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ARTICLES

A REVIEW OF ARGENTINE AND ECUADORIAN TAX LAW REGARDING TRANSFER PRICING AND RECOMMENDATIONS FOR IMPROVING ECUADOR'S APPROACH

STEVEN E. HENDRIX*

I. INTRODUCTION

In recent years, issues surrounding the use and abuse of transfer pricing¹ have received a great deal of attention.² The United

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1. A transfer price is defined as the price used for internal sales of goods and services between the divisions of a business enterprise. Rugman & Eden, *Introduction*, in *MULTINATIONALS AND TRANSFER PRICING 1* (Rugman & Eden eds. 1985) [hereinafter *MULTINATIONALS*].

2. The area of law addressed in this article is rapidly developing. A new government has been elected in Ecuador and will be confronting many of the problems discussed in this investigation. This article reflects information available up to February 1989. However, the reader is advised that the law cited is in a process of change. Therefore, if specific questions should arise in practice, it often may be necessary to consult with legal or accounting representatives in the appropriate country.

For a general survey of current issues, see R. ECCLES, *THE TRANSFER PRICING PROBLEM* (1985); R. MARTINEZ, *LOS PRECIOS DE TRANSFERENCIA EN LA PLANIFICACION IMPRESARIAL* (1981); Aud & Wright, *Intercorporate Transfer Pricing and Puerto Rico, Revisited: A Comment*, 12 *INT'L TAX J.* 43-48 (1986); Bohman & Bohman, *Transfer Pricing under the Tax Reform Act of 1986 — Sections 482 and 1059A*, 14 *INT'L TAX J.* 83-90 (1988); Casey, *International Transfer Pricing*, 67 *MGMT. ACCT.* Oct. 1985, at 31; Coburn, Ellis & Milano, *Dilemmas in MNC Transfer Pricing*, 63 *MGMT. ACCT.*, Nov. 1981, at 53; Dekker, *The Netherlands: Transfer Pricing*, 40 *BULL. FOR INT'L FISCAL DOCUMENTATION* 502 (1986); Eccles, *Control*

States has given its Internal Revenue Service the discretion to correct abuses in deductions, credits and income distribution between two related entities.³ Other nations have their own mechanisms for controlling abuse.

This article will examine how Ecuador, one of the less economically developed Latin American nations, handles transfer pricing in comparison with how Argentina, a more economically advanced state, deals with the same issues. Based on the lessons learned from the Argentine model, improvements will be suggested to the Ecuadorian system. However, a number of definitions and concepts should first be addressed.

A. Definitions of Transfer Pricing and its Abuse

Transfer pricing is a transaction in which the normal market forces do not determine the price paid by a buyer to a seller for a particular good, service, or technology. Instead, the price is established at the seller's discretion.⁴ Transfer pricing occurs when two

with *Fairness in Transfer Pricing*, HARV. BUS. REV., Nov-Dec. 1983, at 149-61; Finn & Munter, *The Importance of Transfer Pricing to Oil and Gas Companies*, 35 OIL & GAS TAX Q., Sept. 1986, at 136-47; Fisher, I.R.C. Sec. 482 — *Applying the Arm's Length Standard to Transactions Between Foreign Car Manufacturers and Their United States Subsidiaries*, 4 WISC. INT'L L.J. 134-61 (1985); Goldsmith, *Summary of Rules Applicable to Transfer Pricing in France*, 40 BULL. FOR INT'L FISCAL DOCUMENTATION 564-68 (1986); Gordon & Donohue, *Tax Reform Act of 1986: Transfer Prices for Imported Merchandise*, 35 CANADIAN TAX J. 1543-46 (1987); Granwell, Hirsh & Milton, *Worldwide Unitary Tax: Is It Valid Under Treaties of Friendship, Commerce and Navigation?*, L. & POL'Y INT'L BUS. 695 (1986); Greenhill & Herbolzheimer, *International Transfer Pricing: The Restrictive Business Practices Approach*, 14 J. WORLD TRADE L. 232-41 (1980); Hongskrailers & Jap, *Thailand: Transfer Pricing Provisions, Rulings and Case Law*, 40 BULL. FOR INT'L FISCAL DOCUMENTATION 514 (1986); Jensen, *Transfer-Pricing and Output Decisions: The Dynamic Interaction*, 17 DECISION SCIENCES 428 (1986); Keegan & Howard, *Making Transfer Pricing Work for Services*, 165 J. ACCOUNTANCY, MAR. 1988, at 96; Lanthier, *Canada: Draft Guidelines on International Transfer Pricing*, 40 BULL. FOR INT'L FISCAL DOCUMENTATION 487 (1986); Rafferty, *The Profit-Split Method of Income Allocation in Intercompany Pricing Disputes: The Eli Lilly Case*, 64 TAXES 662 (1986); Schindler, *Intercorporate Transfer Pricing*, 19 TAX ADVISER, May 1988, at 378; Schindler, *U.S.A.: Taxation of Intercorporate Transfer Pricing — A Management Responsibility*, 40 BULL. FOR INT'L FISCAL DOCUMENTATION 497 (1986); Terbruggen, *Can a Central Cash Pool Work for Transfer Pricing?*, 68 MGMT. ACCOUNTANT, July 1986, at 31; Wheeler, *An Academic Look at Transfer Pricing in a Global Economy*, 40 TAX NOTES 87-96 (1988); Yoost, Watanabe & Fox-Moore, *Japan: The New Inter-Company Pricing Rules*, 40 BULL. INT'L FISCAL DOCUMENTATION 506 (1986); Gutfeld, *IRS Plans to Toughen Rules for Taxing Transfer Among Firms, Overseas Units*, WALL ST. J., Oct. 20, 1988, at C18.

3. I.R.C. § 482 (1988). See also 5 D. TILLINGHAST, *TAX ASPECTS OF INTERNATIONAL TRANSACTIONS* 54-55 (2d ed. 1984).

4. Irish, *Transfer Pricing Abuses and Less Developed Countries* 2 (1985) (unpublished

related parties, often a parent company and its subsidiary, engage in a transaction.⁵

Transfer pricing abuse is more difficult to define,⁶ because transfer prices are not easy to determine, even when they are set in an honest manner.⁷ An abuse is said to occur when the price falls outside the normal expectation for the expense.⁸ However, it is rare to find a single, expected price.⁹ In fact, it is probably more accurate to speak of an acceptable range of normal transfer prices.¹⁰ This latitude makes detection of abuse less accurate and more complex. A brief description of the ways in which transfer price abuse produces financial rewards may aid in further defining the scope of the problem.

B. How Transfer Pricing Can Be Used

There are basically three reasons why firms engage in transfer pricing abuse. First, transfer pricing allows companies to circumvent restrictions on repatriation of income and currency conversion.¹¹ Second, transfer pricing may be used to “. . . quietly withdraw profits in the face of economic uncertainties in host countries or in any instance in which business considerations dictate showing low profits in a particular jurisdiction.”¹² This inquiry focuses pri-

manuscript) (available at offices of INTER-AM. L. REV.).

5. C. KORTH, *INTERNATIONAL BUSINESS: ENVIRONMENT AND MANAGEMENT* 562 (1985).

6. *New Tune for Corporate Tax Fiddlers*, *ECONOMIST*, June 20, 1981, at 108-09 [hereinafter *Fiddlers*].

7. McGuinness, *Comments on the Difficulties in Regulating Transfer Prices*, in *MULTATIONALS*, *supra* note 1, at 309.

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

9. C. KORTH, *supra* note 5, at 505.

10. Irish, *supra* note 4, at 3. For a comprehensive, yet concise chart depicting the complexity of establishing a transfer price, see R. ECCLES, *supra* note 2, at 29.

11. C. KORTH, *supra* note 5, at 505. Before oil price deregulation, United States oil firms tried to skirt Department of Energy restrictions by using transfer prices. *Fiddlers*, *supra* note 6, at 108-09. See also R. TANG, *TRANSFER PRICING PRACTICES IN THE UNITED STATES AND JAPAN* 79-98 (1979) (discussing the objectives for using transfer pricing).

12. Irish, *supra* note 4, at 8. For a discussion of other motives for transfer pricing, see Drumm, *Transfer Pricing in the International Firm*, 23 *MGMT. INT'L REV.* No. 4, 32-33, 38-42 (1983); Kassiech, *International Intra-Company Transfer Pricing*, 29 *OPERATIONS RES.*, July-Aug. 1981, at 817, 819-27. For a summary of data on the relative importance of transfer price objectives, see Yunker, *A Survey Study of Subsidiary Autonomy, Performance Evaluation and Transfer Pricing in Multinational Corporations*, 18 *COLUM. J. WORLD BUS.*, Fall 1983, at 51, 58-59. For an outline of alternative transfer price methods, see Grosse, *Financial Transfers in the MNE: The Latin American Case*, 26 *MGMT. INT'L REV.* No. 1, 33 (1986).

marily on the third purpose of transfer pricing abuse: tax evasion. In this context, abuse occurs where a taxpayer takes an aggressive position in setting the transfer price in order to avoid taxation. The following scenario illustrates the use of transfer pricing to evade or lower taxes.¹³

Suppose a parent company with two subsidiaries is located in a high-tax jurisdiction. Subsidiary I is located in a moderate-tax jurisdiction, while Subsidiary II is located in a low-tax jurisdiction (a so-called "tax haven"). If the parent has a product it wishes to sell to Subsidiary I's country, barring any tax restrictions, the parent may work out the following transfer price scheme to drastically lower its tax liability. If the product costs fifty cents to produce and the parent wishes to sell the product for one dollar, it could simply sell the product to Subsidiary I, and realize a fifty-cent profit, on which it would pay tax accordingly. However, a more complex transaction could lower the parent's tax liability. The parent could sell the product to Subsidiary II for fifty cents and realize no profit in its own high tax jurisdiction. Subsidiary II could then re-sell the product for one dollar to Subsidiary I, and realize a fifty-cent profit in that low-tax jurisdiction. Subsidiary I could then re-sell the product locally, and realize no profit at all. The savings to the entire corporation (parent and subsidiaries) under this scenario is equal to the difference in tax between the high- and low-tax jurisdictions. Corporations have learned to use this scheme to their advantage whenever possible.¹⁴

C. Determining the General Frequency of Transfer Pricing Abuse

Not a great deal of research has been done to ascertain the parameters and frequency of abuse.¹⁵ Any statistics that do exist with regard to transfer pricing abuse are suspect, because the figures in corporate accounts on which taxes are based and which form the basis for any dispute between the tax authority and the company bear little resemblance to the final settlement created by

13. For more detailed examples, see R. BARNET & R. MULLER, *GLOBAL REACH: THE POWER OF THE MULTINATIONAL CORPORATIONS* 157-59 (1974) [hereinafter *GLOBAL REACH*].

14. *Id.* at 277-82.

15. S. PLASSCHAERT, *TRANSFER PRICING AND MULTINATIONAL CORPORATIONS* 11-12 (1979); Lall, *Transfer Pricing and Developing Countries*, 7 *WORLD DEV.* 59, 60 (1979); Lecraw, *Some Evidence on Transfer Pricing by Multinational Corporations*, in *MULTINATIONALS*, *supra* note 1, at 223, 229.

the tax authority.¹⁶ Moreover, given that much international trade takes place between related parties, there remains great opportunity for abuse.¹⁷ One study estimated that one-third of all parent company exports went to related firms.¹⁸ United States related-party imports in the third world are estimated at 43.4% of total imports.¹⁹ In the petroleum industry, the figure climbs to 59.6% of total imports.²⁰ In the area of royalties, licensing fees, and technical assistance, with regard to parent companies located in Great Britain and the United States, the figure for intra-company trade can climb to as high as eighty to eighty-five percent of the total revenue received by the parent.²¹

Further, data reveals that "very high proportions of some United States imports from developing countries originate with related parties; there are frequently large differences between import unit values in related-party trade and those in non-related-party trade."²² Investigation reveals that export tax increases in the 1970s led multinationals to justify increased market prices in the United States, while retaining a constant nominal purchase price for bananas in Central America.²³ Thus, while total tax revenue increased, the countries received only a portion of the taxable increase in revenue due to the government because of pricing schemes by multinational enterprises.²⁴ Similarly, copper marketing companies in Zambia have been able to deprive partially nationally-owned operating companies of profit, transferring the money to tax havens.²⁵ Another study has found that from one to

16. *Fiddlers*, *supra* note 6, at 108. For a discussion on how eventual settlements may have little relation to legal mandates, see also S. Hendrix, *Is What You See What You Get?: Perspectives on Post-Verdict Bargaining*, (Fall 1985) (unpublished seminar paper given at a seminar on Disputes Processing, at the Univ. of Wisconsin) (available at the offices of INTER-AM. L. REV.).

17. *Irish*, *supra* note 4, at 4

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

19. Helleiner, *Intra-Firm Trade and the Developing Countries: An Assessment of the Data*, in *MULTINATIONALS BEYOND THE MARKET* 31, 46 (Murray ed. 1981) [hereinafter *BEYOND THE MARKET*].

20. *Id.*

21. *Id.* at 120.

22. *Id.* at 54.

23. Ellis, *Export Valuation and Intra-Firm Transfers in the Banana Export Industry in Central America*, in *BEYOND THE MARKET*, *supra* note 19, at 61-75.

24. *Id.* at 73-74.

25. Lamaswala, *The Pricing of Unwrought Copper In Relation To Transfer Pricing*, in *BEYOND THE MARKET*, *supra* note 19, at 77, 84-85.

nineteen percent under-invoicing of Greek aluminum resulted in a loss of more than \$4 million in government revenue in 1976 alone.²⁶ In Brazil, a number of abuses have been reported in firms, including Yamaha Musical do Brazil (a subsidiary of Nippon Gakki Company), Ericsson (a telecommunications firm), and Cargill (a firm in the grain sector).²⁷ Recent data for Brazil also shows that multinational entities paid twenty-one to thirty-nine percent higher import prices in sample areas.²⁸ In addition, not only were prices higher, on the average, in multinational firms, but the prices also displayed greater variability.²⁹ Furthermore, widespread literature on the manipulation of transfer prices available to multinational corporations³⁰ suggests that abuse by that sector may be common.³¹

D. Frequency of Abuse in Ecuador and Argentina

There is not a great deal of information available on the degree of transfer pricing abuse in Ecuador and Argentina. However, some limited data for Argentina is available. In 1976, entities affiliated with companies based in the Federal Republic of Germany which had operations in India, Mexico, Argentina and Brazil, transacted approximately sixty percent of their sales with related entities abroad.³² This would suggest that the opportunity for abuse exists. In fact, one study in Argentina found that over-invoicing did occur in the pharmaceutical industry.³³ Subsidiaries of foreign entities which sold drugs in eight different therapeutic groups charged 143 to 700% more than the price for which the same products could have been purchased from other sources.³⁴

26. Roumeliotis, *Underinvoicing Aluminum From Greece*, in *BEYOND THE MARKET*, *supra* note 19, at 86.

27. Greenhill & Herbolzheimer, *supra* note 2, at 238 (citing U.N. CTAD, *Annual Report on Legislative and other Developments in Developed and Developing Countries in the Control of Restrictive Business Practices* at para. 163, U.N. Doc. TD/B/750 (1979)).

28. Natke, *A Comparison of Import Pricing By Foreign and Domestic Firms in Brazil*, in *MULTATIONALS*, *supra* note 1, at 212, 220.

29. *Id.*

30. Irish, *supra* note 4, at 6. See, e.g., Charles, *The Economics Approach to Transfer Price*, 96 ACCT., June 1985, at 110; Kassieh, *supra* note 12, at 817-27.

31. M. GRUNDY, *THE WORLD OF INTERNATIONAL TAX PLANNING* 15-22 (1984).

32. *THIRD SURVEY*, *supra* note 18, at 160.

33. U.N., *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*].

34. *Id.* The Ecuadorian government feels it too may be the victim of over-invoicing in the pharmaceutical industry. In 1988, the Central Bank discovered one company that had

Thus, there is some evidence to suggest that where an opportunity for abuse exists, there may be a strong incentive to use transfer pricing as a vehicle for tax evasion. Another study attempted to measure the opportunity for abuse in Argentina by estimating intra-firm payments as a percentage of total payments in 1972.³⁵ That study found that in sample areas, forty-two percent of total payments in Argentina were made between related entities.³⁶ That same study went on to assert that although exact results computing the difference in price are difficult to reach, evidence of transfer price abuse exists in Argentina.³⁷

There is no reason to believe that Ecuador's situation is very different from Argentina's. An analysis of the general data for related-party transactions in the third world creates at least an inference of the potential existence of abuse in Ecuador. Further, the lack of detailed and specific data for Argentina and Ecuador should not be used as a reason to ignore what may in reality be or become a serious area of abuse. Consequently, Argentina and Ecuador need controls to prevent undefensible transfer pricing. As one scholar noted:

Since the volume of intra firm 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, 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.³⁸

Thus, based on information available with respect to other jurisdictions, as well as on information available for Ecuador and Argentina, it is likely that the absence of attention is, in fact, a sign

been charging Ecuadorian customers over twice the rate it was charging Colombian customers for identical products. Telephone interview with Juana Caicedo, Minister Counselor, Ecuadorian Government Trade Office, New York City (Nov. 17, 1988) [hereinafter Trade Office Interview].

35. Chudnovsky, *Pricing of Intra-Firm Technological Transactions*, in *BEYOND THE MARKET*, *supra* note 19, at 119, 120.

36. *Id.*

37. *Id.*

38. Irish, *supra* note 4, at 7. See also Plasschaert, *Transfer Pricing Problems In Developing Countries*, in *MULTINATIONALS*, *supra* note 1, at 247. For a discussion of the view that multinational corporations have no moral problems with abuse, see *GLOBAL REACH*, *supra* note 13, at 187. President Rodrigo Borja has stated that transfer pricing poses great problems for the Ecuadorians. Trade Office Interview, *supra* note 34.

that transfer pricing abuse is a serious problem.

E. The Policies Involved in Transfer Price Control

Both Ecuador and Argentina must consider the likely impact of implementing programs to control transfer pricing abuse. Because multinational corporations prefer more developed markets,³⁹ a newly-developing country like Ecuador might be uncomfortable adding controls which would discourage investment.⁴⁰ Thus, Ecuadorian transfer pricing abuses may be tolerated or ignored by the government because of the economic disadvantages associated with curbing abuse. Multinationals provide many benefits to the emerging Ecuadorian market, including employment, foreign exchange, and exports.⁴¹ Indeed, the Febres Cordero administration created a substantial incentive program to attract multinationals and significantly liberalized the actual implementation of investment guidelines from the Andean Pact to encourage investment.⁴² Foreign investment appeared to be on the rise in Ecuador, at least until the new government of President Rodrigo Borja came to power in 1988.⁴³ The present regime is concerned with balancing the goal of eliminating or controlling transfer pricing abuse with the risk of losing valuable foreign investment.

In implementing any programs aimed at countering abusive pricing schemes, Ecuador must consider two factors.⁴⁴ First, in order to preserve legitimate multinational corporate interests, corporations must be allowed the discretion to set prices within a flexible range.⁴⁵ This is important because it establishes boundaries

39. THIRD SURVEY, *supra* note 18, at 17.

40. For a discussion of the difficulties of regulating abuse without discouraging investment, see GLOBAL REACH, *supra* note 13, at 207.

41. C. KORTH, *supra* note 5, at 275-302.

42. American Embassy Quito, 1986 Investment Climate Statement for Ecuador 1 (Sept. 23, 1986) (internal memorandum) [hereinafter Investment Climate] (available at offices of INTER-AM. L. REV.).

43. *Id.* at 4. For examples of the "bad press" received by the new administration, see *President of Ecuador Terms Debt Unpayable*, J. Commerce (Aug. 15, 1988); Robinson, *Anti-U.S. Mural Highlights Ecuadorian's Inauguration*, Wash. Post, Aug. 11, 1988, at A23, cols. 3-4. These articles suggest that investors rethink the idea of investing in Ecuador. However, Ecuador is receiving some new investment from the Inter-American Development Bank and the Andean Development Corporation. See *Ecuador to Get \$1 Billion for Development Projects*, J. Commerce (Feb. 10, 1989).

44. For a discussion of these two factors, see Irish, *supra* note 4, at 12-13.

45. ORGANIZATION FOR ECONOMIC COOPERATION & DEVELOPMENT (OECD), TRANSFER PRICING AND MULTINATIONAL ENTERPRISES 12 (1984) [hereinafter OECD/1984].

within which a corporation can still use transfer pricing to reap a reasonable profit. Moreover, setting prices, even in an honest manner, can be a difficult task,⁴⁶ while determining a range of acceptable prices is more realistic and ascertainable. Second, to counter the negative effects of increased regulatory control on the multinationals which Ecuador wishes to keep in or attract to the country, the nation may also wish to take measures to enhance its investment climate by creating an impression that the government is merely streamlining the bureaucracy and cutting back on the institutional inefficiencies which create the opportunity for transfer pricing abuse in the first place.⁴⁷ Alternatively, Ecuador may wish to use another system, like apportionment, which does not require a complex calculation to determine a transfer price or range. A careful consideration of these factors will enable the government to curtail transfer pricing abuse without seriously injuring the investment climate.

Having laid out what transfer pricing is, how it occurs, its frequency, and why it is a difficult subject for control, it is now appropriate to turn to the substantive law of Ecuador and Argentina to examine how each of these nations counteracts the abuse.

II. HOW ARGENTINA PRESENTLY COPES WITH TRANSFER PRICING AND ITS ABUSE

A. *Summary of Argentina's Corporate Tax System as It Affects Multinational Corporations*

In Argentina, affiliated companies of foreign corporations are taxed at the same rate as are domestic corporations.⁴⁸ That rate is thirty-three percent of total profits.⁴⁹ In addition, both foreign affiliates and domestic corporations must pay a 17.50% tax on non-stock or profit dividends distributed to overseas beneficiaries, making the effective tax rate about forty-five percent — a rate equal to the highest individual marginal tax rate.⁵⁰ Similarly, Argentine branches of overseas companies pay forty-five percent on their profits.⁵¹ However, for both the branch and the subsidiary of a for-

46. Irish, *supra* note 4, at 12-13.

47. *Id.*

48. *International Tax Notes*, 10 INT'L TAX J. 373, 374 (1984).

49. *Id.*

50. *Id.*

51. *Id.*

eign corporation, home office expenses can be allocated to the local office and used as a deduction if they "are necessary to obtain taxable income in Argentina."⁵² An additional withholding tax of fifteen to twenty-five percent is due when remittance of profit net of income tax exceeds twelve percent of the registered capital.⁵³ Interest is subject to a forty-five percent withholding tax on twenty-five percent of the gross amount, yielding an effective rate of 11.25 percent.⁵⁴ Generally, royalties are subject to a forty-five percent withholding tax.⁵⁵ Salaries, wages, and directors' fees usually carry a forty-five percent withholding tax.⁵⁶ These amounts are different, however, in a number of Argentina's international tax agreements.⁵⁷

In general, although Argentina tries to treat transactions between related parties in the same manner as transactions between unrelated parties,⁵⁸ it will do so only if the price and conditions of the transaction approximate those of an arm's length transaction.⁵⁹ Argentina is particularly concerned about transfer pricing abuse with regard to loans and technology. Loans are reported to the Central Bank, which may object to the terms of the loan within thirty days if it believes the terms to be unreasonable.⁶⁰ Under the Transfer of Technology Law No. 21617 which governs intra-company transfers of licenses, patents, knowledge, engineering, installation, assistance, and other services, such transactions must be approved by the Authority of Application. Transactions are approved when they approximate the expected market costs between unrelated parties. One exception to the transfer price approval process occurs when trademarks are transferred. In those cases, no matter how similar the transaction is to an arm's length exchange, no transfer price will be accepted.⁶¹ Yet, once the transaction is approved and registered,⁶² the purchaser is allowed to pay for the

52. *Id.*

53. TOUCHE ROSS INTERNATIONAL, TAX AND INVESTMENT PROFILE: ARGENTINA 29 (1984) [hereinafter TOUCHE ROSS INTERNATIONAL: ARGENTINA].

54. *Id.* at 30.

55. *Id.*

56. *Id.* at 30-31.

57. *Id.* at 31.

58. PRICE WATERHOUSE, DOING BUSINESS IN ARGENTINA: PRICE WATERHOUSE INFORMATION GUIDE 49 (1980) [hereinafter PRICE WATERHOUSE].

59. *Id.*

60. *Id.* at 54. See also COOPERS & LYBRAND, 1987 INTERNATIONAL TAX SUMMARIES A-11 (1987) [hereinafter COOPERS & LYBRAND].

61. PRICE WATERHOUSE, *supra* note 58, at 10-11.

62. Transactions are registered in the National Register of Contracts of License and

service and then deduct any corresponding expenses from tax due.

B. How Tax Rates Applicable to Foreign Entities in Argentina Provide an Incentive for Transfer Pricing Abuse

Because Argentine corporations may be taxed at a rate up to 45% (if they distribute non-stock dividends overseas)⁶³ there is a strong incentive to use transfer pricing to move profits from Argentina to a home office or related entity located in a foreign jurisdiction where the tax rates are lower. However, whether a corporation is willing to use transfer pricing to evade Argentina's steep tax may depend, in large part, on the severity of governmental restrictions and efficacy of their enforcement by the government of Argentina.

C. Argentine Regulations Aimed at Controlling the Abuse of Transfer Pricing

Argentina places a number of restrictions on the use of transfer pricing which are specifically aimed at curbing its abuse. These include a generally applicable rule, as well as regulations in certain distinct areas, such as intra-company transfers of royalties, setting of directors' salaries, transfers of technological and financial assistance, and monitoring and setting of export and import prices. Each of these rules and regulations is addressed below.

1. General rule of non-deductibility of overseas expenses

As previously stated,⁶⁴ the general rule in Argentina is that overseas expenses cannot be deducted from gross income, even if the company's home office is overseas. The rationale for this rule is the presumption that overseas expenses have been incurred in the production of foreign income. In exceptional cases, however, this presumption can be rebutted. The Tax Board may allow a deduction for overseas expenses if the company can prove that those expenses directly affect the production of source income in Argentina.⁶⁵

Transfer of Technology. *Id.*

63. See *supra* notes 48-50 and accompanying text.

64. See *supra* notes 48-52 and accompanying text.

65. Ganancias art. 116 (Arg. 1982)..

2. Non-deductibility of royalties paid to a related party overseas

The first of Argentina's specific regulations concerns the deductibility of royalty expenses paid by a local entity to a related foreign company. In an important decision, the Supreme Court of Argentina denied the right of a subsidiary or branch office to deduct royalty expenses from gross income.⁶⁶ In that case, the parent corporation owned over ninety-nine percent of the local entity's shares. The Court taxed the parent on the amount because it considered the expense Argentine source income subject to the corporation's income tax rate. This decision runs counter to and narrows the general rule that domestic corporations may deduct license and royalty expenses paid to overseas companies.⁶⁷

3. Limits to the deductibility of salaries and remuneration of overseas board members

Argentina generally allows board member fees to be deductible from the fiscal balance sheet to which the payment is related⁶⁸ However, if the directors reside overseas, the deductions available for members who perform their duties abroad are limited.⁶⁹ Local entities can deduct salaries and remuneration up to 12.5% of all business profits earned by the entity, provided that those profits are fully distributed as dividends. This is a fixed amount when the service is provided "desde el exterior" (from outside of the country). Salaries and remuneration are limited to 2.5% of profits when no dividends are paid. When some dividends are paid, there is a sliding scale, ranging from 2.5% to 12.5%, which can be deducted depending upon the amount of dividends distributed.⁷⁰ Fees paid to overseas board members are also included in the next section, dealing with assistance expenses.

66. Judgment of Jul. 31, 1973, la Corte Suprema de Justicia de la Nación, Arg., 286 Fallos 97.

67. Leyes y Decretos Impositivos art. 73 (Arg. 1982); Ganancias arts. 116, 117 (Arg. 1982). Argentine Law No. 21617 provides that royalty payments for the use of trademarks are not allowed. See also Chudnovsky, *supra* note 35, at 126.

68. Ganancias art. 136 (Arg. 1982).

69. Leyes y Decretos Impositivos art. 81(e) (Arg. 1982); Ganancias art. 138 (Arg. 1982).

70. Leyes y Decretos Impositivos art. 81(e) (Arg. 1982); Ganancias art. 138 (Arg. 1982)..

4. General deductibility of expenses for technological and financial assistance by related companies

As a general rule, Argentina allows its business entities to deduct fees and remuneration paid for technological, financial, or other assistance from overseas; however, the maximum deduction is limited by two caps.⁷¹ The first cap occurs when such fees and remuneration represent three percent of sales or gross income of the entity, whichever figure has formed the basis of the contract for assistance. The second cap is fixed at five percent of the total amount in fact invested in the assistance which was provided. Any payments beyond these caps are not deductible. Moreover, they are subject to the forty-five percent withholding tax for income remitted abroad.

For transactions which were the product of technical or financial assistance by a parent, subsidiary, branch, or other related entity (including third parties financially related to them), to an enterprise in Argentina, the government will regard these transactions between related parties as taking place between unrelated entities, provided that the transactions comply with income tax law restrictions. However, if there is noncompliance with the law, the payments and transactions will be deemed to have produced profits of the foreign entity in Argentina.⁷²

71. Ganancias art. 138 (Arg. 1982).

72. Leyes y Decretos Impositivos art. 14 (Arg. 1982). Article 14, paragraphs 3 and 4, reads as follows:

Los actos jurídicos celebrados entre una empresa local de capital extranjero y la persona física o jurídica domiciliada en el exterior que directa o indirectamente la controle serán considerados, . . . entre partes independientes cuando sus prestaciones y condiciones se ajusten a las prácticas normales del mercado entre independientes, con las limitaciones siguientes:

1. Préstamos: Deberán ajustarse a las disposiciones establecidas en el inciso 1, del artículo 20 de la Ley No. 21.382.

2. Contratos regidos por la Ley de Transferencia de Tecnología: De acuerdo con lo que al efecto establezca dicha ley.

Cuando no se cumplimenten los requisitos previstos en el párrafo anterior para considerar a las respectivas operaciones como celebradas entre partes independientes, las prestaciones se tratarán con arreglo a los principios que regulan el aporte y la utilidad.

(Judicial acts and agreements between domestic corporations with foreign capital and a physical or juridical person domiciled abroad who directly or indirectly controls it will be considered arm's length transactions provided the terms and conditions reflect current market norms among independent agencies with the following limitations: (1) Loans: Should adjust to the conditions established in clause 1, article 20 of Law 21.382; (2) Contracts governed by the Technology Transfer Law: According to the procedures established by this law. Provided the conditions set forth in the preceding paragraph for the characterization of the

5. Monitoring of export prices by the wholesale market price at the place of destination

In general, Argentine exporters realize domestic source income and are therefore subject to Argentine income tax.⁷³ When the price of exports falls below the wholesale price at the destination, the Tax Board may consider whether the transaction was made between related parties. Indeed, given the presumption that the law creates, and in the absence of contrary evidence, the tax authorities may deem the exporter to have earned additional profits subject to a forty-five percent tax rate, thus treating the parties as if related.⁷⁴ The parties have the opportunity to justify the price. If the Board maintains that the price is unjustified, it may tax the Argentine exporter on the profits from the transaction using the wholesale market price at either the foreign destination or the exporter's own market.⁷⁵

6. Monitoring of import prices by the wholesale market price at the place of destination

The controls on import price are quite similar to the controls on export price. Generally, when foreign exporters realize a profit from a sale to Argentina, they do not have Argentine source income. Thus, they will not have any tax liability in Argentina.⁷⁶ Yet, if the Argentine importer is paying a price higher than the wholesale market price in the country of origin plus appropriate shipping and insurance charges, the Tax Board may find that the transaction has taken place between related parties. As with exporting, the entities may submit evidence to justify the price set. Assuming that the Tax Board still finds the price to be inappropriate, the Board can charge an income tax based upon the created margin or, in the alternative, upon local wholesale prices.

transaction as arm's length are not met loans between the parties will be treated according to capital and equity principles.)

73. Leyes y Decretos Impositivos arts. 14, 5, 8(a) (Arg. 1982).

74. TOUCHE ROSS INTERNATIONAL: ARGENTINA, *supra* note 53, at 26.

75. *Id.* See also Ganancias arts. 8(a), 9, 10 (Arg. 1982).

76. Leyes y Decretos Impositivos arts. 5, 8 (Arg. 1982).

III. HOW ECUADOR PRESENTLY COPES WITH TRANSFER PRICING AND ITS ABUSES

A. A Brief Summary of Ecuador's Corporate Tax System as It Affects Multinational Corporations

In Ecuador, corporations have differing tax rates depending on their domicile or place of incorporation. Generally, there is a twenty percent tax on undistributed profits.⁷⁷ The basic income tax rate on distributed profits for stockholders in Ecuador, including the prior twenty percent rate on undistributed profits, is twenty percent.⁷⁸ The rate of basic income tax on distributed profits to foreign stockholders residing abroad is forty percent.⁷⁹ In addition, the Ecuadorian code makes no provision for the filing of consolidated tax returns.⁸⁰

One investment guide for Ecuador summed up the tax law involving intercompany charges as follows:

The law provides for the deductibility of necessary commissions and expenses incurred abroad, as in the case of exportations. Such expenses are determined on the basis of specific contracts or as a maximum of 2 percent of export sales. Advertising contracted abroad to promote sales of the local company is, in practice, accepted as deductible without giving rise to withholding of income taxes.

Contracts involving technical, administrative and management assistance from abroad and, in general, any type of service that calls for the payment of fees, royalties, etc., on account of intangible technical contributions require approval from the authorities on a case by case basis. The authorities have the right to regulate the period of the contract and the terms of payment. . . . [With respect to royalties] no payment abroad is deductible when the transaction or the contract is entered into between affiliated companies. Withholding of income taxes applies to all the foregoing payments.⁸¹

77. TOUCHE ROSS INTERNATIONAL, TAX & INVESTMENT PROFILE: ECUADOR 14 (1984) [hereinafter TOUCHE ROSS INTERNATIONAL: ECUADOR]; PRICE WATERHOUSE, CORPORATE TAXES: A WORLDWIDE SUMMARY 112-16 (1988) [hereinafter PRICE WATERHOUSE/CORPORATE TAXES].

78. PRICE WATERHOUSE/CORPORATE TAXES, *supra* note 77, at 112-16.

79. *Id.*

80. DELOITTE HASKINS & SELLS, TAXATION IN ECUADOR: A GUIDE FOR THE FOREIGN INVESTOR 34 (1986) [hereinafter DELOITTE].

81. PRICE WATERHOUSE, DOING BUSINESS IN ECUADOR 82-83 (1981) [hereinafter PRICE WATERHOUSE/ECUADOR]. See also DELOITTE, *supra* note 81, at 11. Intra-firm royalty payments are not deductible under Decision 24 of the Andean Pact. Chudnovsky, *supra* note

Additionally, a special tax provision for foreign construction companies permits a deduction of home office expenses of up to twenty percent of the construction contract's value.⁸² However, the home office must use a public accountant or governmental agency to certify that the payment was credited to the home office accounts.⁸³ This documentation must be notarized by the Ecuadorian consul abroad.⁸⁴

Ecuador charges a withholding tax on a number of types of transfer payments. While no withholding tax is levied on interest, loans are subject to a one-time special tax of one-half to two percent of the loan principal at the time of registration with the Central Bank.⁸⁵ There is a forty percent withholding tax, plus additional surtaxes, on fees and royalties for technical assistance.⁸⁶ This forty percent plus surtax rate also applies to professional fees remitted abroad.⁸⁷ Finally, for dividends credited or remitted to non-resident shareholders, there is a twenty percent withholding tax with additional surtaxes.⁸⁸

B. How Tax Rates Applicable to Foreign Corporations and Shareholders in Ecuador Provide an Incentive for Transfer Pricing Abuse

The fact that the tax rate for foreign entities in Ecuador is as high as forty percent in the aggregate,⁸⁹ creates an incentive for abuse. If a company can use pricing to transfer profits from Ecuador to either the home office or a third country with a lower tax rate, that company will be able to avoid paying some of its tax liability. The statutes of Ecuador reveal Ecuador's attempts to curb this abuse.

35, at 126.

82. PRICE WATERHOUSE/ECUADOR, *supra* note 81, at 83.

83. *Id.*

84. *Id.*

85. DELOITTE, *supra* note 80, at 17.

86. *Id.* at 18.

87. *Id.*

88. *Id.*

89. See *supra* notes 77-81 and accompanying text.

C. Specific Ecuadorian Laws Aimed at Controlling the Abuse of Transfer Pricing

Articles 17, 19, and 20 of the Law in Ecuador substantively impact on transfer pricing. Article 17 states that: "When the normal price depends on the quantity of a sale, such price will be determined on the assumption that the sale is limited to the quantity of commodities set forth in the declaration."⁹⁰ The text of Articles 19 and 20 is as follows:

Article 19. The price shown on the commercial invoice (except when there is a doubt as to the correctness of the data contained thereon) will be taken as a basis for determining the customs value, provided that it complies with the conditions stipulated for determining the normal price of the commodities.

Article 20. An importer should declare the value of the commodities in conformity with the preceding Articles. Also, he should provide the Customs and the Central Valuation Office with all the data and commercial documents relating to the importation that may be required for the purpose of verifying the taxable value. The obligation prescribed in the preceding sentences will be enforced on the importer for all commodities declared at the Customs, including those which are exempted, in whole or in part, from duties, and those which are subject to specific duties. The Central Valuation Office is authorized to make such investigations as it may deem necessary for verifying the taxable value.⁹¹

The penultimate sentence in Article 20 is significant because it provides that, whether or not an ad valorem tax is levied, the pertinent information is available to tax authorities for computation of transfer prices. Yet, these provisions apply to the customs value of goods and appear to be more concerned with low prices than high prices. In fact, Article 21 authorizes the Minister of Finance to establish minimum prices for commodities. Ecuadorian consuls and commercial advisors abroad send wholesale price information back to Ecuador to aid in the compilation of price lists.⁹² It might

90. DUN'S MARKETING SERVICES, EXPORTERS' ENCYCLOPAEDIA 1986/1987 2.448 (1986) [hereinafter DUN'S MARKETING SERVICE].

91. *Id.*

92. *Id.* See also Trade Office Interview, *supra* note 34. One exporter stated that, in his opinion, the Ecuadorian government was relying almost exclusively on the import duty to prevent transfer pricing. Price lists are not used to establish maximum prices. However, this may not prevent transfer pricing. Further, with other countries in the Andean Pact — countries for which a much lower tariff schedule applies — the goal of deterrence may not be

be expected that, under this arrangement, and due to the ad valorem tax, little over-invoicing of imported consumer goods would occur. However, the provisions do not prevent over-invoicing of capital goods and components usually exempt from customs duties. Under the provisions of Article 24, the burden of persuasion is placed upon the importers to ". . . substantiate the fact that the declared prices are in agreement with the normal prices in the country of origin."⁹³

Regarding intra-company transfers in particular, the Ecuadorian Law contains a provision which places the burden of persuasion on the interrelated companies to prove any contractual arrangement they had between themselves.⁹⁴

Ecuador's Central Bank oversees export and import procedures. It controls letter of credit issuances, collection authorizations and import licenses, as well as terms for import payment.⁹⁵ In

achieved. In fact, there are rumors that shrimp exporters have been using transfer pricing quite effectively to their advantage in Ecuador. Telephone interview with Toni Diamond, Finance Officer for Ecuador, Ford Finance, in Miami, Florida (Oct. 13, 1988).

93. DUN'S MARKETING SERVICES, *supra* note 90, at 2.448.

94. 1 FOREIGN TAX LAW ASSOCIATION, ECUADOR INCOME TAX SERVICE 31 (1986). This section provides:

Article 46. Transactions Among Companies or Affiliated Individuals: The transactions carried out among companies or associated persons among themselves, of which a person or company is not subject to the income tax of Ecuador, they will be required to present evidence, proof or special documentation which establishes the bargain and sale or transfer of machinery, products, lands, transfers of rental, payments for services, whatever their nature may be, etc. For the purposes considered here, the Director's Office of Income Tax can establish specific individual regulations, to which the person or company who should pay the income tax in Ecuador will be subject, so that the computation of the tax caused, is the most beneficial to the country. Similarly, if a company or person is engaged in operations, a part of which is subject to the income tax, and the other not, the declaration rendered for the purposes of the income tax, can be submitted to specific individual regulations or provisions which the Director's Office of Income Tax will dictate.

According to one exporter, proving a price is particularly difficult when insurance, transport and installation are included along with the sale of products. The Ecuadorian government can demand a breakdown of all U.S. and Ecuadorian costs. Many expenses may not qualify, and the exporter could stand to lose a great deal of money if the transaction is not well documented. That same exporter stated that he personally lost US\$30 to US\$40 thousand dollars in sucres (the unit of currency in Ecuador, divided into 100 centavos) because of pre-shipment inspection delays of several weeks and disqualifications by the SGS. Other exporters have also lost large sums of money. In conclusion, he stated that exporters were not opposed to a reasonable and honest checking system, but that the system the SGS employed created a mess that was simply "ridiculous." Telephone conversation with Mr. Rafael Portela, Senior Vice President and Director, Contract Division, Calmaquip Engineering Corp., in Miami, Florida (Sept. 13, 1988).

95. U.S. DEPT. COMMERCE, OVERSEAS BUSINESS REPORTS: MARKETING IN ECUADOR 6

the past, the Central Bank had a contract with the Societe Generale de Surveillance S.A. (SGS) to physically inspect the quality, quantity, and price of exports.⁹⁶ After the SGS had inspected the export or import, it issued a "Report of Findings" containing its opinion of the transaction.⁹⁷ A "Clean Report of Findings" would satisfy the Central Bank as to the quality, quantity, and price of the export.

IV. HOW ECUADOR MIGHT BETTER DETER TRANSFER PRICING ABUSE

Ecuador has a simpler, more discretionary system for controlling abuse than does Argentina. Because the Febres Cordero Administration in Ecuador attempted to alleviate the country's internal economic crisis⁹⁸ by liberalizing domestic regulation of foreign investment,⁹⁹ the incoming government may wish to preserve whatever progress was made and should, perhaps, reconsider the further regulation of transfer pricing. In so doing, the government should analyze the potential impact on the present economy of a change in transfer pricing regulation. Because Argentina has a more highly developed tax code, Ecuador should begin by examining how Argentina tackles the same problem. Of course, Ecuador will want to consider other options available to deter transfer pricing abuse.

(1985) [hereinafter *OVERSEAS BUSINESS REPORT*]. See also Trade Office Interview, *supra* note 34.

96. *OVERSEAS BUSINESS REPORT*, *supra* note 95. According to one official at the U.S. Embassy at Quito, the Central Bank decided to discontinue its contractual relationship with the SGS at the beginning of 1988. Because no alternative entity replaced the SGS, the Central Bank presently performs the functions previously delegated to the SGS under the contract. It is expected that the Ecuadorian government will either contract with another pre-shipment inspection firm, or re-hire the SGS in the near future. Whether the Central Bank or some other entity performs the transaction approval functions, opportunities for abuse continue to exist. The problem is exacerbated by the fact that, during the final year of its administration, the Cordero government made no attempt to confront the problem of transfer pricing. Moreover, the Borja government has not yet considered or proposed any changes to the tax code aimed at preventing such abuse. Telephone Interview with Gordon Jones, Commercial Attache, U.S. Embassy, Quito, Ecuador (Oct. 13, 1988). The Ecuadorian Trade Office affirmed that the Central Bank will continue to perform the duties once performed by the SGS. Trade Office Interview, *supra* note 34.

97. *OVERSEAS BUSINESS REPORT*, *supra* note 95.

98. U.S. DEPT. COMMERCE, *FOREIGN ECONOMIC TRENDS AND THEIR IMPLICATIONS FOR THE UNITED STATES: ECUADOR 4-11 (1986)* [hereinafter *FOREIGN ECONOMIC TRENDS*].

99. *INVESTMENT CLIMATE*, *supra* note 42, at 1-2.

A. Steps Ecuador Has Already Taken To Deter Transfer Pricing Abuse

As noted earlier, there are many reasons for engaging in transfer pricing abuse which are not motivated by a desire to evade taxes.¹⁰⁰ Ecuador has already eliminated some of the non-tax incentives for abuse. For example, Ecuador no longer requires that firms be nationally owned.¹⁰¹ Thus, parent firms with holdings in Ecuador are no longer forced to use transfer pricing as a means to repatriate profits to the parent without splitting the revenue with local owners and without paying any tax on dividends.¹⁰² Ecuador has also eliminated restrictions on repatriation of profits,¹⁰³ so that the incentive to use transfer pricing as a surrogate for repatriation is no longer present. However, shortly after the government transferred private foreign exchange transactions from the Central Bank to the free market — making transfer pricing less attractive — it withdrew this concession and increased the term for domestic currency deposits, forcing importers to deposit sucres equivalent to 100% of the value of imports for List 1B items (mostly capital goods and raw materials), and 160% for List 2 items (mostly luxury goods).¹⁰⁴ By engaging in this policy reversal, the government created an incentive to use transfer pricing as a means to avoid perceived difficulties in transacting business with the Central Bank. At this point, Ecuador may need to take additional steps toward decreasing the incentives for abuse.

100. See *supra* notes 11-13 and accompanying text.

101. INVESTMENT CLIMATE, *supra* note 42, at 1.

102. For a discussion of the problems with which Greece was faced regarding this situation, see Roumeliotis, *supra* note 26.

103. INVESTMENT CLIMATE, *supra* note 42, at 1. See also THE ECONOMIST INTELLIGENCE UNIT, COUNTRY PROFILE: ECUADOR 40 (1988) [hereinafter COUNTRY PROFILE]. As an encouragement to foreign investors, the new government in Ecuador has also taken economic measures to put its house in order. *Ecuador Announces Steps to Stem Economic Crisis*, J. Commerce (Sept. 1, 1988).

104. INVESTMENT CLIMATE, *supra* note 42, at 9. For details regarding the exchange rate, see COUNTRY PROFILE, *supra* note 103, at 40. For details on the requirements for approval of the transaction by the Central Bank, see *id.* at 12. The general perception that Ecuador is in the midst of an economic and political crisis adds to the incentive for transfer pricing abuse. For a summary of the political and economic problems facing the nation, see Martz, *Instability in Ecuador*, 87 CURRENT HIST. 17 (1988). Moreover, Ecuador's inability to repay its debt may further deter investment in the country. *Ecuador May Withhold Some Debt Payments*, J. Commerce (Sept. 2, 1988). See also *Official Says Country Must Renegotiate Debt*, Quito Voz de los Andes, Oct. 29, 1988, as reprinted in 88-213 Foreign Broadcast Information Service — Latin America (FBIS-LAT), Nov. 3, 1988, at 38.

B. An Examination of the Alternatives Available to Ecuador

Transfer pricing abuse is most likely to occur with finished or consumer goods, which are subject to import and value added taxes, because over-invoicing to transfer profit abroad will only result in increased import and value added taxes. By contrast, however, intermediate goods, capital goods, and raw materials carry relatively little import duty, and thus are more likely to be the subject of abuse. Similarly, where services are treated unfavorably, either by denial of deductibility or by imposition of a gross withholding tax, the benefits to be derived from transfer pricing abuse will be small enough to deter significantly any such actions. However, where services are subject to a low rate of withholding tax and deductibility, the advantages of, and opportunities for abuse will be significantly enhanced. Thus, with regard to those transfers in which the payment is deductible in Ecuador and little tax is levied on the transfer payment, abuse will be most likely to occur.

There are a number of methods Ecuador can use to deter transfer pricing abuse. In attempting to employ a method which utilizes the correct arm's length price, Ecuador should always begin by inquiring whether the expense is legitimate in the first place. Assuming that it is, Ecuador can go on to estimate a defensible transfer price. The method of establishing an actual transfer price through formal accounting procedures is currently used by Ecuador, and by Argentina for transactions involving goods. Other methods include: taxing intra-firm transfers; limiting the deductibility of certain expenses for services, as Argentina does; imposing artificial restraints; and using notional pricing for exports. There are two options which do not try to establish a true transfer price. The first involves a tax on world income, with tax credits given for foreign tax paid. This is a variation on the idea that there should be a single, world tax rate. The second of these options is the utilization of an apportionment scheme. While none of these approaches is perfect, some are better suited to Ecuador's situation than are others. Each alternative will be discussed and evaluated below, with an eye toward finding the least objectionable method by which Ecuador may deter transfer pricing abuse.

1. Attempt to establish the actual transfer price through formal accounting

At present, Ecuador attempts to determine the actual transfer price on a case-by-case basis.¹⁰⁵ The Ecuadorian code may thus appear quite unfavorable to multinational corporations, which have the burden of establishing that their prices are in conformity with normal prices.¹⁰⁶ Until recently, the SGS had a great deal of discretion in the implementation of this policy,¹⁰⁷ and very little guidance was available to investors who wanted to know exactly how the SGS reached its decisions and recommendations.¹⁰⁸ At the beginning of 1988, the formal accounting process once again became the responsibility of the Central Bank, although it remains quite possible that the government will enter into another contract with the SGS (or another firm) to handle the procedure.

The multinational corporations which Ecuador seeks to attract require more specific guidelines as to how the formal accounting process works, so that they have some indication of whether their transfer prices will meet with approval. Ecuador could create a more certain investment climate by limiting and defining the role of the Central Bank (or whomever is in charge of the pre-shipment inspection).¹⁰⁹ The Office of the United States Trade Representa-

105. See *supra* notes 81-84 and accompanying text.

106. DUN'S MARKETING SERVICES, *supra* note 90, at 2.448.

107. See *supra* note 96. For a general discussion regarding the broad powers delegated to pre-shipment inspection firms throughout the Third World, and the problems which result from their discretionary exercise of such powers, see Barone, *Make Inspection a Trade Issue*, J. Commerce (Apr. 5, 1988).

108. See *supra* note 97. According to one exporter, not only were exporters to Ecuador unable to understand how the SGS established prices, the SGS itself, when asked to elucidate its methods and bases for determining acceptable transfer prices, could offer no explanation. The exporter tried to obtain information from the SGS, the Central Bank, and other sources within the government of Ecuador, and finally concluded that no one "had any idea what SGS was doing." The pricing system, he stated, was extremely unfavorable to exporters, who had no predictable standard by which to measure the likelihood of transfer price approval. Thus, even those exporters who set their transfer prices in good faith, according to reasonable commercial standards, may have their transactions nullified or delayed for unknown and therefore unappealable reasons, either legitimate or illegitimate. Exporters, in turn, will be encouraged to "jack up their prices to cover for the delays and the uncertainty. . . . This is ultimately paid for by the Ecuadorian people." Telephone interview with Armando Paz, Treasurer, Calmaquip Engineering Corp., in Miami, Florida (Sept. 13, 1988). For a more generalized discussion of problems that occur with pre-shipment inspections, and in particular, problems associated with the SGS in Ecuador and elsewhere, see *Pre-Shipment Checks: A Stranglehold or a Submission*, 60 TRADE FIN. 43 (1988).

109. Neither the Ecuadorian Embassy in Washington, nor the SGS offices in Miami and New York would provide the author with a copy of their agreement regulating the con-

tive has received numerous complaints about the SGS from U.S. exporters.¹¹⁰ Representatives of exporters in Florida filed, but later withdrew, a Section 301 petition concerning the SGS and other pre-shipment inspection companies operating in Latin America.¹¹¹ It is apparent that dissatisfaction with the SGS and similar companies which operate as agents of foreign governments, impedes the flow of international trade.¹¹² Multinational enterprises are deterred from entering into business operations in Ecuador because of the present policy. Ecuador might change this situation by adopting the approach of Argentina, and spelling out in a more predictable and calculable manner how transfer prices are established for transactions involving goods. Like Argentina, Ecuador already has provisions establishing a credible price monitoring mechanism.¹¹³ However, Argentina, unlike Ecuador, places the explicit use of these mechanisms in the Tax Law.¹¹⁴ While Ecuador uses price listings overseas as a means to check abuse in a highly discretionary process,¹¹⁵ Argentina uses similar information to create a range of objectively verifiable transfer prices.¹¹⁶ This difference is significant, in that a foreign entity may perceive that Ecuador uses the price lists to make discretionary judgments, whereas Argentina presumes transfer prices to be reasonable and defensible and only uses the lists to check serious abuse in cases where prices are truly out of line. Although in reality both countries may make identical use of the lists, Argentina's approach seems more conducive and conciliatory to foreign investment. In short, Ecuador may wish to consider modifying public use of lists designed to check

duct of the SGS. The U.S. Departments of State and of Commerce similarly did not have a copy of the agreement for distribution. The State Department informed the author that the details of the agreement were confidential and not available to the public. This situation is a disincentive for investment in Ecuador because potential investors cannot obtain information on import guidelines.

According to British trade law professor, Clive Schmitthoff, "Exporters have complained that the inspection organization insisted on an unjustified reduction of a price firmly agreed with the overseas buyer, or that it demanded the disclosure of a price calculation regarded as confidential." *Pre-Shipment Checks: A Stranglehold or a Submission*, *supra* note 108. For further criticism of pre-shipment inspections, see Barone, *supra* note 107.

110. Telephone interview with Betsy Stillman, Director for Andean and Caribbean Affairs, United States Trade Representative (Apr. 9, 1987).

111. *Id.* See also 51 Fed. Reg. 32,387 (1986).

112. *Id.* See also 51 Fed. Reg. 32,387 (1986).

113. See *supra* note 92.

114. See *supra* notes 72-76 and accompanying text.

115. See *supra* notes 90-95 and accompanying text.

116. See *supra* notes 72-76 and accompanying text.

transfer pricing abuse in order to alter the present perception that judgments are discretionary.

In addition to having an explicit price monitoring system, Ecuador could take two additional steps to ensure that actual transfer prices are in conformity with reported prices. First, Ecuador could audit the firm to verify reported prices. Tax authorities could gather information on prices from a variety of sources: other branches of government; Andean Pact and OPEC nations; other international agencies; the firm itself; and other nations. Because other nations may be reluctant to freely divulge such information without a bilateral treaty, Ecuador may wish to enter into agreements with its major trade partners to exchange information.¹¹⁷ On the other hand, when entering into tax treaties with tax haven nations, Ecuador should insist on exchange of information agreements with these jurisdictions.¹¹⁸ As an enticement to be party to such an agreement, Ecuador, along with other Andean Pact nations, could threaten to increase taxation on transactions with tax havens, as well as increase penalties for proven abuse in these areas. Further, Ecuador might impose a higher burden of proof on corporations dealing in tax havens to justify their transfer prices.

Second, correlative price adjustments should also be considered,¹¹⁹ and could best be implemented where a tax treaty is in place. This would minimize the risk of double taxation while preventing transfer pricing abuse. Unfortunately, Ecuador has no single policy regarding the avoidance of double taxation.¹²⁰ The only nations with which it has ratified and signed a tax treaty are those of the Andean Pact.¹²¹ Thus, when Ecuador audits a firm, Ecuador may wish to use a correlative adjustment procedure. This would allow any upward adjustment in Ecuador to be matched

117. Casey, *supra* note 2, at 240-41 (recommending the negotiation of international agreements for cooperation to assist governments in prohibiting transfer price manipulation).

Ecuador's major markets in 1984 were: United States, 64 percent; Latin American Integration Association (ALADI), three percent; and the European Community, three percent. Ecuador's major suppliers in 1984 were: United States, 32 percent; the European Community, 16 percent; Japan, 13 percent, and ALADI, 19 percent. U.S. Dept. State, Bureau of Public Affairs, *Background Notes: Ecuador* 1 (1986).

118. Fiddlers, *supra* note 6, at 109.

119. This is also referred to as "corresponding adjustments." OECD/1984, *supra* note 45, at 9.

120. PRICE WATERHOUSE/Ecuador, *supra* note 81, at 94.

121. The Andean Pact consists of Bolivia, Colombia, Peru, and Venezuela. See *id.* Ecuador has no other signed tax treaties. See DELOITTE, *supra* note 80, at 11.

with a downward adjustment in the host country. The opposite would also hold true. There are two benefits to this procedure. First, it avoids the threat of double taxation.¹²² Second, by not punishing the firm for arriving at a different conclusion than did the government, it acknowledges the difficulties in setting transfer prices. Thus, the mechanism ensures that the government can establish an arm's length price without discouraging foreign investment.¹²³ Although correlative adjustment mechanisms are highly regarded by some, one limitation on use of the mechanism is that

. . . the competent authorities have only a duty to negotiate; they are not required to reach an agreement, nor are they required to implement it when reached and; indeed, they may be unable to do so because of conflicting domestic law — such as that imposing time limits on the adjustment of assessments or on the making of refunds of tax. In the view of [multinational enterprises] this is a serious weakness in the arrangements.¹²⁴

Furthermore, these arrangements empirically have been slow and unpredictable.¹²⁵ In addition, despite the 1979 OECD Model Convention's provisions,¹²⁶ Ecuador's correlative price mechanism should require and make explicit that Ecuador decides each case on its own merits. This would counteract the corporations' fear that when tax authorities attempt to agree, they may compromise one company's claim for that of another.¹²⁷ The mechanism should also allow for the corporations to be kept abreast of progress and discussions concerning the corporation's case.¹²⁸

Finally, treaties could allow for the creation of binding arbitration between member nations when they disagree on the appro-

122. *Fiddlers*, *supra* note 6, at 109 (claiming that large scale, simultaneous audits by several jurisdictions will become more popular with international tax authorities in the coming years).

123. For a more detailed discussion of correlative adjustment mechanisms, see Irish, *supra* note 4, at 60. For a model provision showing how this mechanism would work, see MODEL CONVENTION art. 9, cl. 2 (OECD 1979) [hereinafter OECD/1979]. For a similar provision by the United Nations Group of Tax Experts, see Surrey, *United Nations Group of Experts and the Guidelines for Tax Treaties between Developed and Developing Countries*, 19 HARV. INT'L L.J. 1, 54 (1978). See generally UNITED NATIONS DEPT. INT'L ECON. & SOCIAL AFFAIRS, TAX TREATIES BETWEEN DEVELOPED AND DEVELOPING COUNTRIES — SIXTH REPORT, 1976, U.N. Sales No. E.76.XVI.3 (1980).

124. OECD/1984, *supra* note 45, at 17.

125. *Id.* at 8.

126. OECD/1979, *supra* note 123.

127. OECD/1984, *supra* note 45, at 18.

128. For a discussion of concerns about how this might function, see *id.* at 33.

priate transfer price.¹²⁹ This would aid to shore up the corporate perception of correlative price mechanisms by ensuring against the threat of double taxation. Further, exchange of information through treaty arrangements would enable Ecuador to have a better understanding of the operations of multinational corporations, improve their own audit abilities and monitor the pricing of firms with less administrative cost.¹³⁰

Argentina's and Ecuador's present case-by-case method is only one of the options available in the regulation of transfer pricing in the area of intangible property. The United Nations has outlined the two main approaches most commonly taken.¹³¹ The first approach involves either a lump sum payment for the patent or intangible property, or a royalty fixed in relation to a specific base such as gross sales, or production.¹³² The second approach involves the sharing of research and development costs among related companies.¹³³ Ecuador could utilize both approaches, together with tax treaties and correlative adjustment procedures,¹³⁴ to develop a mechanism that would allow for legitimate expenses while guarding against abuse.

Determination of an arm's length price using monitoring, audits, and correlative adjustments works best when comparable goods are available on the open market. When no comparable good is available on the open market, and in the case of pricing services and intangibles, an appropriate price may be difficult or impossible to ascertain because there are no readily identifiable and comparable open market transactions, "comparable uncontrolled price methods"¹³⁵ of calculating the actual transfer price will not work.

129. The European Economic Community has a Draft Directive of the European Communities by the Assembly of the Communities and by the Economic and Social Committee under the Treaty of Rome, which essentially outlines how this could work. It is discussed in OECD/1984, *supra* note 45, at 21-25. A treaty solely between two nations should be more workable than the EEC one, which is quite complex.

130. Monitoring multinational corporations has been troublesome, even for the United States Internal Revenue Service. A treaty would do much to help Ecuador. *See generally* GLOBAL REACH, *supra* note 13, at 206, 282-83.

131. UNITED NATIONS, TAX TREATIES BETWEEN DEVELOPED AND DEVELOPING COUNTRIES — SEVENTH REPORT, 1978, at 35-36, U.N. Sales No. E.78.XVI.1 (1978) [hereinafter SEVENTH REPORT].

132. This appears to be the approach taken by Argentina.

133. For a more detailed discussion of these options, see generally Irish, *supra* note 4, at 22-25.

134. *See supra* notes 119-25 and accompanying text.

135. This is defined and discussed in OECD, TRANSFER PRICING AND MULTINATIONAL ENTERPRISES 34-38 (1979) [hereinafter OECD/TRANSFER PRICING].

The "resale price method"¹³⁶ is similarly plagued in those instances where there is a great deal of disagreement over what a "fair" mark-up for profit should be, or indeed whether there should be a profit at all. The "cost plus method" runs into trouble when the definition of "costs" is debated. For example, do costs include research, advertising, or management? Finally, the "negotiated price method" may be the worst method of all.¹³⁷ In the give and take of negotiation, the final price is often based on criteria which are not objectively verifiable. Moreover, this is the crux of the present criticism of the Ecuadorian system.¹³⁸ Thus, the determination of actual transfer prices should be explicitly limited to the area where it works best — transactions involving goods for which there is an ascertainable open market price.

In addition to considering Argentina's price guideline method of checking transfer pricing abuse with respect to goods,¹³⁹ Ecuador may wish to consider some of the following options.

2. Taxation of intra-firm transfers

With regard to goods being sold to Ecuadorian companies, there is less chance of over-invoicing due to ad valorem duties or the value added tax placed on most imported goods.¹⁴⁰ However, for those goods not covered by the import ad valorem tax,¹⁴¹ as well as for services and intangibles, a tax on intra-firm transfers might be desirable to curb abusive transfer pricing. This would entail placing a withholding tax or a net income tax on the profit portion of the intra-firm transactions. Unfortunately, this method has a number of drawbacks.

First, there is the problem of determining which sales should be taxed. If Ecuador only taxes sales within the jurisdiction, a company can move the place of sale across the frontier. If extra-territorial sales are taxed, problems result with respect to taxing an

136. *Id.* at 38-40.

137. *See, e.g., Fiddlers, supra* note 6.

138. *See supra* note 109 and accompanying text.

139. Argentina's guidelines are similar to those suggested by the OECD Model Convention. *See* OECD/1979, *supra* note 123. *See also* TOUCHE ROSS INTERNATIONAL, TAX AND INVESTMENT PROFILE: ARGENTINA, *supra* note 53, at 32.

140. The value added tax is summarized in TOUCHE ROSS INTERNATIONAL: ECUADOR, *supra* note 77, at 18; DELOITTE, *supra* note 80, at 43.

141. Exempt items include medicine, magazines, books, newspapers, basic food products, exports, and other products. DELOITTE, *supra* note 80, at 43.

entity which is not a permanent establishment.

Second, services can easily be rendered outside of the taxing jurisdiction. Thus, unless Ecuador decides to tax services provided outside of Ecuador and ignore the lack of permanent establishment, Ecuador will not have a basis for taxing the provider of the service.

Ecuador might consider denying to Ecuadorian entities the deductibility of transactions beyond Ecuador's tax jurisdiction. Yet this might result in the denial of deductions for legitimate expenses, thereby motivating firms to engage in transfer pricing in other areas to make up for the loss in deductibility. Further, it would negate the positive steps Ecuador has already taken to curb abuse.¹⁴² Thus, this is not a very satisfactory method of preventing abusive transfer pricing in Ecuador.

Argentina's scheme forbids a subsidiary or branch of a foreign corporation to deduct royalty expenses from gross income.¹⁴³ While this rule does give domestic firms a competitive advantage over the operations of foreign entities in Argentina, it may also serve to discourage foreign investment in that jurisdiction, since the rule eliminates the deductibility of legitimate expenses of a corporation. Argentina, because it is newly industrialized, and because multinational corporations prefer more developed markets, may be able to do this without causing investment disincentive.¹⁴⁴ Ecuador, however, cannot afford to discourage investment by adopting the Argentine rule. At present, Ecuadorian law calls for approval of royalty expense deductions and deductions for other intellectual property on a case-by-case basis,¹⁴⁵ with no deduction being given for related party transactions.¹⁴⁶ Ecuador's provisions regarding royalties could be modified to allow for defensible transfer prices without as much discretionary judgment as is now the case. This would better reflect the reality of international transactions and would decrease the motivation to engage in transfer pricing abuse

142. See *supra* notes 40-42 and accompanying text.

143. See *supra* notes 66-67 and accompanying text. Interestingly, this rule is contrary to the general rule of deductibility of license and royalty expenses paid to overseas companies by domestic firms. *Id.*

144. See THIRD SURVEY, *supra* note 18.

145. See *supra* note 81 and accompanying text.

146. *Id.* As noted earlier, even Argentina allows a deduction for related party transactions involving licenses, patents, knowledge, engineering, installation, assistance, and other services, provided that they are approved by the Authority of Application. See *supra* notes 58-61 and accompanying text.

in other activities. Further, a liberalization in this area would offset tightening restrictions in other areas. So long as the Ecuadorian government realizes the difficulties of setting a transfer price and allows the corporations a "good faith" range in which to set prices, liberalization of provisions regarding royalties and other transfers could enhance Ecuador's investment image.

3. Limiting the deductibility of expenses

Another method to deter abuse which Ecuador may wish to consider is using limitations on the deductibility of certain expenses. Argentina allows deductions for fees, salaries, and other remuneration to foreign members of a company's corporate board of directors.¹⁴⁷ However, the deductions are capped by objective, easy to compute formulas. Ecuador considers this a "payment for services" under Article 46, which again places the burden on the firm to establish the merit of the transaction.¹⁴⁸ Not only does Ecuador's provision increase uncertainty, but it also has the potential for creating a perception of uneven enforcement. The merit of Argentina's provision is that it is easy to enforce, as well as easy to comply with. As Ecuador already allows a deduction, a less discretionary standard may prove more manageable for both government and business.

Argentina allows the deduction of expenses for technology, financial assistance and other help from abroad even if the entities are related.¹⁴⁹ Yet, as with remuneration to board members, Argentina places an easily calculated, objective cap on the deductibility of these expenses.¹⁵⁰ In contrast, Ecuador places the burden on the parties to prove the legitimacy of the expenses before allowing a deduction.¹⁵¹ Again, a liberalization of Ecuador's approach in this area might prove beneficial.

Argentina's approach with respect to remuneration to board members has the advantage of allowing for legitimate expenses while insuring that the deductions do not deviate too radically from the expected norm. Ecuador's case-by-case approach is a disincentive to foreign capital investment. Companies now required to

147. See *supra* notes 68-69 and accompanying text.

148. See *supra* note 94 and accompanying text.

149. See *supra* notes 70-72 and accompanying text.

150. *Id.*

151. DUN'S MARKETING SERVICES, *supra* note 90, at 2.448.

report to the Director's Office of Income Tax for specific individual regulations computed in a manner "most beneficial to the country,"¹⁵² could, under this scheme, deduct defensible assistance expenses up to a reasonable limit.

On closer inspection, it becomes apparent this proposal is flawed as well. The determination of the expense is no more certain here than was the establishment of an actual transfer price under previous methods. This proposal has the additional limitation of not allowing for legitimate expenses above a certain artificially-imposed cap. Thus, this method also is vulnerable to criticism.

4. Artificial restraints

Artificial restraints are yet another way to prevent abuse. Under this method, Ecuador would ban certain types of suspect payments to related entities outside of Ecuador. At present, Argentina bars any transfer price payment for trademarks.¹⁵³ This is probably the most drastic and least desirable method in today's business world, where firms are often dependent on related entities for information and expertise, trademarks, patents, engineering, machines, liquidity, and so on. Again, given the strides Ecuador has taken to deter abusive transfer pricing by improving the economic climate,¹⁵⁴ this approach may be least desirable for Ecuador.

5. Notional prices

Posted or notional prices are often used for primary commodities. This method establishes the price of a primary good as a percentage of a downstream product for which a price is available. Such a system is also available for intermediate goods.¹⁵⁵ Thus, this mechanism can be used to establish an objectively verifiable transfer price.¹⁵⁶

Notional prices can be used to check transfer pricing abuse with regard to primary products. Basically, notional prices amount

152. *Id.*

153. See PRICE WATERHOUSE, *supra* note 58.

154. See *supra* notes 39-41 and accompanying text.

155. *Supra* note 33, at 20.

156. See generally Irish, *supra* note 4, at 27-28; SEVENTH REPORT, *supra* note 131, at 34-35.

to an official export price listed by the government. They have the advantages of being both extremely easy to calculate and predictable. On the down side, notional prices can only be established where open market prices allow for such a price. Thus, the method is not really very practical where intangibles, services, and non-open market goods are involved. Given these shortcomings, the use of notional prices should be limited to the export of primary products.

The last two options available to Ecuador do not attempt to use methods to estimate the true transfer price. Instead, they break from these earlier methods by trying to use generalizations rather than accounting formalities to estimate a proper income allocation.

6. Taxation of world income with tax credits

If there were a globally uniform tax rate, the tax evasion incentive for transfer pricing would disappear.¹⁵⁷ Whether profits surfaced in one country or another, the same tax would be due. Unfortunately, such a system does not now exist. Further, there may be policy reasons why such a system would be undesirable. Developing countries may wish to give tax incentives to encourage investment. Tax havens, which owe their wealth to their tax status, will obviously be reluctant to join in with such a plan. Thus, this concept is not feasible in today's economic world.

Yet Ecuador could consider a similar plan in an adapted form. This would entail computing the tax base as a company's worldwide income and then giving tax credits for taxes already paid overseas. Under this system, to the extent that a company is able to move profits from a high tax jurisdiction to another lower tax jurisdiction, the reward for such a transfer will be non-existent, because less tax credits will be accumulated in the low tax jurisdiction. In theory, this would put an end to the tax evasion incentive for transfer pricing abuse.

However, this system creates many additional problems. First, the scheme does nothing to discourage non-tax reasons for transfer

157. For a discussion of "international harmonization of taxes," see S. PLASSCHAERT, *supra* note 15, at 14, 104-05. Interestingly, Pope Paul VI's statements during Vatican II support the notion of a worldwide tax system. See R. BROWN, *THEOLOGY IN A NEW KEY* 33 (1978). Similarly, the World Council of Churches, a main line Protestant organization, has called for a system of international taxation for world development. *Id.* at 41.

pricing abuse.¹⁵⁸ Second, other developing nations would object to this formulation because it would financially deprive companies of the benefits they receive from operating in countries which grant tax holidays as a means to stimulate investment. Third, Ecuador would in effect be able to tax non-Ecuadorian foreign source income any time a company conducted business in any other country which had a lower tax rate than that of Ecuador. This would mean that corporations would be deterred from conducting business in Ecuador. Thus, this approach is not one which Ecuador should seriously consider.

7. Apportionment schemes

A final method by which Ecuador could effectively tax corporations on their Ecuadorian income and deter transfer pricing abuse is the use of an apportionment mechanism. This method taxes the entire unitary corporation on a portion of its worldwide income.¹⁵⁹ The portion taxed is determined by an apportionment formula, which allocates world income on the basis of such factors as sales,¹⁶⁰ property, and payroll. Many American states have apportionment formulas, although the formulas vary from state to state.¹⁶¹ However, many states subscribe to the Council of State Government's "Multistate Tax Compact,"¹⁶² which the U.S. Supreme Court has held to be valid, despite the fact that it lacks Congressional endorsement.¹⁶³ The compact outlines a uniform formula for allocating income for net income tax purposes among the states.¹⁶⁴

The apportionment method has a number of virtues. First, it is easy to administer. Ecuador would not need to conduct elaborate audits to discover the "true" transfer price because transfer prices

158. Irish, *supra* note 4, at 75.

159. *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159 (1983).

160. *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978) (upholding Iowa's single factor formula as applied, based on percentage of sales in the state).

161. For example, Wisconsin has a statute on allocation, apportionment, and situs of income. WIS. STAT. § 71.07 (1985).

162. The compact is laid out in Corrigan, *Interstate Corporate Income Taxation — Recent Revolutions and a Modern Response*, 29 VAND. L. REV. 470 (1976).

163. *United States Steel Corp. v. Multistate Tax Comm'n*, 434 U.S. 452 (1978). See also Brooks, *Worldwide Combination Upheld at Cost to the Commerce Clause*, 2 J. STATE TAX 293-314 (1984); Christian, Howe & Harrington, *State Power to Tax Interstate Carriers: The Supreme Court's Decision in Burlington Northern Railroad Co. v. Oklahoma Tax Commission*, 55 TRANSP. PRAC. J. 219-41 (1988).

164. For a discussion of the compact, see Corrigan, *supra* note 162, at 423.

are irrelevant under this scheme. Multinationals can set the transfer price at whatever they like without influencing the overall profit of the unitary corporation. Second, it is predictable. Unlike the "fuzzy" nature of transfer pricing, apportionment formulas are clear and objective. This also aids in the avoidance of the favoritism presently engaged in by the tax administration under Ecuador's current system of discretion. Third, many multinationals operating in the United States are already familiar with the system and are accustomed to using it.¹⁶⁵ Even though the method is not popular outside of the United States, the fact that it has wide currency within the country suggests that it could be employed elsewhere.

Still, there are criticisms of apportionment systems. First, it may result in over- and under-taxation. For example, if parent of Unitary Corporation is located in country A, and related corporation, Subsidiary, is located in country B, if the overall profits of Unitary Corporation are \$100.00, an apportionment formula might allocate this profit \$50.00 to parent and \$50.00 to Subsidiary, assuming that labor, sales, and property were equally distributed between the two jurisdictions. However, in actuality, Subsidiary may have had a profit of \$120.00, and parent a loss of \$20.00, or vice-versa. Thus, the apportionment formula would over- or under-tax the entity.¹⁶⁶ But this criticism ignores the fact that apportionment allows the flexibility of averaging of taxes and income. Over- and under-taxation is the strength of apportionment because it allows corporations to use profits which would be taxed in one jurisdiction for investment in new areas which may create losses in the early years due to start-up expenses.

Second, critics of apportionment claim that the record-keeping involved in the system is too burdensome. Yet, since corporations operating in the United States are required to keep such records, many multinationals already have the records available. Ecuador could further ease the record-keeping burden by allowing records to be denominated in U.S. dollars instead of requiring that they be translated into sucres.

Third, it is argued that the system is unpopular with multinationals. Some American states have repealed their laws mandating

165. For an opposing viewpoint, see OECD/TRANSFER PRICING, *supra* note 135, at 14 (calling "global" methods "radical," and noting their non-conformity with Articles 7 and 9 of the OECD Model Double Taxation Convention).

166. *Id.* at 14 (global methods of income allocation called "arbitrary").

a unitary formula after foreign businesses threatened to pull out of the state.¹⁶⁷ In this respect, the apportionment method is admittedly quite controversial. However, it is important to note that the threats came to the states from foreign multinational corporations. Further, such objections may be a response to the certainty of taxation involved with this system. Apportionment allows for no transfer price evasion of tax. Thus, the objections by multinationals may be seen in another light as an acknowledgement of the perceived effectiveness of the plan at preventing tax evasion.

Fourth, apportionment has been criticized in the United States because it involves the states in the diplomatic arena. Indeed, while the Supreme Court has never flunked an apportionment scheme on its face, "Congress could prevent the use of the unitary business concept, and . . . a treaty might also forbid employing the concept."¹⁶⁸ Indeed, Congress has in one case mandated that states may not tax foreign corporations if all they do in the state is solicit orders.¹⁶⁹ Thus, states may be reluctant to adopt such a scheme because of a fear of later federal intervention. However, Ecuador need not have these concerns, being a sovereign nation. Thus, the appeal of apportionment becomes stronger.

Fifth, apportionment presents the problem of precisely defining a "unitary corporation." Depending upon the circumstances, tax authorities may want a broad interpretation, while corporations may desire a narrow view, or vice-versa. The inclusion of more overseas entities in a unitary corporation will yield two results. First, it will increase the income subject to apportionment. Second, it will decrease the percentage of that income which will be attributable to the jurisdiction. The U.S. Supreme Court has held that the taxpayer always has the "distinct burden of showing by 'clear and cogent evidence' that [the state tax] results in extra-territorial values being taxed."¹⁷⁰ Thus, the U.S. standard is a starting point. Ecuadorian tax officials could make their best calculation as to what constitutes a unitary corporation under Ecuadorian tax law and then place the burden on the taxpayer to rebut the presumption.

Sixth, apportionment raises the possibility of double taxa-

167. Baldwin & O'Conner, Notes for Constitutional Law I 25 (Fall 1986) (unpublished notes for a course taught at the University of Wisconsin Madison Law School).

168. *Id.* at 24.

169. *Container Corporation of America v. Franchise Tax Bd.*, 463 U.S. 159, 175 (1983).

170. *Container Corp. of America*, 463 U.S. at 175.

tion.¹⁷¹ Indeed, some of the income taxed by foreign nations without apportionment because attributed to a taxpayer's foreign subsidiaries, may also be taxed in Ecuador as the Ecuadorian portion of the total income of the unitary corporation of which Ecuadorian operations were a part.¹⁷² Yet double taxation is not an inevitable result of apportionment. Apportionment merely uses mathematical generalizations to estimate the allocation of income, while the arm's length approaches utilize complex and formal accounting mechanisms. From one point of view, allocation on the basis of the factors of production and the amount of sales is a more accurate measure than allocation on the basis of arm's length accounting formalities.¹⁷³ Thus, if double taxation results because of Ecuador's acceptance of the apportionment notion, it may be as much due to the inaccuracy of the arm's length approach as to the overreaching of the apportionment scheme.

In order to reduce the threat of double taxation under the apportionment method, Ecuador could take several steps. First, it might develop its own multi-nation tax compact and encourage Andean Pact nations to consider joining.¹⁷⁴ This would establish a uniform formula, and help to avoid double taxation resulting from differing formulas. Second, Ecuador could use tax treaties as a means of coordinating taxation with other jurisdictions so as to avoid double taxation — something Ecuador does not now do even under the arm's length approach.¹⁷⁵ Third, Ecuador could use apportionment to set the level of taxation, while allowing corporations to petition tax authorities when threats of double taxation arise. Tax authorities could then consider the merits of the case and decide the case accordingly.

Ecuador's present economic situation would improve under the apportionment method. Ecuador's manufacturing sector is geared primarily for the internal market.¹⁷⁶ Additionally, Ecuador is a net importer of wheat and livestock.¹⁷⁷ Thus, arm's length ap-

171. OECD/TRANSFER PRICING, *supra* note 135, at 15.

172. This is analogous to the situation in *Container Corp.*, 463 U.S. 159.

173. Indeed, the United States uses apportionment in a number of cases in which formal accounting fails to produce an appropriate allocation. This is the "residual" method under I.R.C. § 482 (1988). Internationally, apportionment is accepted and used in shipping and air transport.

174. S. PLASSCHAERT, *supra* note 15, at 14 (advocating regional harmonization).

175. See *supra* note 119 and accompanying text.

176. U.S. Dept. State, *supra* note 117, at 7.

177. *Id.*

proaches, which are useful in these areas, would be put to little use in regulating exports. However, Ecuador's big export is oil.¹⁷⁸ While notional prices are useful with such a commodity, determining expenses for such things as know-how, exploration, and research would be troublesome. Further, the complexities will be enhanced since multinationals such as Occidental, Belco, Esso/Hispanoil, Conoco, British Petroleum and Texaco/Pecten currently have contracts in Ecuador. Thus, a more certain and predictable measure like apportionment might be preferred.

V. CONCLUSION

Transfer pricing abuse is an available tool for tax evasion. There is a great potential for abuse which, if left unchecked, could result in significant tax evasion. However, countries like Ecuador need to consider the policy implications of exercising stricter control over transfer pricing. Ecuador has already taken a number of steps to control transfer pricing abuse. What remains to be done is to select an appropriate mechanism for improving Ecuador's current system.

There are a number of approaches Ecuador could take to control transfer pricing abuse. Basically, the approaches fall into two categories: those which use accounting principles to determine a defensible transfer price based on the arm's length concept as a means to allocate income, and those which use mathematical generalizations to allocate income. Each of these approaches has faults. Thus, selection becomes a process of weighing costs and benefits.

The first option, determination of the "actual" transfer price, is most successful when used for transactions in goods for which an open market price exists. It is not as effective when dealing with non-open market goods, services and intangibles. Its efficiency can be enhanced, however, by using monitoring systems, audits, tax treaties, and correlative price adjustments. Computation of a transfer price will be very difficult under this approach and may not be any more accurate than under other measures.

Another method to deter transfer pricing abuse is the taxation of related party transfers. This works best for services and intangibles, which are not subject to the value added tax. Yet,

178. *Id.*

problems surface as to what sales and services should be taxed if they are provided overseas. Were Ecuador to tax overseas services and sales, it might compromise the progress which it has already made. Thus, this method is probably not the one best suited for Ecuador.

A third method limits the deductibility of expenses. Yet this method, too, is faulted for not allowing for legitimate deductions. Since Ecuador's last two administrations have been attempting to make Ecuador a better place for investment, this would be a step backwards.

Artificial restraints are a fourth option. Under this system, certain expenses may not be charged by a parent to its subsidiary. Argentina's ban on payments for the use of trademarks is an example of an artificial restraint. This approach also discourages business by disallowing legitimate related party expenses. Thus, this approach should not be used in the case of Ecuador, which, unlike the larger and more economically developed Argentina, cannot afford to discourage investment.

Notional prices are a fifth option. These can be used only with primary products for which an open market price exists. They are not very useful when dealing with vertically integrated firms, such as Ecuador has in its area of primary export — oil. Thus, this method would be of limited value to Ecuador.

The sixth and seventh options differ from the previous five in that they break away from trying to establish an arm's length price. The sixth method calls for an Ecuadorian tax on worldwide income with the granting of tax credits for tax paid to other jurisdictions. Unfortunately, this sort of system is not popular internationally and would deprive companies of the benefit of investment in countries which grant tax holidays to encourage investment.

The final method, and the method this author most favors, is the apportionment method. Under this method, Ecuador would tax a unitary corporation on its worldwide income. Using an apportionment formula, Ecuador could estimate what portion of the unitary corporation's profits were Ecuadorian source income. This system is predictable and easy to administer. Further, it involves no messy attempts to determine the elusive defensible transfer price. Thus, this is the method recommended for Ecuador's use. It should be noted that apportionment may be useful even if it is not chosen as the primary method for Ecuador. It can be used as a

proxy to establish that which more formal accounting methods should produce.¹⁷⁹

If Ecuador combines these suggestions with the other economic liberalization steps which it is already in the process of implementing, it should be able to cut back on the transfer pricing abuse which is now occurring. Further, it will avoid the perception of anomalous, discretionary results. Investors will perceive the new scheme as a reduction in the bureaucracy involved in the investment process. In short, as Ecuador moves from subjective to objective criteria in its taxation, investors will find it easier to comply with the law while the government will find it easier to enforce.

179. OECD/TRANSFER PRICING, *supra* note 136, at 15.