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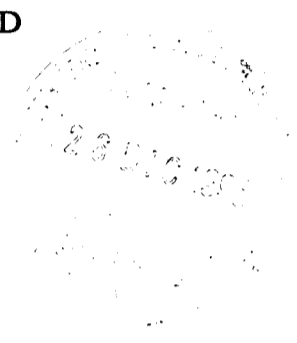
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***AN INTRODUCTION TO TRANSFER PRICING THE AMERICAN
VERSUS THE EUROPEAN APPROACH****

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AN INTRODUCTION TO TRANSFER PRICING
THE AMERICAN VERSUS THE EUROPEAN APPROACH
Professor Hubert Hamaekers*

CONTENTS:

1. What is transfer pricing?
 2. The arm's length principle
 3. The tax treaty aspect
 4. The OECD Reports on transfer pricing
 5. Impact of the OECD Reports
 6. Developments in the United States
 7. The draft OECD Guidelines on the transfer pricing
 8. Global comparison between the U.S. Regulations and the draft OECD Guidelines
 9. The difference between the United States and other OECD countries
 10. Practice among MNEs
 11. Pricing methods, checking methods and dispute-solving methods
 12. Setting up a new statutory transfer pricing system
- Annex. Transfer pricing bibliography

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1. WHAT IS TRANSFER PRICING?

My colleagues and I at the IBFD have given several courses on transfer pricing, in particular to tax administrators from East European and Asian countries; for instance, two courses of one month each to members of the Chinese tax administration, who had the task of producing regulations on transfer pricing after the courses.

In the Chinese courses I started with the question "What is transfer pricing?". The answer, after some reflection, was: "Prices manipulated by multinationals to reduce their tax burden". My reaction was that this may indeed occur, but that transfer pricing is a completely neutral concept. The term relates to the system of pricing the transfer of goods, services and intangibles between entities of one MNE. It is in the first place a term used in business economics.

The definition of "transfer price" in business economics reads¹: the amount charged by one segment of an organization for a product or service that it supplies to another segment of the same organization. The economic reason for charging transfer prices is to be able to evaluate the performance of the group entities concerned. By charging prices for goods and services transferred within a group, managers of group entities are able to make the best possible decision as to whether to buy or sell goods and services inside or outside the group. About half of the major groups in the world transfer goods and services internally on the basis of a cost-oriented system. Some MNEs use only variable costs, other full costs, and still other use full costs plus a profit mark up (cost-plus method). Some use standard costs, other actual costs.

If there is a competitive open market for the products or services transferred internally, the best solution from a business economics point of view is to use the market price as a transfer price. The market price may be derived from published price lists for similar products and services (external market price) or it may be the price charged by a group entity to its external customers (internal market price). The latter may be the basis for the transfer price in an earlier stage of production by subtracting costs and a reasonable profit of the last internal stage from the internal market price.

Apart from the cost-based methods and transfer prices based on open market prices, a third category may be distinguished. In various MNEs group entities negotiate with each other like independent parties. The transfer price resulting from such negotiations is equally acceptable from a business economics point of view.

Returning to the tax aspect, transfer pricing is, indeed, sometimes used, incorrectly, in a pejorative sense, to mean the

¹ See: Charles T. Horngren and Gary L. Sundem "Introduction to Management Accounting", page 336, ninth edition. Prentice Hall International Inc.

shifting of taxable income from a group company in a high taxing jurisdiction to a group company in a low taxing jurisdiction in order to reduce the overall tax burden of the group.

The Preface of the 1979 OECD Report on Transfer Pricing and Multinational Enterprises clearly explains that the term "transfer pricing" is neutral. The new draft report of the OECD, published in 1994, makes this even more clear by using the title "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations".

Indeed, transfer pricing gives opportunities to MNEs to shift profits from a high taxing country to a country with a low corporate tax rate or with tax incentives for certain activities of MNEs. One should, however, realize that tax planning is only one of a series of considerations which are relevant for MNEs. Many MNEs prefer to maintain a good relationship with the tax authorities of the countries where they are active. Certainty about the amount of tax to be paid is a top priority for large companies so they usually operate a well-documented, straightforward transfer pricing system, which is - as I have explained - in the first place a requirement of sound business economics. I should add that clear transfer pricing regulations and well-trained tax administrators are the best safeguards against incorrect transfer pricing practices.

2. THE ARM'S LENGTH PRINCIPLE

Prices set for transactions between group entities should - for tax purposes - be derived from prices which would have been applied by unrelated parties in similar transactions under similar conditions in the open market.

This is the so-called "dealing at arm's length" principle, which is the international standard for transfer pricing matters. The word "pricing" indicates that the emphasis is on single transactions.

It is important to note that the arm's length principle has two different origins:

- (1) In several continental European countries the arm's length principle stems from the adjustment of income of shareholders who have received extraordinary benefits from a company that have not officially been declared as dividends. Majority shareholders may be able to derive such benefits as a result of their special position. The adjustment in such cases is made by deeming such benefits to be dividends, called constructive dividends or hidden profit distributions, which are not deductible for the company concerned. This concept is applied in Austria, Germany, Luxembourg, the Netherlands, Switzerland and other European countries.
- (2) Specific transfer pricing provisions with an international focus were first introduced during World War I in the United Kingdom and the United States. These provisions aimed at deterring companies from shifting profits to associated

companies overseas through under- or overpricing of cross-border transactions.

Both approaches are based on the concept of equal treatment or the neutrality principle: taxpayers with a controlling interest in a company are placed in the same position as other taxpayers and controlled taxpayers are placed on a parity with uncontrolled taxpayers through application of the arm's length principle which neutralises the advantage of the former.

In the actual implementation of the arm's length principle in national laws three categories can be distinguished:

- (1) countries which have included a reference to the arm's length principle (or to open market prices), and adjustment in case of deviations, in their tax laws, e.g.
 - Australia refers to considerations less than arm's length considerations (Sec. 136 AD Income Tax Assessment Act);
 - Argentina (article 14 Income Tax Law): legal acts between a domestic foreign-held company and an individual or a corporation abroad which directly or indirectly controls it are to be regarded as entered into by independent parties when the relevant consideration and condition are in agreement with normal market practices between independent parties;
 - Austria (§ 6-6 Income Tax Act), Germany (§ 1 Foreign Relations Tax Act) and Sweden (sec. 43(1) Municipal Tax Act) refer to conditions which deviate from those which would have been agreed between independent parties;
 - Canada requires a comparison with the price that would have been reasonable in the circumstances (Sec. 69(2) Income Tax Act);
 - Denmark: section 12(1) Corporate Income Tax Act refers to "conditions which differ from those which would be made between independent enterprises";
 - Italy refers to "normal value": the price generally given for goods and services of the same or similar type in free commerce (art. 76(5) and 9(3) Direct Taxation Act);
 - Japan refers in a sentence of 450 words to the arm's length price (art. 66-4 of the Special Tax Measures Law, amended in 1992);
 - Spain says that the valuation in case of associated enterprises must be on the basis of prices at fair market value between independent parties (art. 16.3 Corporate Tax Law);
 - United Kingdom: "the price which it might have been expected to fetch if the parties to the transaction had been independent persons dealing at arm's length" (Sec. 770 Income and Corporation Tax Act 1988 - formerly Sec. 485).
- (2) countries which permit prices to be adjusted in case of associated enterprises, without reference to the arm's length principle:

- Belgium (art. 26 Income Tax Code): "abnormal advantages";
 - France (art. 57 General Tax Code): "transferred income";
 - Norway (art. 54, § 1 Tax Act): "income reduced due to () community of interests";
 - United States (Sec. 482).
- (3) countries with a broad statutory basis, which has been worked out for transfer pricing purposes in case law:
- Germany (apart from § 1 Foreign Relations Tax Act): excessive payments to, or understated receipts from, shareholders constitute constructive dividend which is not deductible (§ 8(3) Corporate Tax Act);
 - Netherlands: benefits derived from a business under whatever name and in whatever form (article 7, Income Tax Act); benefits obtained by a shareholder because of that relationship are not deductible for the company and are treated as (constructive) dividends for the shareholder;
 - Switzerland: voluntary granting of advantages (art. 49 Direct Federal Tax Decree).

3. THE TAX TREATY ASPECT

The arm's length principle was already included in treaties concluded by France, the United Kingdom and the U.S.A. in the twenties and thirties of this century.

In a multilateral context the arm's length principle was formulated for the first time in article 6 of the League of Nations draft Convention on the Allocation of Profits and Property of International Enterprises in 1936. It was taken over as article VII in the Mexico Draft of 1943 and in the London Draft of 1946. Their articles are substantially similar to article 9 of the 1963 OECD Draft Convention and article 9, paragraph 1 of the present OECD and U.N. model tax treaties.

Article 9 confirms in a treaty situation the right of a contracting state to adjust the profits of an enterprise located on its territory, which is managed, held or controlled directly or indirectly by an enterprise of the other contracting state if the conditions in their relationship differ from the conditions which would have been stipulated between independent enterprises.

Since 1977 article 9 of the OECD Model has been supplemented by a second paragraph which provides for a corresponding (downward) adjustment of the profit of the related entity in the other State. The corresponding adjustment avoids (economic) double taxation. A corresponding adjustment is only mandatory if state B agrees to the method applied and the amount of original adjustment made in state A. A consensus on arm's length transfer pricing methods within the OECD is therefore very important.

4. THE OECD REPORTS ON TRANSFER PRICING

Before 1979 administrative guidance on the application of legal provisions relating to transfer pricing was extremely scarce.

In the U.S.A., however, transfer pricing regulations date back to 1935. In 1968 the U.S. Treasury issued elaborate regulations for specific types of intercompany transaction. These regulations had a great influence on the discussions in the OECD on transfer pricing in the seventies.

Because of the spread of MNEs and the increase of transactions within MNEs since the sixties the Member States of the OECD found it necessary to produce guidelines for their tax administrations on how to deal with transfer pricing. It was also found useful to elaborate article 9 of the Model Treaty and the Commentary thereon. Since one of the two main goals was the avoidance of double taxation, the multilateral framework of the OECD was chosen for developing a consensus on the matter of transfer pricing.

Working Party No. 6, which is a subgroup of the Committee on Fiscal Affairs of the OECD, produced a useful report in the second half of the seventies. The 1979 OECD Report "Transfer Pricing and Multinational Enterprises" did not intend to establish a detailed standard, but to set out the problems and the considerations to be taken into account and to describe which methods and practices were acceptable from a tax point of view in determining transfer prices.

In 1984 the OECD published a second report comprising three topics: the mutual agreement procedure, transfer pricing in the banking sector, and the allocation of central costs. The latter report in particular was a useful elaboration of the 1979 report.

Very briefly, the 1979 OECD Report contains the following important considerations and principles:

- the arm's length principle is the appropriate approach to adopt in arriving at profits of related entities for tax purposes (§ 3);
- the consideration of transfer pricing problems should not be confused with the consideration of problems of tax fraud or tax avoidance, even though transfer pricing policies may be used for such purposes (§ 3);
- the dual purpose of the report is: to enable the interests of the national tax authorities involved to be protected, and to enable double taxation of the enterprises involved to be prevented (§ 7);
- the ideal method is the comparable uncontrolled price (CUP) (§ 11);
- if no useful evidence is available, cost-plus or resale price methods are acceptable from an arm's length point of view (§ 12);
- other methods are not excluded (§ 13), but with respect to these other methods the Report is vague and negative:

- the profit-split method is necessarily arbitrary (§ 14 + 22); profit comparison is only a pointer to further investigation (§ 71);
- the return on capital invested presents difficulties (§ 73); net yield expectations are too imprecise (§ 74). According to § 14, such methods may be used as a double check (profit comparison) or as a solution in bilateral negotiations among countries (profit-split);
 - global methods and formulatory methods for allocating profits to affiliates are not endorsed, as they are incompatible with articles 7 and 9 of the Model, are arbitrary, disregard market conditions, ignore the management's own allocation of resources, do not bear a sound relationship to the economic facts, and cause the risk of double taxation (§ 14);
 - it is always useful to begin with a functional analysis (actual functions, responsibilities, risks) (§ 17);
 - the approach of the Report is to recognise the actual transaction, not substitute it by another transaction; (if required) the price for the actual transaction should be adjusted to an arm's length price (§ 23);
 - transfer pricing policies of MNEs may in fact be market-oriented and, where the different entities within such groups have their own profit responsibility, they may be free to contract either with an associated enterprise or with a third party with the result that there is a degree of bargaining within the group which produces a price effectively indistinguishable from an arm's length price (§ 38).

The 1979 Report further discusses transfer pricing of goods (Chapter II), technology and trademarks (Chapter III), services (Chapter IV) and loans (Chapter V).

The 1984 Report on the allocation of central management and service costs contains e.g.:

- a definition of shareholders' costs (these are costs which may not be allocated to subsidiaries (§ 33-43));
- a description of direct and indirect methods of cost allocation, in particular cost-sharing methods (§ 44 to 73); and
- guidance on the inclusion of a profit mark-up when cost-oriented methods are used (§ 74-86).

5. IMPACT OF THE OECD REPORTS

The 1979 Report is followed by a recommendation of the OECD Council of Ministers to the Governments of the Member Countries that their tax administrations take into account the considerations and methods set out in the Report.

Although the Recommendation has no immediate legal force, the fact that all Ministries of Finance of the OECD Member States have adopted the 1979 Report without reservations gives it a high amount of authority. There is a more than moral obligation for tax authorities not to deviate from the Report in their domestic administrative regulations.

In several countries judges look upon the report as binding on the tax administration concerned unless pertinent legislation deviates from it.

It should be noted that in almost all countries regulations, circular letters and other publications of the tax administration are regarded as containing the interpretation of the law by the tax administration, which does not have force of law, but which is binding on the tax administration itself. In the United States, however, transfer pricing regulations have almost the same effect as statutory provisions because of the authority of the IRS to make adjustments on the basis of Sec. 482.

The adoption of the OECD Report was followed by the publication of regulations and circular letters of Ministries of Finance or tax administrations of several Member States.

In Austria the Ministry of Finance published the German translation of the OECD Report as a decree in 1982.

In Canada Information Circular No. 87-2 on International Transfer Pricing was published in February 1987, which endorses the 1979 OECD Report.

The Danish Audit Instructions of 10 June 1983 closely follow the OECD Report.

The German Administration Principles for the examination of the allocation of income in the case of internationally related enterprises of 23 February 1983 closely follow the OECD Report.

The Italian Circular Letter No. 32/9/2267 of 22 September 1980 contains detailed instructions on transfer pricing. In its introduction reference is made to the OECD Report. See also Circular Letter 42/12/1587 of 12 December 1981.

The Netherlands Ministry of Finance issued an instruction to the tax administration in 1985, which is restricted to intra-group services. It takes the 1984 OECD Report on this topic as a basis.

In Spain resolutions of TEAC (Tribunal Económico Administrativo Central) of 3 October and 20 December 1989 and others elaborate on the rule contained in article 16.3 Corporate Tax Law. The latter resolution refers to the 1979 OECD Report for methods other than the comparable uncontrolled price (CUP).

In the United Kingdom Inland Revenue has issued Notes on Transfer Pricing which refer to and closely follow the OECD Report.

The United States regulations on transfer pricing date from 1968; they have served as a model for the 1979 OECD Report. Deviations from the Report in regulations occurred from 1992.

For about one decade the OECD reports have indeed resulted in a common approach to transfer pricing principles and methods among the tax administrations of industrialised countries. Without such

a common approach it is extremely difficult to reach an agreement under mutual agreement procedures on transfer pricing matters. The unfortunate result is double taxation. The publication of the White Paper by the U.S. Treasury and the IRS in 1988 disrupted this consensus.

Although administrative regulations based on the OECD report have no force of law they have also provided guidance to MNEs as to what tax administrations deem acceptable pricing methods.

6. DEVELOPMENTS IN THE UNITED STATES

6.1. Until 1986

Section 482 IRC was enacted in 1928 as section 45. Until 1986 it remained substantially unchanged. It gives authority to the Secretary of the Treasury - in the case of two or more organizations owned or controlled by the same interests - to distribute, apportion or allocate gross income, deductions, credit or allowances between or among these organizations if he determines that such a distribution etc. is necessary to prevent tax evasion or to clearly reflect income of such organizations. This language is very broad and grants the IRS very far-reaching powers to make adjustments.

In 1961 the Treasury tried to convince Congress that Section 482 was inadequate to protect the interests of the fisc in the case of U.S. companies with foreign affiliates. The House responded by adopting a formula for allocating profits between commonly controlled domestic and foreign corporations.

The Senate deleted this House amendment to the Revenue Bill of 1962, saying that sec. 482 already contained a sufficiently broad authority for the IRS and that better regulations were necessary.

New regulations were adopted in 1968. To tangible property the regulations apply a rigid hierarchy: CUP, resale price, cost-plus and other methods. For intangibles the comparable transaction method (CUP) had to be used; if a CUP was not found, 12 factors were to be applied to determine the arm's length price, starting with "prevailing rates in the industry".

From the early eighties concern in the IRS, Treasury and also Congress increased about tax planning involving the transfer of intangibles (technology) developed in the United States to subsidiaries of U.S. companies in tax havens. The following overview discusses the developments on this particular issue - transfer pricing of intangibles - since 1986.

6.2. A new approach to intangibles

The Tax Reform Act of 1986 added a sentence to Sec. 482 dealing with intangibles. In the case of the transfer or licensing of intangible property the income of the transferor or licensor had to be "commensurate with the income attributable to the intangible".

This so-called super royalty provision looks to the future actual profit to determine the price of the transaction at the date of the contract. It means that a price may be adjusted for tax purposes if the profit of the transferee is higher than expected at the time of the transaction.

Critics of the new provisions commented that the use of hindsight was in conflict with OECD principles since prices are normally not recalculated between unrelated parties if the deal is more profitable than expected for one of the parties.

6.3. The White Paper

In 1988 the IRS and the Treasury produced a discussion paper on how to implement the new "Commensurate with Income" rule. The White Paper presented four methods: two based on comparable uncontrolled prices, two based on profits.

Exact CUPS were put forward as the primary method but it was admitted that they are very rare in practice. The second price based method, inexact comparables, whereby the differences with the transaction between the related parties had to be accounted for and quantified via adjustments, was not given a clear priority over the two profit-based methods.

The Basic Arm's Length Return Method ("ballroom method"), developed in the White Paper, was a novelty in transfer pricing. It tries to identify an appropriate return for an intangible by applying industry-wide return rates to the assets and functions performed by the parties to the actual transactions. The fourth method was a profit-split method, based on the ballroom method. It was intended to be applied if both parties to the agreement own self-developed intangibles. After calculation of an appropriate return for each party based on the ballroom method, the residual was split between the parties on the basis of what unrelated parties were expected to do. The White Paper gave little information on how to operate this profit-split.

The ideas put forward in the White Paper met with severe criticism. In the first place the ballroom method was considered to be in conflict with the arm's length principle. Independent parties would not use such a method in practice to arrive at a price. In the second place the method would be difficult to apply without information on returns on assets and functions. Ballroom would also be unfair to corporations with return rates that vary considerably from the industry average. Another reasonable comment was that in many cases it is not possible to define exactly the part of the business or the product the profit of which must be compared. Other Member countries of the OECD feared that the method would allocate more profit to U.S.-based companies than reasonable.

6.4. The 1992 proposed Regulations

In January 1992 the IRS and the Treasury proposed Sec. 482 regulations partly replacing the 1968 regulations. The purpose was

to implement the "commensurate with income" clause of Sec. 482 and to improve the litigating position of the IRS.

The proposed regulations contain two price-based methods and one profit-based method for intangibles. The matching transaction method (MTM) is the same as the exact comparable method of the White Paper. The comparable adjustable transaction method (CATM) is more or less the same as the inexact comparables method of the White Paper. The result of the application of this method should, however, fall within the comparable profit interval (CPI). The CPI is an aspect of the profit-based method of the regulation, called the comparable profit interval method.

If there are no CUPs available, the profit of the transferor of the intangible must fall within a range of comparable profits, the CPI. Data to establish the CPI are derived from similar companies, or, if not available, from statistical data from the sector. The profits considered are the average of the current year, the preceding year and the following year. The method is applied with the help of a complicated, six-step procedure.

The proposed regulations went beyond the scope of intangibles by also prescribing the CPI-check for transactions with tangibles. If other methods than CUP are used, e.g. resale price or cost-plus, CPI should test the result.

The regulations also contained detailed rules for cost sharing arrangements involving intangibles.

The proposed regulations have been strongly criticised. The OECD formed a special Task Force to study the 1992 regulations. The United States served as an observer to the Task Force. In January 1993 the Task Force published its conclusions. The main comments were on the use of hindsight when applying the commensurate with income rule. The arm's length standard is endangered because under this standard a transfer price depends on the evaluation of the facts and circumstances at the time the transaction takes place. Only events which may be reasonably known and foreseen by the parties may be taken into account. The OECD Task Force was also concerned about the CPI. Profit comparison may only be used as a method of last resort or as a check of the results of other methods.

A principal argument from business circles was that the proposed regulations in fact abandon the arm's length standard in favour of a requirement that transfer pricing produce an operating profit substantially equal to an industry's average result. Another argument was that data on comparable trade or business are very often not available. Averages for the industrial sector are usually unclear because of the lack of comparability.

6.5. Rostenkowski-Gradison Bill

Another incident was the Rostenkowski-Gradison Bill - HR 5270 - introduced in May 1992, proposing an amendment to Sec. 482. For any U.S. company more than 25 percent foreign-owned which had at

least \$ 2 million in transactions with foreign related parties a minimum taxable income would be computed by multiplying the gross receipts of the company concerned by 75 percent of the average income of all U.S. companies in that category.

6.6. The 1993 Temporary and Proposed Regulations

The negative comments worldwide on the proposed regulations have resulted in revised temporary Sec. 482 regulations issued in January 1993.

Apparently it was necessary for the IRS to state explicitly in the regulations a principle which is self-evident and is only common sense, namely that taxpayers must charge an arm's length consideration only if there has been a transfer of a "commercially transferable interest". This principle is intended to reduce the scope for controversies between the IRS and taxpayers.

The clause originates in the Merck case in 1991 in which the IRS put forward that the foreign subsidiary should pay for the use of an intangible consisting of the mere existence of a group structure, an intercompany pricing system and a group-wide planning process. The Court rejected the IRS contention, stating that for purposes of Sec. 482, an item of intangible property must have substantial value as independent property. It is indeed difficult to imagine that such types of intangible are transferred between unrelated parties, except in the context of the transfer of an entire business.

The 1993 Temporary regulations are much broader than the 1992 Proposed regulations as they do not only deal with intangibles but also contain revised regulations on transfers of tangible property.

For intangibles the comparable uncontrolled transaction method (CUT) is introduced, which combines the matching transaction method and comparable adjustable transaction method of the 1992 proposed regulations. The 1993 regulations are less rigid on comparability than the 1992 regulations. The uncontrolled transactions must be sufficiently similar to provide a reasonable and reliable benchmark for determining whether the controlled transaction led to an arm's length result.

The so-called "best method" rule is introduced; this means that the arm's length result of a controlled transaction must be determined by the method that provides the most accurate measure of an arm's length result under the facts and circumstances of the transaction. When selecting a method the completeness and accuracy of the data used, the degree of comparability and the necessary adjustments to apply the method must be considered by the taxpayer. It is, however, not necessary when selecting a method to check whether other methods are inapplicable. If the IRS obtains information which would permit the use of another, more accurate, method, it will apply such a method to determine the arm's length result.

If CUT cannot be applied because no adequate data are available, the comparable profit method (CPM) may be used, which is derived from the CPI method of 1992.

Other methods, e.g. the profit-split method, may be used, provided that the taxpayer prepares documentation explaining why this other method provides the most accurate measure of an arm's length result.

In December 1993 the OECD Task Force released a report on the 1993 Temporary and Proposed Regulations. The Task Force is still concerned that the CPM may become the predominant method used by the IRS, although the Task Force is satisfied with the elimination of CPM as a mandatory check for all methods and with the introduction of the best method rule. The Task Force recommends that CPM be used only in abusive cases and as a method of last resort. Periodic adjustments should be restricted to abusive cases. The Task Force remains concerned, however, that application of the regulations will lead to double taxation since treaty partners may not agree to the U.S. approach. Consequently, the United States should issue a statement that it will not be bound by the regulations when dealing with a case through the mutual agreement procedure or arbitration under a tax convention.

6.7. Final regulations

On 1 July 1994 the IRS released final Regulations under Sec. 482, which are effective for tax years beginning after 6 October 1994. According to the Preamble they clarify and refine provisions of the 1993 regulations where necessary, without fundamentally altering the basic policies reflected in the 1993 regulations.

§ 1.482.1 deals with the allocation of income and deductions among taxpayers. This paragraph gives a best method rule which is much more detailed than the 1993 version. The arm's length range is the range of reliable results produced by an accepted method. A taxpayer will not be subject to adjustment if the results fall within such a range.

§ 1.482.2 deals with specific "situations" such as loans and services. The rules on services in the 1968 Regulations remain applicable, however.

§ 1.482.3 discusses the transfer of tangible property, including the three standard methods (CUP, resale price method and cost-plus method) plus "unspecified methods".

§ 1.482.4 deals with the transfer of intangible property. Four methods are given: CUT, CPM, profit-split and "unspecified methods".

§ 1.482.5 sets out CPM.

§ 1.482.6 explains the profit-split method.

§ 1.482.8 gives examples of the best method rule.

Final rules on cost-sharing are not yet included.

The final regulations provide more flexibility in the use of comparables. The profit-split method has become a specified method for transfer pricing of intangibles.

I leave a detailed discussion of the final regulations to the next speaker.

6.8. Documentation and penalties

Section 6038A IRC as amended in 1989 contains rules on information to be filed or maintained by foreign-owned companies active in the United States. Final regulations of June 1991 implement the documentation requirements. Section 6038A is not applicable to companies with less than \$ 10 million gross U.S. receipts or with less than \$ 5 million payments made to or received from foreign related parties.

Section 6662(e) IRC imposes penalties. Temporary and Proposed Regulations were issued on 2 February 1994. On 5 July 1994 Section 6662 regulations were amended to bring them in line with the final transfer pricing regulations and in particular with the best method rule.

The amended penalty regulations contain requirements on contemporaneous documentation. To avoid penalties taxpayers must be able to explain how they selected their pricing method and the reasons for not using the other possible methods.

The penalties applicable in case of adjusted transfer prices are substantial: a 20 percent penalty (of the portion of an underpayment of tax) if the adjustment amounts to the lesser of \$ 5 million or 10 percent of the gross receipts; a 40 percent penalty if the adjustment amounts to the lesser of \$ 20 million or 20 percent of the gross receipts.

7. THE DRAFT OECD GUIDELINES ON TRANSFER PRICING

The discussion draft of the 1994 OECD Guidelines (part I) was released on 28 June 1994. The new Guidelines update and consolidate the 1979 and 1984 Reports. An update was necessary to reflect developments in international trade, e.g. global trading, and also technological developments. The draft also tries to bridge the differences which have arisen between the United States and other OECD countries since the publication of the U.S. White Paper in 1988.

The OECD is trying to formulate a worldwide standard on this matter, in particular to avoid (economic) double taxation.

The Guidelines are being issued in three instalments. Part I covers a discussion of the arm's length principle, a chapter on transaction-based methods and a chapter on other methods.

In the course of 1995 part II with chapters on documentation (and probably penalties), intangibles, services and administrative

rules is expected. The third instalment would consist of chapters on permanent establishments, their capitalisation and cost sharing.

The Guidelines find, in general, transaction-based methods superior to profit-based methods, such as CPM. Global formulary apportionment, such as unitary taxation, is clearly rejected. The OECD reaffirms the arm's length principle as the basis for determining transfer prices. Although there may be application problems, "there is no legitimate or realistic alternative to the arm's length principle (§ 31).

Application of the arm's length principle starts with a functional analysis and a determination of comparability. Adjustments are admitted which are reasonably accurate to eliminate the effect of differences.

The arm's length range consists of the result of applying different methods. "Any point in the range (...) satisfies the arm's length principle" (§ 64). The draft further discusses set-offs, business strategies, the determination of the relevant point in time, package deals, losses, the effect of government policies and customs valuations.

An important principle in the draft is that the actual transaction should be recognised. Only in exceptional cases may the actual structure of a transaction be disregarded (§ 53).

The draft discusses the three basic methods: CUP, resale price and cost-plus. If its use is at all possible, CUP is the method preferred by the draft.

The three transaction-based methods have priority over the profit-based methods (§ 172).

Profit split goes with a functional analysis and comparison to find profit-split percentages or returns observed among independent enterprises with similar functions (§ 131). CPM may be used in exceptional cases only (§ 173).

8. GLOBAL COMPARISON OF THE U.S. REGULATIONS WITH THE OECD DRAFT GUIDELINES

Three main conflicts between the 1992 draft Regulations and OECD principles were determined, in particular, by the OECD Task Force:

- profit-based methods should not be used as primary transfer pricing methods, only as a last resort method and as a check of the results of other methods;
- the use of hindsight by tax authorities and the making of annual adjustments;
- the implicit abandoning of the arm's length standard in favour of the requirement that operating profits must be substantially equal to an industry-wide average profit.

In the 1993 and 1994 Regulations the negative comments of the OECD and business circles have been taken into account to some extent, in particular by putting less emphasis on CPM.

The issuing of the 1994 Regulations coincided with the publication of part I of the OECD discussion draft for a new Transfer Pricing report. Part I of the OECD draft does not cover intangibles, services and documentation, so a full comparison is not yet possible.

The new U.S. regulations have - at least on paper - reduced the priority of the profit-based method, while the OECD recognizes that the comparable profits method may be used in certain cases as a last resort method (§ 173-174). There is, however, a great difference in emphasis between the two approaches. The Regulations keep CPM as a primary method whereas the OECD discourages the use of profit methods (§ 173). Some OECD countries, including Germany, remain strongly opposed to even referring to CPM as a last resort method.

The draft OECD Guidelines state that tax authorities should not make use of hindsight. The 1994 U.S. Regulations have reduced the use of hindsight somewhat: retrospective adjustments need not be made if actual results in the first five years after the transfer of the intangible property remain within the range of 80 to 120 percent of profits projected at the time of the transfer or where profits are affected by exceptional events which could not have been foreseen. On this point there is still a big gap between the OECD and the U.S.A.

An important difference is also the rather mechanical nature of the U.S. regulations compared with the more subjective basis of the OECD Guidelines. The U.S. "arm's length range" may be a result of using inexact comparables. Statistical methods such as the interquartile range must be used to select a result out of that range. The OECD, in contrast, stresses the role of judgment in determining an appropriate point in the arm's length range (which is the different result of applying two different methods).

The OECD Guidelines restrict comparison to actual market transactions. In some circumstances the U.S. regulations envisage using the result of a hypothetical transaction to adjust the results of the actual transaction. This is in conflict with one of the basic OECD principles: not to replace a business decision with a hypothetical transaction made up by the tax authorities.

Also the profit-split method is different in the two sets of rules.

Under the U.S. Regulations the District Director ultimately decides on the method to be applied. The OECD draft refers to an agreement between the taxpayer and the authorities: "any method should be permitted where its application is agreeable to the members of the MNC group involved (...) and also to the tax authorities in the jurisdiction of all those members".

The OECD approach of penalties and documentation cannot yet be compared with the U.S. regulations on these matters. Several OECD countries, including Canada, oppose the harsh U.S. penalty rules. The threat of these penalties in the U.S.A. may cause large shifts in income to the United States at the expense of treaty partners' revenue.

The complexity of the Regulations in combination with the extreme documentation requirements has received criticism from several countries and from business circles. It is very burdensome for taxpayers to comply with the Regulations. The OECD is trying to find a more reasonable solution for documentation.

9. THE DIFFERENCE BETWEEN THE UNITED STATES AND OTHER OECD COUNTRIES

The program for this conference introduces my presentation as the European viewpoint on transfer pricing in contrast to the US viewpoint. It would be better to speak of the United States, on the one hand, and the other 24 OECD countries, on the other hand.

With respect to many aspects of international tax law we see different approaches between the United States and the other countries. I was in particular involved in discussions on those differences during the years I was a member of the Committee on Fiscal Affairs of the OECD.

The discussions on unitary taxation, for instance. All other OECD countries and the 1979 OECD Report (§ 14) disqualify the use of unitary taxation. The Supreme Court of the United States on 20 June 1994, however, approved the method as used in California. The U.S. Congress is considering replacing the arm's length standard for international transactions with a unitary tax method (Foreign Tax Compliance Act 1994, introduced in the House in mid-1994).

Another point of difference was the treatment in the United States of branches of foreign banks. Interest income of such branches is allocated directly, but interest expense was and still is diluted via a global method based on the total interest expense of the worldwide bank concerned. The OECD report on transfer pricing in the banking sector of 1984 says that such a combination of direct allocation and a global method is not allowed under article 7 of the OECD model. The system nevertheless continues to be applied in the United States.

As the reports of the OECD Task Force demonstrate, the regulations on transfer pricing under section 482, published in 1992 and 1993, also reveal a principal difference in approach and a departure from standards set in the 1979 OECD Transfer Pricing Report. I have already indicated differences between the 1994 Regulations and the new OECD Draft.

The most serious difference of opinion is probably the position the US takes on treaty override: that later laws could set aside obligations under a treaty. The Foreign Income Tax Rationalization and Simplification Bill of 1992 introduced by Rostenkowski and

Gradison is a striking example of a violation of internationally accepted principles of taxation and of international law. The Technical Explanation states very clearly: "it is believed that (...) the minimum taxable income requirement mandated by the bill generally is consistent with the business profits and associated enterprises articles of treaties"; "if, despite the belief expressed above, it is ultimately determined that this provision of the bill violates a treaty obligation of the United States, it is intended that the provisions of the bill will nevertheless apply".

A higher degree of disrespect for treaty partners cannot be imagined. Not only tax treaties would be violated but also Friendship, Commerce and Navigation treaties which forbid more burdensome taxation of companies held by residents of the treaty partner than domestically held companies in the United States.

What is the reason for all these deviations from internationally accepted rules?

I think that the main reason is politics. If a high budget deficit exists, it is attractive from a political point of view to state that more revenue should come from foreigners rather than from an increase of income tax for all taxpayers. Remember the 45 billions dollars more tax which - according to president Clinton two years ago - should be collected from foreign investors in the United States. To justify such an increased tax yield the average profitability of foreign-held companies in the U.S.A. would have to be several times higher than the average profitability of U.S. held companies.

There are other differences between the United States and the other OECD countries.

The IRS tries to collect even the last dime, whereas other countries take into account the high administrative costs of such a policy. The last dime is very expensive to collect. It also requires extremely detailed implementing rules, which is a typical American feature. Other countries rely on global rules such as the concept of the sound business manager, which gives the taxpayers much flexibility. Discretionary powers for the tax administration and the possibility of individual advance rulings are also common in various countries outside the United States. APAs have only recently been introduced in the United States, but they again go with detailed regulations.

The onus of proof constitutes a difference as well: a profit adjustment by the IRS on the basis of section 482 is presumed to be correct unless the taxpayer can prove that the adjustment was arbitrary, capricious or unreasonable and that the transfer price was at arm's length. Judges in other countries are usually rather free to allocate the burden of proof to the appropriate party. When a taxpayer applies a transfer pricing method consistently and in a reasonable manner, the tax inspector would normally have to prove that in that particular case the price is not at arm's length. (In some European countries like France and Belgium, the

onus of proof is on the taxpayer in the case of transactions with tax havens).

10. PRACTICE AMONG MNEs

In 1992 the International Bureau of Fiscal Documentation sent a questionnaire on the use of transfer pricing methods to about 150 large MNEs in 20 countries.

Seventy answers from 12 countries provided useful information. Main sectors of activity were: oil and chemicals, electronics, finance, forestry, metals, pharmaceuticals, retailing and textiles.

The results were as follows:

	<u>CUP</u>	<u>Cost plus/ resale price</u>	<u>all three basic methods</u>	<u>other methods</u> ¹⁾
goods	8	44	11	3
services	6	48	13	4
intangibles	19	20	11	7

1) in particular profit-split, and bargaining like open market parties.

Per country the following pattern appears:
(only countries with at least 5 respondents are included)

Belgium: large majority uses cost-plus/resale price.
Germany: goods and services: if CUP is available it is used, but nevertheless the majority applies cost-plus or resale price;
intangibles: majority applies CUP.
Netherlands: goods and services: almost all use cost plus or resale price;
intangibles: great majority use cost-plus/resale price, some CUP or mixed methods.
Sweden: majority applies CUP.
Switzerland: large majority use cost-plus/resale price.
U.K.: goods: some CUP, other cost-plus/resale minus;
services: cost-plus;
intangibles: CUP.
U.S.A.: goods and services: a clear majority applies cost-plus/resale price;
intangibles: equally divided over CUP, cost-plus and other methods.

Although it was only a small-scale questionnaire, the enquiry nevertheless reveals a clear dominance of the cost-plus and resale price methods in the case of goods and services. CUP is better represented with respect to intangibles. Some respondents indicated that internal CUPs were used: prices charged by group members to non-related clients.

11. PRICING METHODS, CHECKING METHODS AND DISPUTE-SOLVING METHODS

In my opinion the OECD Reports, the U.S. Regulations and also the draft Guidelines should have made a clear distinction between pricing methods, checking methods and dispute-solving methods.

(1) Pricing methods

The arm's length principle requires that methods be followed between related parties which are also used between unrelated parties (or to put it otherwise: not at arm's length are methods which are not used among unrelated parties). Unrelated parties bargain about the price of goods, services and intangibles. If equivalent goods etc. are also available from third parties in the market, that third-party price is an important factor.

Bargaining at arm's length between related parties is achieved if the bargaining conditions are similar to those existing between non-related parties.

Paragraph 2 of the 1979 OECD Report states that the conditions for arm's length bargaining are sometimes fulfilled by MNEs when the group members have considerable autonomy and have reasons for recording favourable results. Paragraph 38 makes a similar point.

Indeed, in many multinational groups authentic internal competition and serious bargaining among group entities is brought about by factors such as:

- own profit responsibility;
- manager remuneration (partially) related to profits;
- group entities being allowed to buy from non-related parties if their prices are lower.

If such factors are genuine elements of the structure and transfer pricing system of a group, the basic requirements for arm's length bargaining are fulfilled and the prices resulting therefrom should be accepted as arm's length prices.

I put forward this viewpoint in a panel on transfer pricing at the IFA Congress in Cancun in 1992, where I had the task of discussing the origin and essential aspects of the arm's length principle. This resulted in a resolution adopted unanimously at the IFA Congress:

"Paragraphs 2 and 38 of the (1979) OECD Report recognize that within affiliated groups, conditions for arm's length bargaining may be fulfilled. This could be the case if the persons, having a decisive influence on the transfer price, have diverging economic interests; where civil law rules prescribe certain behaviour; where group entities have their own profit responsibility and are free to contract with third parties; or where there are significant minority or even majority interests.

The OECD Report should provide criteria to identify such situations and provide that, if they are found to be present,

the price that has been established should be accepted as an arm's length price."

The resolution has, unfortunately, not had much impact on the OECD Working Party drafting the new Guidelines. It in fact rejects the resolution by saying in § 21: "Evidence of hard bargaining alone is not sufficient to establish that the dealings are at arm's length." This is a simplification of the point raised. The OECD Working Party should distinguish situations, circumstances and conditions in which it may be assumed that arm's length bargaining takes place. This would in the first place be helpful to tax administrations.

For tax authorities it may be easier to verify whether objective conditions and circumstances within MNEs are such that arm's length bargaining actually takes place than to go through processes of finding comparables, adjusting inexact comparables, statistical procedures and other conundrums included in the U.S. regulations.

For the above reasons I would characterize the arm's length bargaining method as one of the primary pricing methods, which further include the comparable uncontrolled price methods, the cost-plus method and the resale price method.

As to CUPs a distinction should be made between external CUPs (agreed between two external unrelated parties) and internal CUPs (between the MNE entity concerned and an unrelated party). See § 11 of the 1979 OECD Report. Searching for external CUPs may be very onerous. It is often impossible or very difficult to obtain evidence about the open market situation. A functional analysis of an external situation may be necessary; otherwise it may be impossible to ascertain whether the external price is a real comparable price. Such an analysis cannot usually be made in practice. A pricing system can therefore only be based on external CUPs when such prices and the open market situation can be clearly and consistently ascertained.

The internal CUP is part of the pricing system of the MNE concerned and represents an arm's length price since it also results from bargaining between unrelated parties. Information on internal CUPs is generally readily available to group members.

Application of the cost-plus and resale price methods requires a functional analysis of the group members concerned, but that will not normally cause any difficulty. The amount of the profit margin is the more difficult aspect. It could be based on an estimate of the profit rate which could have been realized in a transaction with an independent party.

The fisc should normally not adjust profits if an external CUP is found which does not deviate to a considerable extent from the price arrived at by the consistent application of the above methods. An external CUP which deviates considerably from a freely negotiated price within a group may justify an adjustment for past years if the manager knew of the CUP or if he should have known of

the price (the latter test is objective). An external CUP known to the parties should normally have influenced the negotiations.

In the case of the cost-plus and resale price methods an external CUP which deviates considerably may provide evidence that the functions performed within the group are not adequately remunerated. Knowledge of such a CUP or application of the "should-have-known" standard may justify adjustments for past years.

Profit split is sometimes used by unrelated parties. It should therefore be admissible as a transfer pricing method provided that the profit is split according to a reasonable functional analysis.

CPM cannot be used as a pricing method since such a method is never applied between unrelated parties. No company knows the operating profits of its competitors except in exceptional and occasional cases.

It is very important for MNEs that their transfer pricing methods are regulated by clear, binding internal instructions, which emphasize consistent and correct use.

(2) Checking methods

Checking methods are used by tax authorities and also by MNEs to test whether the result of the application of arm's length pricing methods is reasonable.

CUP is a checking method, too. A problem is that during tax audits of companies tax officials are often able to obtain information on CUPs which is normally not available to the company's competitors. The use of such CUPs is limited since they may not be revealed as business secrets.

The comparable profit method and similar global methods are checking methods, not pricing methods. Such methods may demonstrate that the profitability of group members is considerably lower than that of comparable businesses. Such evidence can be used by tax authorities as a pointer to the necessity of a tax audit.

(3) Dispute-solving methods

In courts in several countries and in mutual agreement procedures between treaty partners the profit-split method is predominant for resolving disputes.

An analysis of functions, responsibilities and risks should normally give a clue as to a reasonable split of the profits.

12. SETTING UP A NEW STATUTORY TRANSFER PRICING SYSTEM

For countries which are starting from scratch in setting up a legal and regulatory system for transfer pricing I would recommend the following set of measures:

- include a transfer pricing provision in the tax law, e.g. take article 9(1) of the OECD Model (mutatis mutandis);
- adopt regulations which closely follow the OECD Guidelines as soon as they are final, but with a clear distinction between pricing and checking methods. The pricing methods should include the arm's length bargaining method and guidance on the circumstances and conditions in which arm's length bargaining may be assumed;
- insist, in particular, on clear, well documented, and consistently applied transfer pricing rules used by MNEs internally;
- include article 9 OECD Model in tax treaties with an additional clause on arbitration in case the mutual agreement procedure does not produce a result within a limited period of time;
- establish a fast exchange of information system and a system of simultaneous or joint tax audits with major treaty partners;
- adopt a ruling system (APA), under which guidance is given to MNEs on the acceptability of their transfer pricing system; APAs should be coordinated with the treaty partner(s) concerned;
- set up special tax offices for large corporate taxpayers which combine assessment, rulings, and tax auditing; and
- educate and train the tax officials of such offices extremely well (and try to keep them for at least three years with a good salary and a strict contract).

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