reprinted in Rhoades, Income Taxation of Foreign Related Transactions 791-95 (1977).

5. Rev. Proc. 65-17 § 3.02, 1965-1 C.B. 833,34.

6. Treas. Reg. § 1.482-1(a)(3).

7. Treas. Reg. § 1.482-2(a).

8. Treas. Reg. § 1.482-2(b).

9. Treas. Reg. § 1.482-2(c).

10. Treas. Reg. § 1.482-2(d).

11. Treas. Reg. § 1.482(e)(1)(i).

12. Report of the OECD Committee on Fiscal Affairs (1979) 91 [hereinafter cited as OECD Report]; See B. Forman & Co. v. Comm'r, 453 F. 2d 1144 (2nd Cir. 1972), cert. denied, 407 U.S. 934 (1972), reh'g denied, 409 U.S. 899 (1972).

13. OECD Report at 92.

14. OECD Report at 76.

15. OECD Report at 81.

16. OECD Report at 82.

17. Treas. Reg. § 1.482-2(c)(1).

18. Treas. Reg. § 1.482-2(c)(2).

19. Id.

20. Treas. Reg. § 1.482(c)(2).

21. Treas. Reg. § 1.482-2(d)(3).

22. Treas. Reg. § 1.482-2(d)(2)(iii).

23. Treas. Reg. § 1-482-2(d)(4).

24. Treas. Reg. § 1.482-2(d)(ii).

25. *OECD Report* at 63.

26. *OECD Report* at 66.

27. *See, e.g.*, *Ark. Stat. Ann.* § 84-4101 (Supp. 1977); *Idaho Code* § 63-3027 (Supp. 1976, 1981); 7A *U.L.A.* 91 (1978).

28. United States Steel v. Multistate Tax Commission, 434 U.S. 452 (1978).

29. Corrigan, Schoettle & Dexter, *The Search for Equity and Accountability in State and Local Taxation of Multistate-Multinational Corporations*, 12 *Urb. Law* 553 (1980).

30. 458 U.S. ___, 102 S. Ct. 2032 (1982).

31. 445 U.S. 425 (1980).

32. 447 U.S. 207 (1980).

33. 458 U.S. ___, 102 S. Ct. 2032 (1982).

34. 458 U.S. ___, 102 S. Ct. 3128 (1982).

35. 458 U.S. ___, 102 S. Ct. 3103 (1982).

36. 458 U.S. ___, 103 S. Ct. 3562 (1983).

37. *C. Kindleberger*, *The International Corporation* 229 (1970).

38. Rev. Rul. 69-630, 1969-2 C.B. 112.

39. Rubin, *Transnational Corporations and International Codes of Conduct: A Study of the Relationship between International Legal Cooperation and Economic Development*, 30 *Am. U.L Rev*. 903,05 (1981).

40. 52 *U.S. Department of Commerce Survey of Current Business* 25 (1972).

41. *Tax Reform Act of 1975: Hearings on H.R. 10612 before the Senate Comm. on Finance*, 94th Cong. 2d Sess. 2305 (1976) (statement of Timothy W. Stanley, President, International Economic Policy Association).