

10-1-1986

Transfer Pricing Abuses and Less Developed Countries

Charles R. Irish

Follow this and additional works at: <http://repository.law.miami.edu/umialr>

Recommended Citation

Charles R. Irish, *Transfer Pricing Abuses and Less Developed Countries*, 18 U. Miami Inter-Am. L. Rev. 83 (1986)
Available at: <http://repository.law.miami.edu/umialr/vol18/iss1/4>

This Article is brought to you for free and open access by Institutional Repository. It has been accepted for inclusion in University of Miami Inter-American Law Review by an authorized administrator of Institutional Repository. For more information, please contact library@law.miami.edu.

TRANSFER PRICING ABUSES AND LESS DEVELOPED COUNTRIES

CHARLES R. IRISH*

I. INTRODUCTION	84
A. <i>Definitions: Transfer Pricing and Transfer Pricing Abuses</i>	86
B. <i>Magnitude of Transfer Pricing Abuses in Less Developed Countries</i>	87
C. <i>Incentives to Engage in Transfer Pricing Abuses</i>	89
D. <i>The Impact of Dealing with Transfer Pricing Abuses in Less Developed Countries</i>	90
II. IDENTIFYING THE MECHANISMS FOR REDUCING TRANSFER PRICING ABUSES	92
A. <i>Directly: Establishment of a Transfer Price</i>	93
1. Transfer Pricing Guidelines	93
2. Sales of Goods	94
3. Services	95
4. Patent Rights and Other Intangibles	97
B. <i>Indirectly: Apportionment of Overall Profits and Posted or Notional Export Prices</i>	99
1. Apportionment of Overall Profits	99
2. Posted or Notional Export Prices	100
C. <i>Indirectly: Elimination of Tax Differentials, Taxation of Intra-Firm Transfer Payments, and Artificial Restrictions on Intra-Firm Transfer Payments</i>	100

*Volkman-Bascom Professor of Law, University of Wisconsin, Madison, Wisconsin

1. Elimination of Tax Differentials	100
2. Taxation of Intra-Firm Transfer Payments	102
3. Artificial Restrictions on Transactions that are Commonly the Object of Transfer Pricing Abuses	104
III. SELECTION AND IMPLEMENTATION OF APPROPRIATE MECHANISMS FOR CURBING TRANSFER PRICING ABUSES	105
A. <i>Directly—The Arm's Length Approach</i>	106
1. Selection	106
2. Implementation	110
(a) Monitoring Intra-Firm Commodity Transactions	110
(b) Auditing Intra-Firm Commodity Transactions	112
(c) Correlative Adjustment Procedure	118
B. <i>Indirectly: Apportionment of the Overall Profit of an Enterprise</i>	120
1. Selection	120
2. Implementation	123
C. <i>Indirectly: Posted or Notional Export Prices</i>	125
D. <i>Indirectly: Elimination of Tax Differentials</i>	125
E. <i>Indirectly: Taxation of Intra-Firm Transfer Payments, Limits on the Deductibility of Such Payments, and Artificial Restrictions on Intra-Firm Transfer Payments</i>	128
IV. CONCLUSION	131

I. INTRODUCTION

Transfer pricing abuses by transnational corporations¹ are an

1. The term "transnational corporations" refers to enterprises with either substantive

important and vexing problem for the governments of less developed countries. On the one hand, there are strong indications that less developed countries lose significant amounts of tax revenues and foreign exchange as a result of transfer pricing abuses. On the other hand, the introduction of measures to effectively curb transfer pricing abuses may strain the administrative capabilities of all but the most sophisticated governments of less developed countries. Efforts to introduce such measures may be met with such hostility from transnational corporations as to raise serious doubts about their net impact on the economy: measures that are effective in curbing transfer pricing abuses may result in additional revenues and save foreign exchange; alternatively they may drive transnational corporations to other countries where the corporations have greater discretion in the allocation of income and expenses.

The principal purpose of this article is to identify what has been done and to explore what might be done to curb transfer pricing abuses by transnational enterprises. In furtherance of this purpose, this section focuses on necessary, but preliminary topics such as the definitions of transfer pricing and transfer pricing abuses, their magnitude, and the reasons transnational corporations engage in transfer pricing abuses. This section concludes with a discussion of the difficult question of whether it is appropriate or counter-productive to make extensive efforts to curb transfer pricing abuses in less developed countries. The second section considers the governmental mechanisms developed to counteract transfer pricing abuses. The third section deals with the selection and implementation of mechanisms for curbing transfer pricing abuses. Finally, the fourth section is a conclusion with a summary of the recommendations.

or formal economic activities in more than one jurisdiction.

It is clear that transnational enterprises are not the only entities that engage in transfer pricing abuses. There are many instances in which local individuals or companies use transfer pricing to artificially shift profits abroad so as to avoid or evade taxes, circumvent exchange controls, or reduce the economic exposure arising from political or economic uncertainties. See generally R. GORDON, *TAX HAVENS AND THEIR USE BY UNITED STATES TAXPAYERS—AN OVERVIEW* 59-110 (1981). Nonetheless, transnational corporations are the logical focus of concerns about transfer pricing abuses, as they are the major actors in foreign investment and international trade. In addition, the mechanisms for dealing with transfer pricing abuses by transnational corporations should be equally applicable to transfer pricing abuses by others. See U.N. CENTRE ON TRANSNATIONAL CORPORATIONS, *SALIENT FEATURES AND TRENDS IN FOREIGN DIRECT INVESTMENT* at 8-9, U.N. Doc. ST/CTC/14, U.N. Sales No. 83/IIA/8 (1983).

A. *Definitions: Transfer Pricing and Transfer Pricing Abuses*

The essence of a transfer price is that it is not set by an independent transferor and transferee in arm's length negotiations, but is within the discretion of a single enterprise. Thus, transfer pricing usually refers to the value attached to transfers of goods, services, and technology between related entities, such as parent and subsidiary corporations and brother-sister corporations.² In addition, although they are not generally regarded as constituting transfer prices, the values attached to transfers between unrelated parties which are controlled by a common entity should constitute transfer prices. Hence, the values attached to transfers between a government-owned enterprise which is managed by a transnational corporation and its affiliates should be regarded as transfer prices.

The establishment of a transfer price is often an imprecise exercise. As a result, in many cases it is not possible to set a single figure as the appropriate transfer price: it is much more common to refer to a range of defensible transfer prices. Thus, transfer pricing abuses occur only when prices are set so that they fall outside the range of defensible prices.³ The net effect of transfer pricing abuses is that profits properly attributable to one jurisdiction are shifted to another jurisdiction. A simple example of a transfer pricing abuse prompted by tax considerations would be a transnational corporation with a manufacturing subsidiary in West Germany and a sales subsidiary in Hong Kong. Since the Hong Kong corporate tax is relatively low, while the German tax is quite high, it would be in the transnational corporation's interest to set the prices on transfers between the subsidiaries so that the bulk of the profits were allocated to the Hong Kong subsidiary. If the transfer price on goods manufactured by the West German subsidiary and sold to unrelated parties by the Hong Kong subsidiary were set at or just slightly above the German subsidiary's production costs, the effect would be to have all or substantially all of the profits arise in Hong Kong. If this price were below the range of defensible transfer prices it would constitute an abusive transfer pricing practice.

2. See R. TANG, *TRANSFER PRICING PRACTICES IN THE UNITED STATES AND JAPAN* 2-3 (1979).

3. See Van Hoorn, Jr., *Problems, Possibilities and Limitations with Respect to Measures against International Tax Avoidance and Evasion*, 8 GA. J. INT'L & COMP. L. 763 (1978).

B. Magnitude of Transfer Pricing Abuses in Less Developed Countries

Empirical evidence on the level of transfer pricing abuses is far from complete.⁴ Nonetheless, the evidence that does exist suggests that transfer pricing abuses are a major problem and result in significant economic damage in both industrialized and less developed countries. First, because a substantial portion of world trade is intra-firm, it is clear that transnational corporations have substantial opportunities to engage in transfer pricing abuses. It is estimated, for example, that in 1977 roughly one third of all parent company exports consisted of intra-firm sales, with the share varying from forty-five percent for United States enterprises, to thirty percent for those based in Western Europe, to seventeen percent for Japanese firms.⁵ The data for individual less developed countries emphasize the importance of intra-firm trade and the concomitant opportunities for transfer pricing abuses.⁶

Moreover, the level of intra-firm activity is much higher where technology and the resultant products are involved. Data on the earnings from royalties, licensing fees, and technical assistance by United States and British companies indicate that intra-firm transactions predominate, accounting for eighty and eighty-five percent, respectively, of the total earnings of the companies concerned.⁷

The studies that have focused on transfer pricing abuses in individual countries or within specific industries show that transnational corporations are inclined to take advantage of the opportunities that exist for transfer pricing manipulations. In recent

4. S. PLASSCHAERT, *TRANSFER PRICING AND MULTINATIONAL CORPORATIONS* 11-12 (1979); Lall, *Transfer Pricing and Developing Countries*, 7 *WORLD DEV.* 60 (1979).

5. U.N. CENTRE ON TRANSNATIONAL CORPORATIONS, *TRANSNATIONAL CORPORATIONS IN WORLD DEVELOPMENT—THIRD SURVEY* at 160, U.N. Doc. ST/CTC/46, U.N. Sales No. 83/IIA/14 (1983)[hereinafter *THIRD SURVEY*].

6. In Brazil, intra-firm transactions accounted for fifty percent of the imports and seventy-three percent of the exports of U.S. subsidiaries in 1972; U.S. enterprises in Mexico imported fifty-eight percent of their total imports from their parents and exported eighty-two percent of the total exports in the same year. Overall, thirty-seven percent of U.S. imports of manufactured goods and seventeen percent of semi-manufactured goods from less developed countries in 1977 were from related parties. Subsidiaries of British enterprises in the less developed countries imported approximately twenty-five percent of their recurrent imports and slightly less than ten percent of their plant and equipment imports from their parent firms. Similarly, affiliates of West German enterprises operating in Argentina, Brazil, India and Mexico sold nearly sixty percent of their exports to related companies. *Id.*

7. *Id.* at 164-65.

years, the U.S. Treasury and Congress have become alarmed about the growing amount of international tax evasion, some of which is the result of transfer pricing abuses.⁸ A study in Colombia estimated that the weighted average of overpricing for a wide range of pharmaceutical imports between 1967 and 1970 was 155% of the arm's length price.⁹ Similar studies in Argentina, Mexico, Brazil, Ethiopia, Tanzania and elsewhere also indicate that transnational corporations do take advantage of the opportunities to manipulate transfer prices.¹⁰

Finally, the widespread availability of literature advising business enterprises on the intricacies of manipulating transfer prices also suggests that the practice is quite commonplace.¹¹ From a governmental perspective, the current literature indicates that transfer pricing abuses may be a considerable problem.

It is clear that, to the extent transfer pricing abuses occur, they result in revenue losses and a drain on foreign exchange reserves in both industrialized and less developed countries. Further, because of the apparent tendency of transnational corporations to take advantage of the opportunities to manipulate transfer prices, it is reasonable to conclude that the extent to which transfer pricing abuses are a problem in a particular country is in large part a function of the level of intra-firm transactions in that country, the strength of the incentives to engage in transfer pricing abuses, and the risk such abuses will be detected. It also is logical to conclude that however great a problem transfer pricing abuses are in industrialized countries, they are an even greater problem in the less developed countries because the volume of intra-firm

8. R. GORDON, *supra* note 1, at 62-63.

9. U.N. CENTRE ON TRANSNATIONAL CORPORATIONS, TRANSNATIONAL CORPORATIONS IN THE PHARMACEUTICAL INDUSTRY OF DEVELOPING COUNTRIES at 17 U.N. Doc. ST/CTC/49, U.N. Sales No. 84/IIA/10 (1984) [hereinafter PHARMACEUTICAL INDUSTRY].

10. *See id.* at 17, 67; INTERCOMPANY TRANSFER PRICING IN INTERNATIONAL TRADE: THE EXPERIENCE OF THE FEDERAL REPUBLIC OF GERMANY at 4, U.N. Doc. ST/SG/AC.8/L.25 (1977); U.N. CONFERENCE ON TRADE AND DEVELOPMENT, MAJOR ISSUES ARISING FROM THE TRANSFER OF TECHNOLOGY: A CASE STUDY OF ETHIOPIA, U.N. Doc. TD/B/AC.11/21 (1974); U.N. DEPARTMENT OF ECONOMIC AND SOCIAL AFFAIRS, TAX TREATIES BETWEEN DEVELOPED AND DEVELOPING COUNTRIES—FIFTH REPORT at 143, U.N. Sales No. E75/XVI/1 (1975); Makani, *The Control of Transfer Pricing and the Related Malpractices in Developing Countries: The Tanzanian Experience* 4-5 (1975) (unpublished manuscript on file in the office of the author).

11. *See* S. PLASSCHAERT, *supra* note 4, at 54; M. GRUNDY, *THE WORLD OF INTERNATIONAL TAX PLANNING* 15-22 (1984); R. BENKE & J. EDWARDS, *TRANSFER PRICING: TECHNIQUES AND USES* 113 (1980); *see generally* S. ROBBINS & R. STOBAUGH, *MONEY IN THE MULTINATIONAL ENTERPRISE: A STUDY OF FINANCIAL POLICY* (1973).

transactions is high worldwide, and the incentives to engage in transfer pricing abuses are generally greater in the less developed countries than in the industrialized countries, and the risk of detection usually is less in the less developed countries than in the industrialized countries.

C. Incentives to Engage in Transfer Pricing Abuses

Transnational corporations engage in transfer pricing abuses for a variety of reasons. Probably the most widely recognized reason is taxation. For example, if in country A the corporate tax burden is higher than in country B, other factors being equal, an enterprise with operations in both countries is logically inclined to shift profits from country A to country B in order to increase its after tax-profits. Transfer pricing abuses are especially attractive to transnational corporations where the tax differentials between two countries differ greatly, such as is usually the case between industrialized countries and tax havens, or between less developed countries and tax havens.

Transfer pricing abuses, however, are prompted by much more than just corporate income tax differentials. They may be used to circumvent exchange control restrictions because exchange controls usually are more liberal for payments for imported capital goods (and components), services, and technologies than for direct profit remittances. They also may be used as a device to quietly withdraw profits in the face of political or economic uncertainties in host countries or in any instance where business considerations dictate the showing of low profits in a particular jurisdiction.¹²

One notable trend in the structure of investments by transnational corporations in less developed countries which undoubtedly has affected transfer pricing practices has been the movement away from one hundred percent equity investments. Instead, transnational corporations increasingly structure their foreign investments in a package consisting of something less than one hundred percent of the equity, long term debt, technological licenses, and management services agreements.¹³ This investment strategy

12. S. PLASSCHAERT, *supra* note 4, at 66; W. Chudson, Notes on Transfer Pricing and Its Regulation 12 (1978) (unpublished manuscript on file in the office of the author); C. VAITSOS, INTERCOMPANY INCOME DISTRIBUTION AND TRANSNATIONAL ENTERPRISES 96-108 (1974).

13. See THIRD SURVEY, *supra* note 5, at 42-43; C. IRISH, INDONESIA: TAXATION OF TRANSNATIONAL CORPORATIONS ENGAGED IN NATURAL RESOURCE DEVELOPMENT 2-3 (1983) [hereinaf-

is usually in response to government policies intended to infuse some local control over foreign investment. The shift away from traditional equity investments, however, has coincidentally increased the incentives to withdraw profits through excessive management fees and royalties for the use of technology, over-invoicing of imported components, and under-invoicing of exports. Where there is substantial local participation, profits withdrawn through transfer pricing abuses still go one hundred percent to the transnational corporation, whereas profits withdrawn through the payment of dividends are split between the transnational corporation and the local participants. Thus, profit-oriented transnational corporations, operating in less developed countries with significant local participation, are logically inclined to make use of transfer pricing techniques to withdraw profits before they have to be shared with the local participants.

D. The Impact of Dealing with Transfer Pricing Abuses in Less Developed Countries

In considering the mechanisms available for reducing transfer pricing abuses in less developed countries a threshold question that must be considered is whether the benefits from employing such mechanisms would outweigh their disadvantages. Unfortunately, this is a close question, and the closeness of the question is probably a reason many less developed countries have not devoted more time and resources to curbing transfer pricing abuses.

Transnational corporations have a documented preference for larger and more affluent markets. This preference is reflected in the fact that less developed countries accounted for only about twenty-three percent of total foreign investment inflows between 1978 and 1980.¹⁴ Furthermore, just six countries, Argentina, Brazil, Hong Kong, Malaysia, Mexico, and Singapore consistently accounted for between one-half and three-quarters of the total inflow into less developed countries during the late 1970's.¹⁵ The result is that the great majority of less developed countries, with their low per capita GNPs and small markets, account for only a small proportion of the total stock of foreign investment and are relatively unattractive to the transnational corporations. The less developed

ter C. IRISH, INDONESIA].

14. THIRD SURVEY, *supra* note 5, at 17.

15. *Id.*

countries with low incomes¹⁶ accounted for about sixty percent of the population of the less developed countries, excepting China and the other socialist countries of Asia, but they received less than five percent of the total foreign investment inflows to less developed countries between 1978 and 1980, compared to fourteen percent between 1970 and 1972.¹⁷

The uncomfortable position of many less developed countries in their dealings with transnational corporations is further underscored by the fact that while they account for a small portion of the overall activities of the transnational corporations, their presence in the less developed countries may be highly visible and generate employment opportunities and foreign exchange earnings of critical importance to the host economy. Examples of such dominance abound, such as the copper companies in Zambia and Zaire, mining companies in Botswana, and agricultural enterprises in the Eastern Caribbean. The overall impact is that many less developed countries are in a delicate position: if the less developed countries introduce more effective transfer pricing policies, the transnational corporations may respond by shifting their investments to other countries.

In order to introduce more effective transfer pricing policies without discouraging foreign investment, it appears the poorer less developed countries will have to do two things. First, in establishing new transfer pricing rules, the less developed countries will have to insure that the legitimate interests of the transnational corporations are safeguarded. The less developed countries must recognize that determining an appropriate transfer price in a great many intra-firm transactions is a difficult, highly discretionary matter on which reasonable, objective, and well-informed people often differ. Given the numerous factors to be considered in establishing a transfer price, the tax authorities of a less developed country could reasonably set a transfer price on certain imports at \$100, while the transnational corporation just as reasonably could set the price at \$125, and the home country of the transnational corporation, also acting reasonably, could set the price at \$150. It is imperative, therefore, that the less developed countries recognize the wide range of defensible transfer prices in many intra-firm transactions and develop provisions that are simple to understand

16. The low income/less developed countries include countries with per capita GNPs of less than \$380 in 1979, not including China and the other socialist countries in Asia.

17. THIRD SURVEY, *supra* note 5, at 28.

and produce predictable results. It is also essential to apply these transfer pricing mechanisms only where the discrepancy between the government's figures and the figures of the transnational corporation is substantial and to establish effective procedure to resolve threats of double taxation arising out of the application of the transfer pricing mechanisms.

Second, to compensate for the disincentives that rigorous transfer pricing rules may have, the less developed countries should take steps to improve their "investment climate" through non-fiscal measures.¹⁸ For example, new transfer pricing rules would be less likely to receive a hostile reception if they were introduced as part of a general overhaul of the governmental bureaucracies which deal with foreign investment. Included as an initial part of the overhaul might be a streamlining of the procedures the transnational corporations are required to follow in order to invest and operate in the country. If the new transfer pricing rules were also tied to a relaxation of exchange controls and an easing of the restrictions on importing capital goods (and components), the overall reaction of the transnational corporations might be a perception that the government is becoming not only generally more effective, but also more favorably disposed toward private sector development.

II. IDENTIFYING THE MECHANISMS FOR REDUCING TRANSFER PRICING ABUSES

Assuming a governmental policy of curbing transfer pricing abuses exists, it appears that there are three basic ways of dealing with them: (i) directly, by establishing an arm's length transfer price; (ii) indirectly, by apportioning overall profits of an enterprise and using posted or notional export prices; and (iii) indirectly, by eliminating tax differentials, taxing intra-firm transfer payments, and placing artificial restrictions on transactions that are commonly the object of transfer pricing abuses. These three alternative possibilities are explored below.

18. Non-fiscal measures are stressed because of the acknowledged ineffectiveness of fiscal measures to attract and hold foreign investment. For an exhaustive review of this topic, see K. Yelapaala, *The Efficacy of Fiscal Incentives within the Dynamics of the Transnational Enterprise: The Case of Ghana and Liberia* (1985) (unpublished S.J.D. thesis on file in the office of the author). See also C. IRISH, *INTERNATIONAL INCOME TAXATION AND AFRICAN DEVELOPING COUNTRIES* 68-73 (1978) [hereinafter C. IRISH, *AFRICAN COUNTRIES*].

A. *Directly: Establishment of a Transfer Price*

1. Transfer Pricing Guidelines

Transfer pricing abuses can be attacked through a direct audit aimed at determining an appropriate transfer price. The enormous difficulties generally associated with establishing anything other than an arbitrary transfer price,¹⁹ however, have kept most less developed countries from effectively using the direct audit approach. For this reason, in the 1970s the United Nations Group of Experts on Tax Treaties between Developed and Less Developed Countries devoted considerable attention to formulating guidelines to assist the less developed countries in establishing transfer prices for sales of goods, provision of services, and the use of patent rights and other intangibles.²⁰ These guidelines are substantially similar to the transfer pricing guidelines developed by the OECD, which in turn were heavily influenced by the procedures used in the United States and West Germany.²¹

The substantial similarity between the transfer pricing guidelines developed for use in both industrialized and less developed countries correctly suggests that there is little dispute regarding the theory to be used in determining appropriate transfer prices.²² Almost all transfer pricing guidelines are based upon the "arm's length" approach under which the essential inquiry is what unrelated parties, not under common control, would do in similar circumstances. In other words, the arm's length approach involves an attempt to establish the price that would prevail in the marketplace.²³

A litany of the transfer pricing guidelines is necessary to determine how to deal with transfer pricing manipulations. Although

19. See, e.g., Makani, *supra* note 10, at 3-8; U.S. INTERNAL REVENUE SERVICE, TRANSNATIONAL CORPORATIONS, TAX AVOIDANCE AND/OR EVASION SCHEMES AND AVAILABLE METHODS TO CURB ABUSES 4 (1977) [hereinafter TAX AVOIDANCE SCHEMES].

20. See U.N. DEP'T OF ECONOMIC AND SOCIAL AFFAIRS, TAX TREATIES BETWEEN DEVELOPED AND DEVELOPING COUNTRIES—SEVENTH REPORT U.N. Sales No. E78/XVI/1 (1978) [hereinafter SEVENTH REPORT].

21. Compare Treas. Reg. §§ 1.482-1, -2 (1954), with SEVENTH REPORT AND COMMITTEE ON FISCAL AFFAIRS—TRANSFER PRICING AND TRANSNATIONAL CORPORATIONS U.N. Doc. OECD2:P946 (1979).

22. See Surrey, *Reflections on the Allocation of Income and Expenses among National Tax Jurisdictions*, 10 L. & POL'Y INT'L BUS. 409, 414-15 (1978) [hereinafter *Allocation of Income*].

23. *Id.* at 418.

the transfer pricing guidelines in use in the industrialized countries are substantially similar to the U.N. guidelines, the latter are the focus of the discussion that follows because they were expressly formulated for use by less developed countries.

2. Sales of goods

The U.N. guidelines indicate that various methods might be used to determine an arm's length price with respect to sales of goods, but three methods in particular have widespread support: the uncontrolled market price method, the resale price method, and the cost-plus method.²⁴

Under the uncontrolled market price method, the transfer price is established by reference to prices paid by independent third parties for comparable products. In order to ensure that the transfer price is fairly representative of the marketplace, adjustments may be necessary for such factors as transport costs, minor differences in the products, servicing obligations, and differences in quantity. In addition, evidence of comparable prices needs to be reasonably contemporaneous because of fluctuations in market values and currency rates.²⁵

The resale price method involves starting with the price at which the related purchaser (the reseller) resells goods to independent third parties and then subtracting an appropriate mark-up for the reseller. Establishing the appropriate mark-up requires evaluating the functions that the related party performed in reselling the product. If the reseller does no more than sell the goods again, only a small mark-up may be justifiable; but if it can be shown that the reseller takes on full responsibility for advertising, marketing, and distributing, then a more substantial mark-up would be appropriate. The mark-up might also be affected by whether the reseller has the exclusive right to sell the goods in a particular market, although the value of the exclusive right may not be very great.²⁶

The cost-plus method involves establishing the seller's costs and then adding an appropriate mark-up. The considerations in determining a mark-up are basically the same as are involved with

24. SEVENTH REPORT, *supra* note 20, at 29.

25. *Id.* at 30-31.

26. *Id.* at 31-32.

the resale price method. Establishing the seller's cost requires an analysis of the various expenses incurred in the production and sale of the goods to ensure that only expenses properly allocable to the seller are included in the seller's cost. Thus, expenses such as transportation, start-up advertising, and overhead need to be examined to determine the extent to which the expenses benefit the seller and were properly included in the seller's cost.²⁷

As between the three methods, the prevailing view is that the transfer price established under the uncontrolled market price method generally comes closest to the actual price in the marketplace. As between the latter two methods, the general view is that the resale price method is preferable to the cost-plus method in that it is most likely to approximate the marketplace. The resale price method relies on two figures, the price at which the goods are resold by the related purchaser and the reseller's mark-up. The former figure is fixed by the open market, while the latter figure is dependent on the tax authority's estimate of the value of the functions performed by the reseller. The cost-plus method also relies on two figures: the seller's cost and the seller's mark-up; however, neither of these figures is fixed in the open market. Instead, the figures are based upon the tax authority's estimates of the proper allocation of expenses and the value of the functions performed by the seller. In addition, where imports are involved, the related purchaser is within the jurisdiction of the tax administration and the seller is located in a foreign country. Therefore, the information necessary to establish an arm's length price under the resale price method is easier to obtain and verify than with the cost-plus method.²⁸

3. Services

To establish a transfer price for services rendered by a parent to a subsidiary or vice versa, the U.N. guidelines stress that it first is necessary to analyze the nature of the services to determine if they are properly chargeable. If the services are for the specific benefit of a subsidiary, however, it is generally agreed that a charge for such services should be deductible by the subsidiary. Examples of services performed specifically for the benefit of a subsidiary include the following: special marketing surveys, financing studies,

27. *Id.* at 32-33.

28. *Id.* at 30.

advertising related to the subsidiary's business, employee training services, and special legal and management consultant services. Conversely, if the services performed by the parent relate to its position as a shareholder of the subsidiary, the expenses involved seem properly attributable to the parent and should not be deductible by the subsidiary.²⁹

Of course, there exists a class of services that falls in-between services performed directly for the subsidiary and services related to the parent's position as a shareholder of the subsidiary. These include a wide variety of services such as centralized planning in the fields of finance, investment, production, marketing, joint advertising or market research, consolidated accounting and centralized public relations. The U.N. guidelines point out that classifying these types of services is not an easy task, but they suggest that a useful indication might be whether the services would have been provided were the parties independent.³⁰

Assuming the services are of the type that should benefit the subsidiary, the tax authority in the country of the subsidiary still must determine whether charges for the services were imposed on the subsidiary merely as a means of withdrawing profits from it. It also is necessary to make certain that the subsidiary has not been doubly charged for the services: once through a separate charge and again in the price of goods sold to the subsidiary.³¹

Having determined that the services were actually for the benefit of the subsidiary, the next step is to establish the proper charge for such services. Here again the goal is the price charged in the marketplace, an arm's length price. In the case of commercial and technical assistance provided directly to the subsidiary, it sometimes is possible to establish an arm's length charge by reference to prices charged between independent parties for similar services.³² In many cases, however, it is impossible to find an appropriate open market transaction with which to compare the services in question. In such instances, it is necessary to determine the total costs of providing the services including both direct costs, such as the expenses specifically attributable to the services, and indirect costs, such as management expenses, financial charges, advertising expenses and some portion of general administrative ex-

29. *Id.* at 41-42.

30. *Id.* at 42-43.

31. *Id.* at 43.

32. *Id.*

penses. After having ascertained the costs attributable to the services, the taxing authority in the country of the subsidiary then has to consider whether the proper charge should include only costs or costs plus a profit. The prevailing view is that a profit mark-up is appropriate where the services formed an integral part of the business of the parent, but not where the services were ancillary to the parent's main business.³³

4. Patent Rights and Other Intangibles

The U.N. guidelines recognize that there are two general methods by which compensation for intra-firm transfers of patents and other intangibles are paid.³⁴ Under the first method, the right to use the patent or intangible property is transferred in exchange for a lump sum with a royalty based on gross revenues, production, or a similar base being given in addition to, or instead of the lump sum. A second method, commonly used by transnational corporations, is the "cost-sharing" arrangement, under which the costs of research and development are shared among related companies around the world.

Where the first method is used, the U.N. guidelines suggest that the taxing authority in the country of the licensee make certain that a real benefit has inured or is inuring to the licensee, before allowing a deduction for payments by the licensee. The guidelines indicate that in making this determination the licensing agreement and other relevant documents should be examined; but the guidelines also stress the importance of basing the determination on the substance of the licensing arrangement, rather than just its formal characterization by the related parties.³⁵

Assuming that a licensing agreement is beneficial to the licensee, the next step is to calculate the proper charge for that benefit. As with income from the sale of goods and services, the ideal charge for use of patents and other intangibles should be determined under the arm's length approach. In some cases, an arm's length charge can be determined by looking to license agreements that the same licensor has concluded with unrelated parties involving the same or similar intangible property under the same or similar market conditions. Alternatively, offers to unrelated parties or

33. *Id.* at 43-45.

34. *Id.* at 35-36.

35. *Id.* at 36.

genuine bids from competing licensees could be useful if such offers or bids exist. Also, the charge established between unrelated parties for similar transactions under similar circumstances could be a guide.³⁶

The U.N. guidelines recognize, however, that in many cases it is not possible to find satisfactory open-market transactions with which to compare the intra-firm transfer. In such instances, all relevant factors, such as prevailing royalty rates, nature of the patent or other intangible, prospective profits of the licensee, and the costs of the licensor should be considered.³⁷ The guidelines mention that an appraisal of the prospective profits of the licensee has been a factor often considered in actual practice. The guidelines also point out that costs of licensor may not be a reliable indicator of the proper charge for the patent or other technology. Any reference to the licensor's cost is made difficult by the uncertainties of an eventual return on research and development expenses, the uncertain length of time during which a patent or other intangible might be commercially useful and the difficulties of accurately estimating such costs.³⁸

Where cost-sharing method is used, an inquiry must first be made to determine if the research and development was actually carried on in the interest of and for the benefit of the local enterprise. This can only be done by examining the formal terms governing the cost-sharing arrangement and the actual substance of the research and development activity. The next problem would be to determine the appropriate amount of costs to be shared. The U.N. guidelines indicate that indirect as well as direct costs might be properly included in a cost-sharing arrangement. A related question is whether a cost-sharing arrangement should include a profit mark-up. The U.N. guidelines indicate there are differing opinions, but suggest that there is widespread support for a profit mark-up where the research and development activities are carried out on special order.³⁹ A third problem is to determine whether the cost sharing formula is fair and equitable. Here, the U.N. guidelines indicate that no formula can be universally applied. They suggest that methods such as allocating costs on the basis of anticipated benefits or the proportionate turnover of the participants in

36. *Id.* at 37.

37. *Id.*

38. *Id.* at 37-38.

39. *Id.* at 38-40.

the cost-sharing arrangement might be appropriate in some circumstances. The guidelines caution, however, that the allocation formula should be closely examined in all cases.

B. Indirectly: Apportionment of Overall Profits and Posted or Notional Export Prices

1. Apportionment of Overall Profits

An alternative to the arm's length approach is an apportionment of the overall profits of an enterprise. The object of the apportionment method is not to determine a market price for an intra-firm transaction, but instead to establish a fair or proper division of the global profits of an enterprise without regard for how the marketplace would operate.⁴⁰

Under the apportionment method, a portion of the overall profits of an enterprise is allocated to a country or state under a formula designed to measure the substantiality of the connection between the enterprise and the country or state relative to the enterprise's other activities. All forty-five of the individual states in the United States that tax corporate income, for example, use some sort of an apportionment formula to determine the income of multijurisdictional enterprises properly attributable to their state.⁴¹ A few of the states apportion profits under a formula that averages the three ratios of local sales, assets, and labor costs to their worldwide equivalents.⁴²

40. *Id.* at 34; See Tannenwald, *The Pros and Cons of Worldwide Unitary Taxation*, TAX NOTES, Nov. 12, 1984, at 649-50.

41. *Id.* at 650.

42. *Id.* at 653. California and Alaska are the most prominent examples of states using these "worldwide combinations."

In an international context, an apportionment formula using only sales and labor costs would work as follows:

Suppose a transnational firm has a worldwide profit of 100. Assume its worldwide payroll is 800 and its worldwide sales are 2000. Also assume that the payroll and sales in country A are 200 and 100, respectively. If the apportionment formula gives twice as much weight to payroll as to sales, the computation of the overall proportion is determined as follows: 200/800 for payroll, plus another 200/800 for payroll (because payroll is given twice as much weight as sales), plus 100/2000 for sales. This adds up to 11/20 and, to get an average proportion from this figure, it is divided by 3 (the number of fractions added together). This yields an average proportion of 11/60, which is the ratio applied to the overall profits of 100 to determine the amount of that profit (18.33) allocated to country A. THE IMPACT OF TRANSNATIONAL CORPORATIONS ON DEVELOPMENT AND ON INTERNATIONAL RELATIONS—TECHNICAL PAPERS: TAXATION at 34, U.N. Sales No. E74/IIA/5 (1974) [hereinafter TECHNICAL PAPERS].

2. Posted or Notional Export Prices

Another alternative to the arm's length approach involves the use of posted or notional export prices for exports of primary commodities. With such prices, the basic principle is to fix the notional price as a fraction of the price of a downstream product for which an established market price exists.⁴³ Hence, posted or notional prices are similar to the apportionment method in the sense that they are used to attribute to the exporting country a predetermined portion of the total value of the finished goods for which the primary commodities are exported. They are also similar to the resale price method of establishing an arm's length transfer price, in that the value attributable to the exporting country is determined by reference to the price at which the primary commodity is resold after some processing of the commodity has taken place.

Posted or notional export prices are already in use in some countries to avoid the need of establishing an arm's length transfer price. This method has been applied in the case of exports of crude petroleum by integrated international oil companies and with the export of bauxite where the notional export price has been set as a fixed proportion of the market price of aluminum ingot.⁴⁴ Variations on notional pricing also have been used to determine the proper cost of intermediate chemicals in pharmaceutical manufacturing and to impute income to purchasing and export activities.⁴⁵

C. Indirectly: Elimination of Tax Differentials, Taxation of Intra-Firm Transfer Payments, and Artificial Restrictions on Intra-Firm Transfer Payments

1. Elimination of Tax Differentials

Transfer pricing abuses often are prompted by the combination of tax differentials (different effective tax rates, for example), the structure of domestic tax systems (which permits transnational enterprises to take advantage of tax differentials by deferring taxes on foreign source profits of foreign subsidiaries until the profits are distributed to the parent) and the natural desire of profit motivated business people to maximize after tax profits by minimizing

43. See W. Chudson, *supra* note 12, at 10-12.

44. *Id.*

45. PHARMACEUTICAL INDUSTRY, *supra* note 9, at 20; U.S.-Argentina Income Tax Treaty, 1 FED. TAX TREATIES 13, 103 (P-H 1986)(not yet in effect).

their tax liability. If there were a globally uniform income tax rate, tax avoidance through transfer pricing would decline since there would be no tax reason to shift profits from one jurisdiction to another. With a globally uniform tax rate, profits would be subjected to the same tax rate wherever they are realized.

Of course, the existence of low tax or no tax countries whose present prosperity is largely attributed to their tax haven status makes it unrealistic to seriously suggest standardization of income tax rates even within the Western world. Tax differentials are the life blood of the tax haven countries, so they are not likely to willingly agree to their elimination.⁴⁶

There is, however, a way to reduce or eliminate the attractiveness of tax differentials without the concurrence of tax haven countries. Since there are no universally acceptable rules on the outer limits of tax jurisdiction, the attractiveness of tax differentials could be largely eliminated by the home countries of transnational enterprises by extending their tax jurisdiction to include all profits of transnational enterprises, wherever such profits arose, and irrespective of whether they were earned by a branch or a separately incorporated foreign subsidiary. Such a change in the tax laws of the home countries of transnational enterprises would mean that all profits of the enterprises, including profits attributable to foreign subsidiaries arising in tax haven jurisdictions, would be currently taxed in the home country regardless of whether the profits are actually distributed to the parent. In order to avoid double taxation of such profits, however, the home country would have to offer a tax credit for foreign taxes paid by foreign subsidiaries as well as for those paid by the parent company.

A growing number of industrialized countries already do have specific provisions that tax certain foreign source profits of foreign subsidiaries. These provisions were introduced for the express purpose of curbing the use of tax haven countries for the accumulation of profits. The United States, for example, taxes U.S. shareholders of controlled foreign corporations on certain foreign source profits, regardless of whether foreign profits are repatriated.⁴⁷ As is generally true in other industrialized countries with anti-tax haven legislation, the U.S. provisions are intended to apply to profits diverted to or lodged in tax haven countries while leaving foreign operating

46. See generally Irish, *Tax Havens*, 15 VAND. J. TRANSNAT'L L. 449 (1982).

47. I.R.C. §§ 951-964 (1982).

profits untaxed.⁴⁸

2. Taxation of Intra-Firm Transfer Payments

As indicated above, the existence of tax differentials is a major reason for transfer pricing abuses. To take advantage of tax differentials, however, amounts shifted out of a high tax country to a low tax country must avoid the high taxes in the former. This means that the intra-firm transfers must be structured so that they are deductible by the payor in the high tax country, and are not taxed to the payee or else are taxed at a relatively low rate. In other words, tax differentials can be taken advantage of only so long as the high tax countries impose no or low taxes on certain remittances and the transnational enterprises are able to characterize their transfers as such remittances. Therefore, it would appear that countries could combat transfer pricing abuses by imposing some form of taxation on intra-firm transfer payments. The greater the amount of such payments, the higher the tax.

To some extent, many less developed countries already use this practice because *ad valorem* customs duties do operate as a tax disincentive to engage in transfer pricing abuses through the over-invoicing of imports. In reality, the decision to artificially inflate the price of goods sold needs to take into account not only the income tax differential between the exporting country and the importing country, but also the *ad valorem* tariff rate in the importing country and export taxes or subsidies in the exporting country. It is only when the netting of all these taxes results in a favorable tax differential that artificial inflation of the price of goods sold will produce a positive tax benefit.

Of course, because tariffs on intermediate and capital goods generally are kept very low in less developed countries as a matter of industrial policy, they often are not a significant factor in intra-firm pricing decisions. Thus, transnational enterprises are able to artificially inflate the prices of such goods without attracting correspondingly higher import duties.

48. P. McDANIEL & H. AULT, INTRODUCTION TO UNITED STATES INTERNATIONAL TAXATION 118 (1981). West Germany, Japan, Canada, Australia, France and the United Kingdom also have similar provisions aimed at curbing the use of tax havens. See generally INTERNATIONAL FISCAL ASSOCIATION, RECOURSE TO TAX HAVENS—USE AND ABUSE: ANTI-TAX HAVEN LEGISLATION (Sept. 18, 1980); PRICE WATERHOUSE, DOING BUSINESS IN THE UNITED KINGDOM 71 (1984).

Apart from the use of customs duties, transfer pricing abuses could be discouraged by taxing the profit element in intra-firm transfer payments. Sales of goods, provision of services, and the licensing of technology are the principal vehicles for transfer pricing abuses; therefore the profit element in these transactions should be taxed. In theory, the most effective policy would be to tax all intra-firm transactions; in practice, however, it may only be possible to impose withholding taxes on essentially passive remittances, and a net income tax on profits attributable to a permanent establishment.⁴⁹

The idea of taxing intra-firm transfer payments is not new. In fact, most less developed countries already have legislation aimed at taxing royalty payments, income attributable to services performed within the host country over a relatively long period of time, and income from the sale of goods if the sales are attributable to a "permanent establishment" in the host country.⁵⁰ To the extent these taxes are actually collected, these transactions become less attractive as vehicles for artificially shifting profits out of the host country.

Of course, unless the tax rates on the intra-firm payments are equal to or in excess of the generally applicable corporate tax, a condition that rarely exists, such payments continue to offer some opportunity to take advantage of tax differentials. In addition, as these taxes are presently structured or administered, many intra-firm transfers actually go untaxed. In the case of royalties and interest payments, for example, the relevant double taxation treaty sometimes either exempts such payments from source taxation or else limits the source taxes to a small percentage of the gross.⁵¹ Alternatively, the transnational enterprise may have intra-firm payments exempted from host country taxes in an ad hoc agreement between it and the host country.⁵² In the case of service income, many countries do not impose their tax unless the persons performing the services are physically present in the country for a substantial period of time or the services are attributable to a "fixed base."⁵³ In other instances, service income also may be ex-

49. C. IRISH, *AFRICAN COUNTRIES*, *supra* note 18, at 74-81.

50. See M. GRUNDY, *supra* note 11, at 15; PRICE WATERHOUSE, *CORPORATE TAXES WORLDWIDE—1985 SURVEY* (1985)[hereinafter *CORPORATE TAXES*].

51. For example, many of the tax treaties to which the Netherlands is a party have low or no withholding tax rates.

52. See C. IRISH, *AFRICAN COUNTRIES*, *supra* note 18, at 49-52.

53. See Surrey, *United Nations Group of Experts and the Guidelines for Tax Treaties*

empted under an ad hoc agreement between the transnational enterprise and the source country. Finally, with respect to the sale of goods, since most host countries limit their taxes to those sales attributable to "permanent establishments" within their territory, sales arranged and executed outside the host country usually are not taxed even though the goods are imported into the host country.⁵⁴ Of course, if the intra-firm payments are not deductible to the payer, then the importance of taxing such payments as a disincentive to engage in transfer pricing abuses is markedly diminished. The net impact of denying deductibility is that the amount of the intra-firm payment is subject to the regular corporate tax in the country in which the payor is a resident. In Indonesia and Brazil, for example, interest and royalty payments to affiliated enterprises may be non-deductible unless the payor establishes that the payments are consistent with normal commercial practices.⁵⁵

3. Artificial Restrictions on Transactions Commonly the Object of Pricing Abuses

An aggressive, but seemingly effective way of dealing with transfer pricing abuses is to simply prohibit intra-firm transactions that are likely candidates for transfer pricing abuses. Brazil, for example, has a very restrictive policy with respect to the payment of royalties and service fees to related enterprises. Such payments are generally limited to between one and five percent of gross sales, depending on how critical the product is to the Brazilian economy. In addition, whatever payments are made to related enterprises may not be deductible by the payor, but instead may be treated as profit remittances and taxed as dividends.⁵⁶ Indonesia also has guidelines that specify the maximum royalty for sophisticated technology as being two percent of net sales for a period of five years.⁵⁷

The advent of new forms of host country participation in the petroleum and mining industries also has reduced the importance

between Developed and Developing Countries, 19 HARV. INT'L L.J. 1, 15-16 (1978) [hereinafter *Group of Experts*].

54. *Id.* at 11-14.

55. C. IRISH, INDONESIA, *supra* note 13, at 16-17; C. IRISH, BRAZIL: TAXATION OF TRANSNATIONAL CORPORATIONS ENGAGED IN NATURAL RESOURCE DEVELOPMENT 21 (1983) [hereinafter C. IRISH, BRAZIL].

56. C. IRISH, BRAZIL, *supra* note 55, at 5.

57. C. IRISH, INDONESIA, *supra* note 13, at 4.

of transfer pricing in connection with the export of primary products. Under production sharing agreements in Indonesia and Malaysia, for example, the issue of transfer pricing is not important since the host government takes its share of the profits by acquiring the commodity itself.⁵⁸

III. SELECTION AND IMPLEMENTATION OF APPROPRIATE MECHANISMS FOR CURBING TRANSFER PRICING ABUSES

Part II identified the three principal ways to curb transfer pricing abuses. The problem to be considered in this part is how to select and then implement the appropriate mechanisms in specific instances.

At the outset, it should be borne in mind that the selection and implementation of the appropriate mechanisms to curb transfer pricing abuses should be governed by two overriding and sometimes competing considerations. The first, obvious concern of policy makers and tax administrators is that the mechanisms employed be effective in curbing transfer pricing abuses. The frequent lack of adequate resources and trained personnel in tax administrations within the less developed countries requires that the mechanisms be relatively easy to understand and simple to administer. The second concern is the sometimes overlooked consideration of protecting the legitimate interests of transnational enterprises. This means that the mechanisms should not have a chilling effect on normal, legitimate international business and investment transactions. In addition, the mechanisms should not be overly cumbersome and should be structured so as to yield relatively predictable results. Also, in recognition of the inexactitude inherent in the transfer pricing process, the mechanisms should not presume an evil intent and should require adjustments only where there is a substantial gap between the taxpayers price or profit and the price or profit determined by the tax administration. With these two overriding considerations in mind, we now turn to a discussion of selection and implementation of appropriate mechanisms to curb transfer pricing abuses.

58. W. Chudson, *supra* note 12, at 10.

A. Directly: The Arm's Length Approach

1. Selection

The arm's length approach would seem to be the least controversial mechanism for establishing a transfer price because it attempts to approximate the market. There appears to be substantial agreement within transnational enterprises and the tax administrations of home and host countries that the ideal against which intra-firm transfers should be tested is the open market. As a result, the arm's length approach probably should be used as the preferred mechanism for curbing transfer pricing abuses.⁵⁹

The arm's length approach is clearly feasible in those instances in which the items transferred within a firm are also the objects of frequent trade in the open market. In such instances, the open market price provides a ready reference for establishing the intra-firm transfer price. Thus, the arm's length approach probably could be readily used with respect to a large proportion of the intra-firm transfers of finished goods because of the general availability of open market prices for sales of finished goods.⁶⁰

The arm's length approach could also be used with respect to many intra-firm transfers of intermediate and capital goods. In such cases, however, use of the arm's length approach would be more difficult because of the frequent absence of comparable transfers in the open market. Without the luxury of comparison, establishing an arm's length price becomes a more tenuous process that requires estimation of the value of the functions performed by a reseller of goods (under the resale price method for determining an arm's length price) or the seller's costs and mark-up (under the cost-plus method). These are items on which reasonable people, acting fairly and objectively, can differ tremendously.⁶¹ Furthermore, the task of formulating the estimates often is very difficult and time consuming. Even the United States Internal Revenue Service (IRS), with its considerable sophistication and relatively long experience with the arm's length approach, reports only mixed success. In the last decade, there have been at least six studies undertaken to measure the effectiveness of IRS's procedures for

59. *Allocation of Income*, *supra* note 22, at 414-15.

60. W. Chudson, *supra* note 12, at 5-6.

61. PHARMACEUTICAL INDUSTRY, *supra* note 9, at 20; Tannenwald, *supra* note 40, at 650; S. PLASSCHAERT, *supra* note 4, at 9-10.

establishing an arm's length price. The studies generally have been critical of the low level of success in applying the procedures. One study suggested that only three percent of the transfer pricing adjustments were based on a true arm's length price.⁶² Even the most optimistic study, undertaken by the IRS itself, found that a true arm's length price was established in only twenty-one percent of the transfer pricing adjustments.⁶³ Some people within the IRS have said that the "U.S. experience has demonstrated that, even with detailed guidelines, the safe haven rules, and substantial disclosure requirements, an arm's length profit margin or mark-up is still often an elusive phantom."⁶⁴ A Court of Claims case also gives some indication of the difficulties involved in using the arm's length approach:

[A]s evidenced by the magnitude of the record compiled in this case, the resolution by trial of a reallocation controversy under section 482 [using the arm's length approach] can be very burdensome, time-consuming and obviously expensive process—especially if the stakes are high. A more manageable and expeditious means of resolution should be found.⁶⁵

Exports of primary products also could be checked fairly easily under the arm's length approach where there are established world markets for the products. Transfer pricing abuses with respect to exports of refined copper, for example, would be easily detectable because of the established and well-publicized open market price for refined copper. On the other hand, where exports of primary products are made largely within vertically integrated transnational enterprises, an established open market price may not be ascertainable. In such cases, and especially where the primary products represent an important source of export earnings, the use of the resale price method (often not applicable because of substantial downstream processing) or the cost-plus method to estimate an arm's length price may be less desirable than other alternatives (*i.e.*, the use of formula apportionment or posted or notional export prices).⁶⁶ On balance, therefore, the arm's length

62. REPORT TO ASSOC. COMMISSIONER, IRS EXAMINATION DATA REVEAL AN EFFECTIVE ADMINISTRATION OF 482 REGULATIONS 6 (1984).

63. *Id.*

64. TAX AVOIDANCE SCHEMES, *supra* note 19, at 4.

65. *E.I. du Pont De Nemours v. United States*, 78-1 USTC para. 9374 (U.S. Ct. Cl. 1978).

66. SEVENTH REPORT, *supra* note 20, at 34-35.

approach probably should be looked to as the preferred method of detecting transfer pricing abuses with respect to intra-firm transfers of goods. Where open market prices for comparable commodities exist, use of the arm's length approach generally should yield a relatively non-controversial transfer price. Tax administrators should at least make an effort to use the resale price or cost-plus method in instances in which open market sales of comparable commodities are not available because their widespread acceptability should minimize disputes arising from the audit procedures. It should be recognized, however, that there comes a point at which the difficulties in establishing a transfer price through use of the arm's length approach outweigh whatever advantages may be gained through using widely accepted procedures. The determination of that point will depend on such factors as the number and sophistication of the personnel assigned to curbing transfer pricing abuses and the amount of information available to them. When that point is reached, however, tax administrators should be prepared to shift to other, possibly more controversial alternatives.

In contrast, the arm's length approach usually is not practical where services and intangibles are involved. Where comparable transfers exist in the open market, the arm's length approach can be used to check intra-firm transfers of services and intangibles. Most services and intangibles are somewhat unique, however, and it is only in infrequently that the transfer price can be determined by reference to comparable transfers in the open market.⁶⁷ As a consequence, in most cases involving services and intangibles, the arm's length price is determined in a time consuming process that involves analysis of the nature of the services and intangibles to determine whether they are of benefit to the recipient, determination of the direct and indirect costs properly attributable to the services, estimating a proper mark up in some cases, and then considering all other relevant circumstances.⁶⁸ This process is so difficult, time consuming, and yields such an imprecise transfer price that most tax administrators would be better off using an alternate method.⁶⁹

67. *Id.* at 43-44.

68. *Id.* at 35-45.

69. It is precisely the unworkability of the arm's length standard that has led tax administrators within the individual states of the United States to use formula apportionment to determine the tax base of multijurisdictional corporations. See Tannenwald, *supra* note 40, at 650.

It is not just the difficulty of the process or the arbitrariness of the result that dictates use of an alternative to curb transfer pricing abuse. Where goods are involved, tax administrators have a tangible starting point: the goods themselves. With services and intangibles, however, tax administrators have nothing concrete to use as the base for their investigation. Instead, where comparable open market transfers are not available, practically all the information necessary to estimate an arm's length price for services and intangibles must come directly or indirectly from the transnational enterprise itself.⁷⁰ The difficulty of the process and the arbitrariness of result have led to a practice of establishing the transfer price for services and intangibles through negotiations between tax administrators and transnational enterprises as opposed to application of the arm's length guidelines.⁷¹ The pertinent information, however, is primarily within the control of the transnational enterprise, so the tax administrators are at a negotiating disadvantage even without considering the relative negotiating skills and bargaining power of the negotiators.

As a consequence, it appears that in many instances, the arm's length approach is not suitable for use with respect to intra-firm transfers of services and intangibles. If comparable open market prices exist, the tax administration is extremely sophisticated and well informed, or the tax administration possesses sufficient bargaining power and negotiating skills to reach a reasonable solution, then the arm's length approach might be appropriate. In most cases, however, the difficulties of estimating an arm's length price, the imprecision of any estimate once it is obtained and the tax administration's frequent lack of bargaining power relative to transnational enterprises are positive reasons why most tax administrators should not rely on the arm's length approach to curb transfer pricing abuses with respect to services and intangibles. At a minimum, where comparable open market transfers are not available, tax administrators should not rely exclusively on the arm's length approach, but instead should employ other alternatives as well.

70. See R. GORDON, *supra* note 1, at 180; see generally U.N. TAX TREATIES BETWEEN DEVELOPED AND DEVELOPING COUNTRIES—SIXTH REPORT U.N. Doc. E76/XVI/3 (1976)[hereinafter SIXTH REPORT].

71. W. Chudson, *supra* note 12, at 14; S. PLASSCHAERT, *supra* note 4, at 79; Lall, *supra* note 4, at 68.

2. Implementation

We concluded above that exclusive reliance on the arm's length approach to curb transfer pricing abuses is usually only appropriate with respect to transfers of goods. Therefore, we will now focus on the implementation of the arm's length approach with respect to transfers of goods.

Implementation of the arm's length approach in a way that curbs transfer pricing abuses and also pays sufficient attention to the legitimate interests of transnational enterprises requires (i) a broad system for monitoring intra-firm commodity transactions, (ii) a relatively simplified audit procedure that focuses on transactions likely to involve transfer pricing abuses, and (iii) a correlative adjustment procedure that ensures that an upward adjustment in one country will be reflected by a downward adjustment in other countries affected by the transaction under audit.

(a) *Monitoring Intra-Firm Commodity Transactions.* A broad monitoring system that compares prices of intra-firm commodity transactions with world market prices could prove to be an effective deterrent against transfer pricing abuses by itself. If transnational enterprises knew there was a good possibility of a transfer price being reviewed, they would be more likely to make a good faith effort to set the price by reference to the open market. An effective monitoring system obviously requires current information on world market prices. For this reason, a number of less developed countries have contracted with private monitoring organizations to compare invoice prices of intra-firm imports and exports with "reference" prices obtained from various sources.⁷² In other cases, governments obtain monitoring information themselves on either a general or ad hoc basis with respect to specific enterprises or economic sectors.⁷³

It should be noted that the need for information on world market prices represents an area ripe for regional cooperation. Clearly, it would be more cost effective if information on world market prices were obtained by a regional body for dissemination

72. Nigerian imports, for example, are subject to inspection by the Société Générale de Surveillance (SGS), a Swiss company which checks to make certain goods are imported at reasonable prices. C. IRISH, NIGERIA: TAXATION OF TRANSNATIONAL CORPORATIONS ENGAGED IN NATURAL RESOURCE DEVELOPMENT 18 (1983).

73. C. IRISH, INDONESIA, *supra* note 13, at 23-24; C. IRISH, BRAZIL, *supra* note 55, at 29; PHARMACEUTICAL INDUSTRY, *supra* note 9, at 18-21.

among the member countries rather than by the countries individually. In addition, regional cooperation in the collection and application of information on world market prices would provide a method for more developed tax administrations to assist the less developed tax administrations in the formulation of monitoring procedures.

Of course, monitoring systems do have built in limitations. First, because effective monitoring of intra-firm commodity prices requires an established open market price, commodities with respect to which there is no such price cannot be checked effectively under a straight monitoring system. Second, it is not feasible and probably unduly burdensome on legitimate business transfers to check all intra-firm commodity transactions with every open market price that exists. Hence, the monitoring systems developed thus far have had significant gaps.⁷⁴ On the other hand, it seems to be well documented that the bulk of intra-firm transactions is usually accounted for by a relatively small number of enterprises; thus, investigations limited to a relatively few enterprises and economic sectors may be adequate to significantly discourage transfer pricing abuses.⁷⁵ In the United States, Brazil, and Mexico, government authorities maintain statistical registers of the largest enterprises. These schedules show the levels of international trade, foreign exchange remittances by type of payment, sales volumes, total assets, employment levels, declared profits, volume of local borrowing, and foreign equity participation. Statistical information from similar registers in less developed countries could be used to pinpoint companies and transactions which need closer scrutiny. In Greece, for example, during the first two years of operation, a system aimed at curbing transfer pricing abuses scrutinized seventy-five key products: the annual level of over-invoicing imports and under-invoicing exports amounted to approximately \$18.6 million (U.S.). Similar results were reported in Colombia, where the products selected were largely imported pharmaceuticals and exports of timber, fish, and some precious metals.⁷⁶ It is worth noting that the establishment of an advance clearance procedure within the monitoring system and the audit procedures described below would offer transnational enterprises much more certainty in the transfer

74. PHARMACEUTICAL INDUSTRY, *supra* note 9, at 20-21.

75. C. VAITSOS, PROPOSALS FOR ESTABLISHING A SYSTEM OF CONTROL OVER TRANSFER PRICING 14 (1978).

76. *Id.* at 14-15.

pricing area. Under an advanced clearance procedure, a taxpayer could apply for prospective review of an intra-firm transaction. Having established an agreed transfer price, the taxpayer could then proceed with the transaction without fear of a retroactive adjustment or audit and a controversy over the level of correlative adjustments in other countries.

(b) *Auditing Intra-Firm Commodity Transactions.* The monitoring system should be complemented with an audit program to review those commodity transactions which are not routinely monitored such as transactions without established open market prices. In general, the audit procedures should be structured to check transfer prices by reference to open market prices or by using the resale price method, the cost-plus method, or other suitable methods. Clearly, to be effective, the monitoring and audit systems must have access to relevant information and make efficient use of trained personnel.

Without relevant information on prices, costs, mark-ups, and the like, no audit can be expected to yield anything other than an arbitrary result. Ideally, tax administrators should be able to obtain information about intra-firm transactions from at least five sources. First, a source of information sometimes overlooked is the tax administrator's own government.⁷⁷ In most instances, several different departments obtain information on the activities of transnational enterprises that could be relevant to monitoring transfer prices. Customs officials, for example, have information on the declared value of goods imported by the transnational enterprises. Central banks generally have information on foreign exchange receipts and disbursements for exchange control purposes. Therefore, tax administrators need to make certain they are making optimum use of information already available within their government.

A second source of information is from within the home country in which the transnational enterprise is located, generally an industrialized country. Sophisticated information gathering and auditing techniques make industrialized countries an especially important source of information on the activities of their transnational enterprises both at home and abroad. A major problem with

77. With respect to collecting relevant information, some commentators have noted that it is surprising how limited the resources and capabilities of some less developed country tax administrations are, even where modest research would yield significant results. See, e.g., Lall, *supra* note 4, at 66.

this source of information is that a bilateral tax treaty with an exchange of information provision is usually necessary to overcome the "tax secrecy" legislation in the industrialized country. Although there are some instances in which information is informally exchanged between home and host countries, in most cases information on specific taxpayers is available only under the exchange of information provision of a bilateral tax treaty. In fact, access to information from industrialized countries is one of the principal reasons why less developed countries should consider concluding bilateral tax treaties with industrialized countries, particularly those countries where transnational enterprises reside.⁷⁸

Inter-governmental exchanges of tax information, particularly between industrialized and less developed countries, could be much more useful than they are at present. For this reason, the U.N. Group of Tax Experts has devoted considerable attention to the problem of inter-governmental exchanges of information. In its *Sixth Report*,⁷⁹ the Group formulated extensive guidelines for bilateral exchanges of information. The guidelines provide an inventory of possible arrangements to be used and a commentary on some of the factors relevant to the use of particular arrangements. The guidelines constitute,

the fullest description, in documents of this nature, of the factors and techniques involved in exchange of information. The material, moreover takes account of the interests and problems of less developed countries as regards both the importance to them of an adequate exchange of information and their ability to participate in such an exchange.⁸⁰

These guidelines thus represent an indispensable reference tool for less developed countries desiring to make better use of bilateral exchanges of information. One source of bilateral information is tax administrators in industrialized countries which are host countries of transnational corporations. Thus, Canada, as the repository of an enormous amount of U.S. foreign investment, should be able to provide information gathered from a host country's perspective on the activities of many U.S. transnational enterprises.

The simultaneous examination programs (SEP's) being used by several of the industrialized countries could also provide a use-

78. *Group of Experts, supra* note 53, at 49-53.

79. *SIXTH REPORT, supra* note 70.

80. *Group of Experts, supra* note 53, at 50.

ful model for bilateral cooperation between the home and host countries.⁸¹ Under these programs, the accounts of a transnational enterprise are concurrently audited by the tax authorities in two or more jurisdictions. The SEP procedures are designed to reduce the opportunities for undisclosed income or inconsistently reported transactions. They also offer an opportunity to limit the number of conflicting determinations unfavorable to the transnational enterprises.⁸² It is clear that participation in SEP's with industrialized countries will give tax administrators in less developed countries access to information and audit techniques they would not otherwise have. Third, international and regional organizations and treaty networks represent a largely untapped source of information. The World Bank and U.N. Centre on Transnational Corporations have worked to gather information on world market prices. An international or regional organization could also serve as a forum for discussing problems in international tax administration, such as the use of bilateral exchange of information provisions to curb the use of tax havens.⁸³

Serious thought should also be given to concluding a multilateral treaty for the exchange of information. The obstacles to such a broad based multilateral treaty caused many of the members of the U.N. Group of Tax Experts to label the idea as premature;⁸⁴ but there is no doubt such a treaty would be an effective mechanism for curbing tax avoidance. It is a widely held belief that,

The increasing seriousness of tax evasion and avoidance by transnational corporations could not . . . be properly tackled in bilateral conventions only. The mere psychological effect of a multilateral framework would in itself have an important impact. Difficulties should, of course, be expected, but difficulties alone are not a justification for lack of action.⁸⁵

For this reason, there should be growing support for beginning preparatory work on the conclusion of a multilateral convention for the exchange of information. To implement the convention on a continuing basis, a permanent body similar to the Customs Co-op-

81. Note, *Taxation: Implementation of Simultaneous Auditing Procedures*, 21 HARV. INT'L L.J. 798 (1980).

82. *Id.* at 802.

83. S. GAFNY, POSSIBLE CONCLUSION OF A MULTILATERAL AGREEMENT ON THE EXCHANGE OF INFORMATION CONCERNING DIRECT TAXATION U.N. Doc. ST/S6/AC.8/L.20 (1978).

84. SEVENTH REPORT, *supra* note 20, at 59.

85. S. GAFNY, *supra* note 83.

eration Council could be established. The functions of such a body would include the following:

(1) Formulation of clear procedures for the exchange of information, as a matter of routine, at specific request, or on a discretionary basis.

(2) Establishment of a central information center for the collection of information and its distribution to the various competent authorities, in accord with the procedures formulated for this purpose.

(3) Creation of machinery for mutual consultation between tax administrators concerned with the exchange of information so as to promote the exchange of technical know-how, to improve administrative procedures, and to develop more effective collection techniques.

(4) Periodic meetings, on a continuing basis, between representatives of the acceding countries, which could develop into a permanent international forum in the field of direct taxation. Such meetings would, in the first instance, deal with all aspects of the problem of tax evasion and the measures called for in order to combat it. Particular reference would be made to the broadest possible exchange of information and the development of mutual consultation and administrative co-operation in matters concerned with the elimination of tax evasion and joint studies of its various aspects, the exchange of technical and administrative know-how, and the recommendation of methods and policies whose adoption might assist all acceding countries to combat tax evasion.

(5) Development of new methods and procedures for expediting the exchange of information, including direct visits by tax administrators, setting up joint teams for the investigation of a particular taxpayer or a specific economic activity, and encouraging of joint administrative action.

(6) Creation of a global approach to the problem of tax evasion, as recommended in the *Sixth Report* of the Group of Experts.⁸⁶

Given the reality that we are probably many years away from the conclusion of a multilateral convention, less developed countries should consider executing regional conventions for the ex-

86. *Id.* See also U.N. DEP'T OF ECONOMIC AND SOCIAL AFFAIRS, INTERNATIONAL COOPERATION IN TAX MATTERS U.N. Doc. ST/ESA/12, (1984).

change of information. Developing countries should look to existing examples of regional cooperation, such as the Nordic Group of European countries and the European Economic Community.⁸⁷

A fourth source of information relevant to transfer pricing is from published sources, especially in the home countries of the transnational enterprises. A certain amount of balance-sheet data usually is published by publicly traded corporations in their home countries, and sometimes in their host countries. There also are publications, such as *Who Owns Whom*, which list affiliated enterprises. With the advent of computerized information retrieval systems, such as Nexis, a great amount of information reported in trade and financial journals now is easily obtained.

Finally, tax administrators can obtain information on local and foreign activities of transnational enterprises from the enterprises themselves. Information on resale prices and the nature of the activities of the reseller, costs of the seller, prices charged to other subsidiaries and independent purchasers on comparable transactions in other countries, and an explanation of how the transnational enterprise arrived at the prices used in the transactions being audited should be available from transnational enterprises.

Of course, a major problem with obtaining information from transnational enterprises is the practical reality that they are often reluctant to divulge information about their foreign activities to tax administrators, especially tax administrators in less developed countries.⁸⁸ Transnational enterprises frequently have been able to forestall inquiries into foreign activities, however relevant such inquiries might be, because of their economic and political power in the less developed countries. This may be changing, however, as pressures mount in the international community for a code of conduct for transnational enterprises which includes expanded obligations on the disclosure of information. The OECD Guidelines for Transnational Enterprises, for example, provide for the disclosure of a wide range of information, a substantial amount of which would be relevant to transfer pricing questions. As a result, the international norm leans toward the disclosure of more information, and if information becomes generally more available, transnational enterprises should be less reluctant to supply such informa-

87. SEVENTH REPORT, *supra* note 20, at 60-61.

88. See Lall, *supra* note 4, at 67.

tion to tax administrators in less developed countries.

Less developed countries can also overcome the reluctance of transnational enterprises by formalizing their routine disclosure requirements on a region-wide basis. With the collective power of an entire region behind it, individual tax administrations should more easily elicit compliance from transnational enterprises. Thus, transnational enterprises, faced with somewhat harmonized disclosure requirements, will find that compliance is less onerous.

With respect to information obtained from transnational enterprises about their foreign activities, there is the obvious problem of ensuring that the information is authentic and accurate. If the foreign activities are in a country where independent accounting firms routinely audit company accounts, a certification from an accounting firm may be a sufficient guarantee of authenticity and accuracy. If, however, independent audits are non-existent or not sufficiently thorough to cover the information requested, then the tax administrator could request verification by an accounting firm chosen by him or his embassy in the foreign country.⁸⁹

Obviously, an effective audit program requires the efficient use of trained personnel. Given the acute shortage of properly qualified persons in the tax administrations of many less developed countries, making efficient use of the few trained persons available is doubly important for them. As indicated above, one way of using personnel more efficiently is through cooperative audits. In recent years, the United States and several other countries have announced cooperative audit programs with respect to taxpayers with activities in both countries.⁹⁰ If cooperative audits were conducted on a regional basis it would reduce the duplicative work for both the participating tax administrations and the transnational enterprise being audited. Region-wide audits would also introduce some harmonization of audit procedures and allow more developed tax administrations to assist the less developed tax administrations through the audit process. Cooperative audits between the home and host country of a transnational enterprise would offer the same benefits, with possibly even greater assistance provided by the home country to the host country. In addition, this would reduce the threat of double taxation as a result of inconsistent determinations, and possibly eliminate the need for post audit correla-

89. *Allocation of Income*, *supra* note 22, at 438.

90. *See Note*, *supra* note 81.

tive adjustments because adjustments could be made during the audit process.⁹¹

Tax secrecy laws will usually preclude cooperative audits unless there is a bilateral or regional tax treaty sanctioning such exchanges of tax information. Thus, the opportunity for cooperative audits with the home countries of transnational enterprises may represent another reason for less developed countries to selectively enter into tax treaties with industrialized countries. The benefits of cooperative audits also should encourage less developed countries to work toward concluding a regional treaty on the exchange of fiscal information.

(c) *Correlative Adjustment Procedure.* As indicated above, if the home and host countries of a transnational enterprise cooperate on transfer pricing audits, the need for post audit correlative adjustments should be reduced because such adjustments can be expected to be made during the actual audit process. On the other hand, where the transfer pricing audit is carried on by the host country alone, the legitimate interests of transnational enterprises in avoiding double taxation can only be adequately safeguarded if there is an effective correlative adjustment procedure that ensures that an adjustment in the host country will be matched by an appropriate adjustment in the home country. Without a correlative adjustment procedure, the spectre of double taxation will give transnational enterprises ample reason to resist efforts to curb transfer pricing abuses in every imaginable way. With a correlative adjustment procedure, tax administrators are in effect saying to the transnational enterprises, "We recognize the inexactitude inherent in the transfer pricing process and we do not want to penalize you just because your original transfer price differs from ours. We do, however, want to ensure that the distribution of profits is consistent with the arm's length approach." As a result of these legitimate interests being safeguarded, transnational enterprises should be much more willing to accommodate the transfer pricing monitoring and audit programs.

The prevailing view is that the correlative adjustment procedure should be authorized and outlined in bilateral tax treaties.⁹² In general, the treaty provisions contemplate that a correlative adjustment will be made in one contracting state when the other con-

91. *Id.* at 802.

92. SIXTH REPORT, *supra* note 70, at 4-5.

tracting state makes an adjustment to reflect profits determined under the arm's length approach. Thus, article 9 of the OECD 1977 Model Tax Convention specifically provides as follows:

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.⁹³

The guidelines of the U.N. Group of Tax Experts also contain a similar provision.⁹⁴ The correlative adjustment called for under article 9 is, however, not automatically required. Instead, it is to be made only if the principal adjustment conforms to the arm's length standard.⁹⁵ In other words, article 9 does not seek to avoid a double charge to tax which arises where the profits of one associated enterprise are increased to such a level where they exceed what they would have been if they had been correctly computed on an arm's length basis. The other state is committed to make an adjustment of the profits of the affiliated company only if it considers that the adjustment made in the first state is justified both in principle and in amount.⁹⁶ Therefore, to avoid conflicting determinations with a correlative adjustment procedure, it may be necessary for the competent authorities of the two contracting states to consult as part of the adjustment process.

The correlative adjustment article and related provisions were extensively discussed at the sixth meeting of the U.N. Group of Tax Experts. In its *Sixth Report*, the U.N. Group set forth detailed guidelines on correlative adjustment and mutual agreement procedures. The *Sixth Report* should thus be essential reading for tax administrators establishing correlative adjustment and mutual

93. *OECD Model Double Taxation Convention of 1977*, article 9, clause 2, in *MODEL INCOME TAX TREATIES* (K. van Raad ed. 1983).

94. *Group of Experts*, *supra* note 53, at 54.

95. *SIXTH REPORT*, *supra* note 70, at 5.

96. *Id.*

agreement procedures.

B. Indirectly: Apportionment of the Overall Profit of an Enterprise

1. Selection

The principal attractions of the apportionment method are that, in contrast to the complexities and uncertainties of the arm's length approach, the apportionment method is simple to operate and generally yields a predictable result.⁹⁷ In general, use of the apportionment method requires only an established formula and such figures as total profits of the enterprise, total sales, total payroll, and sales and payroll within the taxing jurisdiction.

The simplicity and certainty of the apportionment method has led to its fairly widespread acceptance and use. Most double taxation treaties, the OECD 1977 Model Tax Convention, and the U.N. Tax Treaty Guidelines include the apportionment method as an acceptable way to determine the profits attributable to permanent establishments.⁹⁸ A number of tax administrations already use apportionment formulae as an alternative to or as a check on the arm's length approach. For example, it is well known that, notwithstanding its sophisticated staff, substantial disclosure requirements, and extensive guidelines under the arm's length approach, the U.S. Internal Revenue Service in practice sometimes resorts to the apportionment method in computing an inter-firm transfer price.⁹⁹ The apportionment method is also universally used by the individual states of the United States to determine the taxable profits of business enterprises with multi-state operations.¹⁰⁰ Even some transnational enterprises, faced with the extremely arduous if not impossible task of establishing transfer prices under the arm's length approach, allocate costs of services under an apportionment formula.¹⁰¹

The greatest problem with using the apportionment approach

97. See Tannenwald, *supra* note 40, at 650.

98. See U.N. DEP'T OF ECONOMIC AND SOCIAL AFFAIRS, GUIDELINES FOR TAX TREATIES BETWEEN DEVELOPED AND DEVELOPING COUNTRIES at 29, U.N. Doc. ST/ESA/14, U.N. Sales No. E74/XVI/5 (1974).

99. U.N. TAX TREATIES BETWEEN DEVELOPED AND DEVELOPING COUNTRIES—FIFTH REPORT at 109, U.N. Sales No. E75/XVI/1 (1975)[hereinafter FIFTH REPORT].

100. See Tannenwald, *supra* note 40, at 650.

101. See SEVENTH REPORT, *supra* note 20, at 42.

is the substantial risk of conflicting determinations which produce over or under taxation of the total profits of the transnational enterprise. These conflicts can arise in three ways. First, if some of the countries taxing the transnational enterprise determine intra-firm transfer prices under the arm's length approach, while other countries use the apportionment method, the results are likely to be inconsistent. This is due to the fact that the former approach seeks to approximate the open market, whereas the goal of the latter method is to establish a "proper" division of overall profits irrespective of how the marketplace would operate. Second, if all countries taxing the transnational enterprise use the apportionment method, conflicts would arise because of the lack of a uniform apportionment formula. Instead, as the experiences of the individual states of the United States make clear, tax jurisdictions tend to adopt an apportionment formula that favors them as against other taxing jurisdictions.¹⁰² Thus, if a country is a relatively high wage country, it would be inclined to include labor costs as a factor in its apportionment formula; other countries might be inclined to favor other factors. The result would be that although all countries used the apportionment method, each country would use a different apportionment formula with predictably conflicting results. Third, even if all countries agreed to use a single apportionment formula, conflicts could arise over the interpretation of the various factors used in the formula.¹⁰³ For example, if countries agreed that they would use a two factor apportionment formula that gives equal weight to sales and labor costs, conflicts could still arise as a result of different interpretations of the total profits of the enterprise. Different interpretations could also center upon the sales allocated to each jurisdiction—allocated in some instances under a passage of title test, in other cases under a substantial connection test, and in still other cases on the basis of ultimate use. Finally, different interpretations of labor costs could also lead to conflicts because some jurisdictions allocate labor costs on the basis of physical presence in the jurisdiction, and others allocate according to the source of payments for the labor costs.

The problem of conflicting determinations under the apportionment method should not, however, be overly exaggerated. In fact, conflicting determinations are a major problem throughout in-

102. See Freud, *Unitary Taxation Threat to the Multinationals*, FIN. TIMES, July 14, 1978, at 16.

103. See TECHNICAL PAPERS, *supra* note 42, at 74-75.

ternational taxation even without the use of the apportionment method. Differing views on the concept of income, allowable deductions, and jurisdictional rules, for example, make conflicting determinations a common occurrence in international taxation.¹⁰⁴ Thus, conflicts are not unique with the apportionment method, although they may be a greater problem where apportionment is used.

Another major criticism of the apportionment method is the enormous record keeping burden it imposes on foreign enterprises who must translate their foreign economic activities into the local currency of the host country. Many foreign based transnational enterprises have strongly objected to the record keeping burden caused by the tax practices in California, Alaska, and elsewhere.¹⁰⁵ In these states, the net income attributable to them is determined by applying an apportionment formula to the global net income of the transnational enterprises and their affiliates. As a result, there are significant costs associated with translating foreign capital, foreign sales, and foreign labor expenses into United States dollars.

Of course, the administrative burdens of the arm's length standard are precisely why tax jurisdictions have moved to the apportionment method.¹⁰⁶ Thus, when the burdens inherent in the apportionment method are contrasted with the difficulties associated with determining an arm's length price (where there are no comparable open market prices), the apportionment method will usually emerge as the less burdensome procedure. It is probably true, however, that under the arms length approach the administrative burden falls on the government (at least in the early stages of a transfer pricing dispute), whereas under the formula apportionment method the administrative burden falls more heavily on the taxpayer.

Another drawback with the apportionment method is that it occasionally produces unusual or undesirable results. If, for example, a transnational enterprise is operating at a profit in one jurisdiction, but at a loss in all other jurisdictions, the apportionment method would lead to a lack of taxable income in all of the jurisdictions, including the profitable one. Alternatively, if the transnational enterprise has an overall profit, but is operating at a loss in

104. See D. TILLINGHAST, *TAX ASPECTS OF INTERNATIONAL TRANSACTIONS* 11 (1984).

105. See generally Tannenwald, *supra* note 40.

106. *Id.* at 650.

one or more jurisdictions, the apportionment method generally will allocate some of the overall profits of the enterprise to the loss jurisdictions. Also, an apportionment formula that relies on such factors as labor costs and capital assets will produce relatively high taxes on business activities with low profit margins and relatively low taxes on business activities with high profit margins. Use of other factors, such as gross sales, can produce similar distortions in taxable profits. On the other hand, because the arm's length standard fails to account for the efficiencies of vertical or horizontal integration enjoyed by transnational enterprises, an arm's length transfer price determined by reference to the open market may also produce anomalous results.

On balance, the benefits resulting from the ease of administration and certainty under an apportionment approach may outweigh the disadvantages of a greater risk of conflicting determinations, the record keeping burdens, and the occasional anomalous result. This is particularly so with respect to intra-firm transfers of services and intangibles where use of the arm's length approach is exceedingly complex and the result is essentially arbitrary. It is therefore suggested that less developed countries consider making greater use of the apportionment method in determining the proper amount of profits attributable to services and intangibles employed within their jurisdictions. At a minimum, the apportionment method should be used to check results reached under the arm's length approach to ensure that profits are not being allocated disproportionately throughout the transnational enterprise.¹⁰⁷

2. Implementation

Given the spectre of a greater number of conflicting determinations through the use of the apportionment method and the possibility of fewer opportunities for shifting profits through transfer pricing, transnational enterprises will react with predictable hostility to the movement of less developed countries toward greater use of the apportionment method. In fact, the transnational corporations' strenuous objections to use of the apportionment method in California, Alaska, and elsewhere may stem as much from the effectiveness of the method to curb tax motivated transfer pricing abuses as from the difficulties usually associated with the method.

107. See Lall, *supra* note 4, at 66.

The fact that greater reliance on the apportionment method represents a departure from the theoretical norm of the arm's length standard is also likely to engender some opposition. Consequently, if greater use of the apportionment approach is not to act as a deterrent to foreign investment, less developed countries will have to structure the apportionment method so that conflicting determinations are minimized and the legitimate interests of transnational enterprises are safeguarded.

Conflicting determinations would be minimized if there were widespread agreement on a single apportionment formula that could be employed by less developed countries with as little variation as possible. The three factor apportionment formula, with which the individual states in the United States have had considerable experience, should be an appropriate starting point.¹⁰⁸ The extensive guidelines and considerable experience gained by these states over the last several decades could enable tax administrators in less developed countries to avoid many of the administrative problems and uncertainties they might otherwise encounter.

The experiences of the individual states in the United States with the apportionment method in the late 1970s and early 1980s makes it clear, however, that the apportionment method is destined to play only a limited role in efforts to curb transfer pricing abuses in the near term. Transnational enterprises, especially foreign based enterprises, reacted very negatively to efforts to include foreign economic activities in the apportionable base. In Florida, Indiana, Colorado, and Oregon substantial economic pressures were put on state policy makers to limit the inclusion of foreign economic activities in the apportionable base.¹⁰⁹ The pressures were not unlike what a less developed country would encounter if it were to move to wholesale adoption of an apportionment method that took into account foreign as well as domestic economic activities,¹¹⁰ and, as occurred in the various states, the less developed country would probably submit to these pressures.

As a result, in the short term, it would appear that less developed countries should use the apportionment method principally

108. See Miller, *Worldwide Unitary Combination: The California Practice*, in *THE STATE CORPORATE INCOME TAX* 142 (C. McClure ed. 1983).

109. See S. DeCosse, *California Unitary Taxation* (Spring 1985) (unpublished manuscript on file in the office of the author).

110. An apportionment method that took into account only domestic activities would, in effect, be no different than the arm's length standard in most less developed countries.

as a quiet method to make certain the more overt mechanisms for dealing with transfer pricing abuses are working.¹¹¹ In some cases, such as where the intra-firm transfers involve services or intangibles, for which no comparable open market prices exist, the apportionment method may be of more direct assistance. In other instances, it probably is best left as a secondary mechanism to curb transfer pricing abuses.

C. Indirectly: Posted or Notional Export Prices

The use of the posted or notional export prices in lieu of the arm's length approach offers relative simplicity and certainty. With a posted or notional export price system, the proper transfer price is determined by simply applying an agreed fraction to the open market price for specified finished goods. In addition, since the relevant fraction is agreed to in advance of the actual intra-firm transfers, both the transnational enterprise and the host country will be able to determine the appropriate transfer price prior to the actual transaction. Of course, almost by definition, posted or notional export prices can only be used for exports of primary commodities with respect to which there are established open markets for the finished products. In addition, because the relevant factors for determining a posted or notional export price are established in negotiations between the government of the host country and the transnational enterprise, it would appear that less developed countries should consider using this approach only where they are in a relatively strong bargaining position. As a consequence, in their current form, posted or notional export prices offer only a limited solution to the problem of transfer pricing.

Given the simplicity and certainty of operating under a posted or notional export price system, less developed countries should consider the expanded use of such a system. Some countries are beginning to employ a parallel system to impute income to purchasing and export activities within their territories. It also is possible that posted or notional export prices could be used on a regional basis and applied to a broader class of exports.

D. Indirectly: Elimination of Tax Differentials

Elimination of tax differentials would reduce abusive transfer

111. See Lall, *supra* note 4, at 66.

pricing by removing the tax advantage of such practices. As mentioned above, tax differentials could be eliminated through the adoption of a globally uniform tax rate. Given the existence of low- or no-tax countries whose present prosperity is largely attributable to their tax haven status, however, it is unrealistic to expect harmonization of income tax rates even within the Western World. The only practical way to eliminate tax differentials is for the home countries of transnational enterprises to extend their tax jurisdiction to include all profits of transnational enterprises wherever such profits arise, irrespective of whether they are earned by a branch or a separately incorporated foreign subsidiary. This change in the tax laws of the home countries of transnational enterprises would mean that all profits of the enterprises, including profits attributable to foreign subsidiaries arising in tax haven jurisdictions, would be taxed currently in the home country irrespective of whether the profits are actually distributed to the parent. Presumably, to avoid double taxation of such profits, the home country would have to offer a tax credit for foreign taxes paid by foreign subsidiaries. Inasmuch as some industrialized countries already have tax avoidance legislation that taxes foreign source profits of foreign subsidiaries in certain instances, it does not appear to be unrealistic to propose extending that legislation to include all foreign source profits of foreign subsidiaries.

A major problem with legislation in industrialized countries that seeks to tax foreign source profits of foreign subsidiaries is that the extraterritorial effect of the legislation would intrude on the domestic tax systems of all countries in which the foreign subsidiaries are located. Thus, for example, fiscal incentives offered by a less developed country to attract foreign investment would produce no tax benefit to transnational enterprises, but would simply inure to the benefit of the treasury of the home country through a reduced foreign tax credit.¹¹² The inability to create favorable tax differentials could be particularly worrisome to less developed countries because of the perception that fiscal concessions such as tax holding are one of the few ways less developed countries can draw transnational corporations away from their traditional markets in industrialized countries and larger less developed countries.

112. Of course, this consequence of current taxation of foreign source profits of foreign subsidiaries could be a blessing in disguise, as it would enable less developed countries to terminate costly and often ineffective fiscal incentive programs without fear of discouraging foreign investment.

Another problem with current taxation of foreign source profits of foreign subsidiaries is that it might not have a measurable impact on transfer pricing abuses prompted by non-tax considerations. The mechanisms to curb transfer pricing abuses— the arm's length approach, the apportionment method, and use of posted or notional export prices can be employed to curb transfer pricing abuses motivated by non-tax as well as tax considerations. Thus, any of the mechanisms discussed above could be employed to detect transfer prices which are designed to circumvent exchange control restrictions, to minimize reportable profits so as to reduce the share paid to local participants, or to discourage competition. Current taxation of foreign source profits of foreign subsidiaries, however, only eliminates the tax reason for transfer pricing abuses. As a consequence, even with current taxation of foreign source profits of foreign subsidiaries, transfer pricing abuses may continue to be a problem in those countries in which the abuses are prompted by non-tax considerations. Since it appears that, oftentimes in less developed countries, non-tax considerations may offer a strong motive to manipulate transfer prices, the current taxation of foreign source profits of foreign subsidiaries would not eliminate transfer pricing abuses in less developed countries.

Less developed countries should nevertheless not automatically oppose a move in industrialized countries to tax foreign source profits of foreign subsidiaries. Of course, the less developed countries might condition their support on a sharing of the increased revenues from such taxes, especially since the increased revenues will be largely attributable to previously untaxed profits in low tax jurisdictions, many of which are less developed countries. In fact, in the face of industrialized countries taxing foreign source profits of foreign subsidiaries, the less developed countries could adopt a conscious policy of keeping their tax rates below the rates of the industrialized countries. The combined effect of the tax systems in the industrialized countries and less developed countries would thus be to discriminate in favor of local enterprises in the less developed countries. At the same time, such a policy would give the less developed countries a good basis for claiming a share of the increased revenues obtained through the taxation of foreign source profits of foreign subsidiaries.

E. Indirectly: Taxation of Intra-Firm Transfer Payments, Limits on the Deductibility of Such Payments, and Artificial Restrictions on Intra-Firm Transfer Payments

Source taxation of intra-firm transfer payments could effectively reduce the tax incentives to engage in transfer pricing abuses with respect to such payments. At present, most less developed countries subject such payments to high withholding taxes in recognition that untaxed intra-firm royalty payments, rentals, interest, and management service fees are very likely candidates for transfer pricing manipulation.¹¹³ In most cases, no distinction is made between intra-firm payments and payments to unrelated parties. There are, however, several problems with source taxation of these payments. First, the controversy over the level of source taxes on payments to related and unrelated parties has grown commensurately with the importance and incidence of such payments.¹¹⁴ The less developed countries have argued for higher source taxes; the industrialized countries and transnational corporations have supported low source taxes or in the alternative, a complete exemption for such payments.¹¹⁵ In recent years, the controversy has been increasingly resolved in favor of the less developed countries because they have made a firm stand on their position.¹¹⁶ Consequently, fairly high withholding taxes on all royalty payments, rentals, interest, and service fees are coming to be accepted as the international norm. Nonetheless, in a significant number of less developed countries that have withholding taxes on most remittances, the taxes are not actually collected on many intra-firm payments. In some cases involving service fees, the exemption may follow an outdated policy of not taxing the fees unless the person performing the services is physically present for a substan-

113. Gross withholding taxes of 15% to 20% or higher on royalties and management service fees are commonplace in the Eastern Caribbean, South America, Africa, and many parts of Asia. See CORPORATE TAXES, *supra* note 50.

114. THIRD SURVEY, *supra* note 5, at 42-46.

115. For a summary of the arguments for and against higher source taxes, see A. NOOTEBOOM & J.H. TH. SCHIPPER, TAX TREATMENT OF THE REMUNERATION (ROYALTIES AND LUMP SUMS) PAID BY ENTERPRISES IN DEVELOPING COUNTRIES FOR TECHNICAL ASSISTANCE AND LICENSES UNDER PATENTS (1973); C. IRISH, AFRICAN COUNTRIES, *supra* note 18.

116. For example, the tax treaties recently concluded by the United States with Argentina, Barbados, Egypt, and the Philippines all sanction historically high taxes on royalties and/or management service fees. See *Argentina Income Tax Treaty*, 1 FED. TAX TREATIES 13, 101 (P-H 1986); *Barbados Income Tax Treaty*, 1 FED. TAX TREATIES 20, 101 (P-H 1986); *Egypt Income Tax Treaty*, 1 FED. TAX TREATIES 34, 101 (P-H 1986); *Phillippines Income Tax Treaty*, 3 FED. TAX TREATIES 74, 101 (P-H 1986).

tial time in the host country or the services are attributable to a "fixed based."¹¹⁷ In other instances, the exemption may arise as a government concession in the negotiations that led to the licensing of technology, leasing of movable property, loans, or technical assistance.¹¹⁸

It is difficult to know how widespread this practice is, but where it exists less developed countries should recognize that they are sanctioning a practice through which substantial profits can be artificially shifted abroad with only a minimal risk of detection. As a result, it seems clear that less developed countries concerned about transfer pricing abuses should strongly resist the efforts of transnational corporations to obtain tax exempt status for such payments. In any event, less developed countries should also recognize that source taxation of intra-firm royalties and service fees does not usually completely eliminate the tax differentials that attract transfer price manipulation. In fact, only if the withholding tax rate equals the generally applicable corporate tax rate—a situation that seldom exists—are tax differentials completely eliminated.¹¹⁹

As a corollary to withholding taxes on intra-firm payments, some countries deny tax deductions to the paying entity.¹²⁰ The net effect of denying deductibility is that the amount of the intra-firm payment is subject to the regular corporate tax rate in the host country. The problem with this approach is that if it is applied across the board to all external payments it probably will inhibit international trade and investment flows into the country. On the other hand, if deductibility is denied only in the case of payments to related enterprises, then the tax administrators have to be able to distinguish between payments to related parties and payments to unrelated parties. Such a distinction may be difficult to make and may result in discrimination against enterprises having economic relations with foreign affiliates. Consequently, it seems administratively preferable to permit deductions for intra-

117. See *supra* text accompanying note 53.

118. See C. IRISH, *AFRICAN COUNTRIES*, *supra* note 18, at 51-52.

119. A simple example will illustrate: If the generally applicable corporate tax is 40% and the withholding tax rate is 15%, an intra-firm service payment overstated by 100 will yield a tax benefit of 25 to the enterprise, assuming the payment is fully deductible by the payor and not subject to any additional taxes in the home country of the recipient. Of course, as the gap between the generally applicable corporate tax rate and withholding tax rate narrows, so does the tax benefit.

120. See *supra* text accompanying note 55.

firm payments, but to impose a generally applicable withholding tax on them.¹²¹

Reliance on generally applicable withholding taxes is counter-balanced by the fact that such withholding taxes usually do not completely eliminate the tax differentials that stimulate transfer pricing manipulations. Denying deductibility of intra-firm payments, however, does eliminate the tax differentials and the concomitant incentive to engage in transfer pricing abuses. As a result, at a minimum, less developed countries should expressly retain the authority to deny the deductibility of intra-firm payments where it appears the payments exceed normal commercial standards.¹²²

A system of generally applicable withholding taxes can not be readily extended to intra-firm transactions involving goods whatever the merits of taxing intra-firm royalty payments, rentals, interest, and service fees. The international norm is that where goods are imported the source country should tax the foreign importer only if the importer has a substantial presence, or a "permanent establishment," in the source country. In addition, where a permanent establishment does exist, it is generally accepted that the profits of the permanent establishment should be taxed on a net basis, after a deduction for the expenses incurred in the production of income. The permanent establishment concept, however, can be easily manipulated to avoid the existence of a permanent establishment in the source country. Source income taxes on intra-firm transactions involving goods also are unlikely to be an effective device to limit transfer pricing abuses because of the difficulties associated with determining the net income of the permanent establishments that do exist. Conversely, *ad valorem* customs duties do counter the income tax benefits obtained from over-invoicing imports. Therefore, in addition to their other functions, customs duties should be recognized as playing some role in inhibiting transfer pricing abuses involving imported goods.

The lack of a notable impact on transfer pricing abuses prompted by non-tax considerations is another problem with greater source taxation of intra-firm payments. Greater source tax-

121. Of course, tax administrators will always want to reserve the power to recharacterize royalty payments service fees as in substance profit distributions, which should be taxed as dividends. In such cases, the payments usually will be both non-deductible and subject to a gross withholding tax.

122. Formula apportionment is probably the most effective mechanism to monitor whether or not the payments deviate significantly from normal commercial practices.

ation of transfer pricing payments is like the elimination of tax differentials: it attacks the tax reasons for transfer pricing abuses, but acts only to increase the cost of transfer pricing abuses which are motivated by the desire to minimize local profits. As a consequence, greater source taxation may not markedly reduce transfer pricing abuses, where such abuses are occasioned by non-tax considerations.

As indicated above,¹²³ some countries have significantly limited the extent to which remittances can be made. In Brazil and Indonesia, for example, the remittance of royalties and service fees above certain amounts is prohibited. Such a prohibition, if enforced, would clearly curb transfer pricing abuses involving royalties and service fees. The negative impact on foreign investor confidence in the host economy is likely to be so great, however, as to limit the feasibility of this mechanism to the larger, more affluent less developed countries.

IV. CONCLUSION

The preceding sections have established that transnational enterprises have many opportunities to engage in transfer pricing manipulations because, of the large volume of intra-firm transactions.¹²⁴ The limited empirical evidence on the level of transfer pricing abuses suggests that transnational enterprises do make use of the opportunities they have, so that profits properly attributable to one jurisdiction actually do surface in another jurisdiction.¹²⁵

As indicated in sections II and III, governments generally have taken three approaches to dealing with transfer pricing abuses. First, they have developed extensive guidelines to be used in the determination of an arm's length price.¹²⁶ Second, they have diminished the importance of transfer pricing practices. They have done this through unilateral measures in industrialized countries aimed at eliminating tax differentials,¹²⁷ through the use of formula apportionment and posted or notional export prices,¹²⁸ and through the restructuring of foreign investment participation

123. *See supra* text accompanying notes 56-58.

124. *See supra* text accompanying notes 5-7.

125. *See supra* text accompanying notes 8-11.

126. *See supra* text accompanying notes 19-39.

127. *See supra* text accompanying notes 47-50.

128. *See supra* text accompanying notes 40-46.

so that the host government's share of the profits is withdrawn in kind as a portion of the aggregate production.¹²⁹ Third, the governments have imposed taxes on intra-firm transfer payments, denied deductions to the payor of intra-firm payments, and in some instances prohibited certain intra-firm transfers.¹³⁰

No one mechanism has been devised to effectively deal with all transfer pricing abuses. Some, such as the arm's length guidelines and the use of posted or notional export prices could be effectively used with certain transactions but not others. Similarly, the mechanisms designed to eliminate tax differentials, tax intra-firm transfers and deny tax deductions for intra-firm payments could be effective to curb tax motivated transfer pricing abuses, but may not be effective against abuses prompted by non-tax considerations. In addition, some of the mechanisms may not be appropriate or feasible for the governments of less developed countries. Included in this category are the unilateral measures of the industrialized countries to eliminate tax differentials and the absolute prohibitions on certain intra-firm payments imposed by some of the larger, more affluent less developed countries.

To deal effectively with transfer pricing abuses, less developed countries will have to apply a range of mechanisms specially tailored to deal with their particular intra-firm transactions. Some specific suggestions, arranged by the type of transaction, are set forth below.

Imports of Goods

Transfer pricing abuses involving imports of goods can be best dealt with through a monitoring and auditing system designed to provide information on open market prices and to compare the open market prices with intra-firm prices. Empirical studies on the nature of intra-firm trade in goods have established that in a great many instances the trade is confined to only a few products. As a result, the monitoring and auditing system need not concern itself with the entire panoply of imports, but only with the few goods that are imported from foreign affiliates in such volume as to create opportunities for manipulating profits. An effective monitoring and audit system, at minimum, therefore, must have information

129. See *supra* text accompanying note 58.

130. See *supra* text accompanying notes 49-57.

about the nature of imports of the larger, foreign owned enterprises. Only in this way can the monitoring and auditing system be sufficiently focused to be effective.

The countervailing impact of customs duties should be taken into account where imports of goods are involved. If the duty on a finished good is one hundred percent (*ad valorem*) and the regular corporate tax rate is forty percent, a transnational enterprise will not have a tax incentive to over-invoice that finished good. If, however, the goods are imported components or capital goods, which often are duty free or taxed at only nominal rates, the transnational enterprise will have a tax reason to over-invoice.

It would appear that the less developed countries could effectively complement their monitoring and auditing system by quietly using the formula apportionment method as a rough guide to relative profitability both in their country and elsewhere. If formula apportionment indicates that a transnational enterprise should be more profitable in the host country than the tax returns indicate, the government probably should pay even closer attention to that enterprise's accounts.

Obviously, both the monitoring and auditing system and the formula apportionment method require access to relevant information. The less developed countries use much less information than is available in today's environment: information from within the governments of the less developed countries, from the governments of industrialized countries, from international agencies such as the World Bank or the U.N. Centre on Transnational Corporations, from published sources (especially computerized information retrieval systems such as Nexis), and from the transnational enterprises themselves.¹³¹

It should be noted that a monitoring and auditing system aimed at determining arm's length prices complemented with the selective use of formula apportionment should effectively curb transfer pricing abuses involving imports of goods, irrespective of the reasons for the abuses. Hence, transfer pricing abuses prompted by the desire to circumvent exchange control restrictions should be as detectable as abuses prompted by tax considerations.

131. See *supra* text accompanying notes 77-89.

Imports of Services and Intangibles

Imports of services and intangibles should also be covered by the monitoring and auditing system described above. If open market prices for the services or intangibles exist, an effort should be made to identify them. In addition, charges for services and intangibles should be examined to make certain there is no double charging and that the services and intangibles actually benefit the payer.

The difficulties associated with determining an open market price where services or intangibles are involved limits the utility of the monitoring and auditing system. High withholding taxes on management service fees, interest payments, rents, and royalties is the more effective way of dealing with transfer pricing abuses of this kind. Imposition of the taxes on intra-firm transactions should not inhibit international trade or investment flows—as long as the taxes are part of a generalized scheme for withholding taxes on passive income remittances—because such taxes are becoming commonplace. To minimize administrative problems in characterizing payments for services, interest, rents or royalties, it is suggested the withholding taxes all be set at a single rate of approximately twenty percent.

Simply taxing such payments will not eliminate the incentive to engage in transfer pricing manipulations, as long as the withholding tax rates are less than the generally applicable corporate tax rate. Therefore, in addition to taxing payments for service fees and royalties, less developed countries should use the formula apportionment method as a quiet check on relative profitability. Where the use of formula apportionment suggests that an enterprise should be much more profitable, that country should examine the accounts of the enterprise very closely and consider denying the deductibility of intra-firm payments unless an adequate explanation for the different profitability levels is forthcoming. It should be recognized that taxing intra-firm transfer payments and denying the deductibility of such payments only attacks the tax reasons for engaging in transfer pricing abuses. As a result, these mechanisms may not effectively curb transfer pricing abuses prompted by non-tax considerations; they may only have the effect of increasing the costs of the abusive practices.

Exports

The monitoring and auditing system complemented by a selective use of formula apportionment as a check on profitability should also be somewhat effective in dealing with transfer pricing abuses involving exports. In addition, where primary products are involved, some countries have used posted or notional export prices which are set as a proportion of a downstream price for processed goods if the downstream price was easily ascertained in the open market. In such cases, the transfer prices actually used do not affect reported profits for tax purposes, although they may affect the foreign exchange flows and reportable profits for non-tax purposes. Some countries have diminished the importance of transfer prices with respect to exports by withdrawing their share of the profits in kind, as a proportion of the commodity being exported. In order for this device to be effective, however, the host government must have either an internal use for the commodity, such as oil and natural gas, or an independent means of disposing of the commodity on the open market.

A concluding question is whether the program outlined above for dealing with transfer pricing abuses will have a negative impact on transnational enterprises: whether it will drive transnational enterprises to countries with more sanguine transfer pricing policies. As indicated earlier,¹³² it is a difficult question and the answer depends in part on the overall impression transnational enterprises have of a particular country. If a country plays a marginal role in the activities of transnational enterprises and the activities are easily transportable, the introduction of major mechanisms to deal with transfer pricing abuses may prompt the enterprises to go elsewhere. It seems likely, however, that the greatest negative impact will be on those enterprises which are contributing only marginally to the local economy. If the enterprises are enjoying tax holidays, making use of factory shells put up by the local government, and employing only a few indigenous personnel, they may be quite mobile. On the other hand, if the enterprises have substantial, long-term investments in fixed assets and trained labor forces, and the program to deal with transfer pricing abuses is packaged as part of an overhaul of the government which is intended to improve the effectiveness and responsiveness of the government, then the entire package may be applauded rather than condemned.

132. See *supra* text accompanying notes 14-18.

At a minimum, if a less developed country is going to embark on a program to combat transfer pricing abuses, the government must make clear to the transnational enterprises that their legitimate interests will be carefully safeguarded. This means that the government will have to explicitly recognize that the establishment of an appropriate transfer price in a great many intra-firm transactions is a difficult, highly discretionary matter. Hence, evil intent should not be presumed, de minimis adjustments should be avoided, and adequate safeguards to avoid double taxation should be a central part of the program.