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Treatment of Intercompany Transfer Pricing for Tax Purposes - A Survey of Legislative and Administrative Issues

Prepared by Yuichi Ikeda*

Authorized for Distribution by Milka Casanegra de Jantscher

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Abstract

Tax authorities in several countries have intensified their surveillance of intercompany transfer pricing in recent years. This paper examines the legislative and administrative issues related to the treatment of intercompany transfer pricing for tax purposes. It reviews the existing international guidelines and national rules on methods for determining appropriate transfer prices, as well as the issues related to tax administration practices for the implementation of those rules. Various systems, proposed or introduced to improve the predictability of taxation, are also examined. This paper further reviews the recent discussions on the "commensurate-with-income" standard and the pricing methodologies proposed thereunder. It finally reviews some alternative approaches to international income allocation which are proposed or adopted in lieu of the transfer pricing approach.

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Summary

Tax authorities in several countries have intensified their surveillance of transfer pricing in recent years. Concurrently, international discussions on methods for determining arm's length prices are being renewed, especially in the area of application of so-called "fourth methods" and valuation of intangible property where the existing international rules do not provide sufficient guidelines.

Developments have also taken place in the area of tax administration practices for monitoring transfer prices. More centralized administrative systems and more powerful administrative tools--for example, longer time limitations and some extraterritorial measures for collecting foreign-based information--have been introduced in some countries.

One argument against the transfer pricing approach is that it is difficult to apply the pricing rules to actual cases and to determine precisely the arm's length prices. In light of this, some systems for improving the predictability of taxation together with a prudent attitude on the part of tax authorities in their transfer pricing examination practices are essential. The system of advance pricing agreements involving prediscussions between competent authorities could particularly be important.

In spite of all these efforts, the argument remains that the application of the arm's length price rule is difficult and unpredictable. Unitary apportionment, which is a frequently proposed alternative to

international income allocation, will continue to be an important topic in international tax circles, though it is unlikely that there will soon be an international consensus for a move to this approach.

A transfer pricing policy is an important issue not only for developed countries but also for developing countries, where taxation of foreign-related businesses often represents a substantial part of total tax revenue. Some taxation techniques are often used in developing countries to deal with the problem of less-equipped tax administrations. In discussing international transfer pricing rules and practices, appropriate attention should be paid to these taxing practices in developing countries.

I. Introduction

The long-standing issue of intercompany transfer pricing has been receiving increasing attention in recent years. This is easily understood against the background of growing internationalization of economic activities. Multinational enterprises are expanding their foreign investments; 1/ international trade, which includes a large amount of transfers within a multinational enterprise, is also increasing. Under such circumstances, the tax authorities in several countries are intensifying their surveillance on the transfer pricing practices of multinational enterprises. 2/ As a result, the number of tax cases involving transfer pricing issues is increasing, with significant revenue consequences. 3/

This tendency is marked in the United States where Congress and the tax authorities are putting new focus on transfer pricing issues. After Section 482 of the Internal Revenue Code (IRC), which authorizes the IRS to allocate income among related taxpayers, was amended in 1986 with particular attention to transfers of intangible property, the U.S. Treasury and IRS conducted a thorough study of the theory and administration of the section, and, in 1988, published their findings and recommendations in "A Study of Intercompany Pricing (Discussion Draft)" (the so-called White Paper). Since then, a large number of articles or seminars on transfer pricing have been

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1/ Regarding investments to or from the United States, Woodard (1988), a former Assistant Commissioner (International) of the U.S. Internal Revenue Service (IRS), presents the following statistics:

Foreign-owned assets in the United States	\$306 billion in 1977 \$1.3 trillion in 1986
Income on foreign investments in the United States	\$14 billion in 1977 \$67 billion in 1986
Number of foreign-owned corporations in the United States	6,198 in 1972 38,390 in 1986
U.S. assets abroad	\$379 billion in 1977 \$1.1 trillion in 1986
Income on U.S. investments abroad	\$32 billion in 1977 \$88 billion in 1986

2/ Woodard (1988) shows that the number of international examiners in the IRS increased from 150 in 1977 to 505 in 1987, while the number of revenue agents increased only from 13,635 to 14,944. The IRS plans to increase the number of the international examiners to 2,000 in 1995 (see a remark by David Swenson, in Jeffcote (1990)).

3/ Official data for recent developments are not available, however. The U.S. IRS (1984) shows that, during the period 1980/81-1981/82, 2,306 income adjustments were made under Section 482, totalling US\$4.4 billion, which was seven times the amount during the period 1968-1969 (US\$662 million).

written or held by scholars, practitioners, taxpayers, and tax authorities. Some of the White Paper's recommendations to help strengthen the monitoring of transfer pricing have since been added to the IRC and the regulations thereunder; others, including those regarding methods for establishing transfer prices, are still under discussion. 1/

The U.S. initiatives have also stimulated discussions among national tax authorities in bilateral or multilateral fora. Some important progress in bilateral negotiations has been reported in recent years. The Committee on Fiscal Affairs of the Organization of Economic Cooperation and Development (OECD), which has been setting guidelines in this area, 2/ is continuing to review practical aspects of transfer pricing.

This paper reviews the legislative and administrative issues related to the treatment of intercompany transfer pricing for tax purposes. Emphasis is more on practical issues than on the economic and theoretical analysis of transfer pricing. Section II outlines why transfer pricing matters for tax purposes. Section III first explains an internationally agreed principle on the treatment of transfer pricing, that is, the arm's length price principle, and then analyzes international guidelines and national rules on its application. Section IV addresses administrative issues to which special attention should be paid in relation to transfer pricing. Section V focuses on the systems which have been proposed or introduced, in connection with transfer pricing, to give more predictability or flexibility to taxation and to reduce taxpayers' compliance costs. Section VI reviews the recent discussions on methods for establishing transfer prices, stimulated by the amendment of Section 482 of the IRC and the issuance of the White Paper. It also reviews some taxation techniques and income allocation practices, which have been adopted or proposed in lieu of the transfer pricing rules. Section VII contains some concluding remarks. The Appendix addresses the issues related to the problem of double taxation arising from the adjustment of transfer pricing by the tax authorities of a country.

II. Multinational Enterprises and Transfer Pricing

This section explains why and how transfer pricing typically matters for tax purposes.

1/ For recent developments in the United States, see U.S. Treasury Department and IRS (1992). For discussions at Congress, see, e.g., the congressional document (U.S. Joint Committee on Taxation (1990)) prepared for "Hearing on Underpayment of Income Taxes by U.S. Foreign-Owned Subsidiaries Before the Subcommittee on Oversight, House Ways and Means Committee, 101st Congress, 2d Session." Hearings on this issue were held before the same subcommittee again in April 1992 (for a summary of the hearings, see Turro (1992b)).

2/ For examples, see OECD (1979) and OECD (1984).

1. Why transfer pricing matters 1/

One phenomenon of internationalized economic activities is the development of multinational enterprises. A multinational enterprise is a group of associated companies operating across national frontiers. 2/ While the individual members of the group are more or less directed by a parent company at headquarters, they are legally autonomous and operate under different national laws. Within a multinational enterprise, many transactions take place between members of the group, such as the sales of goods, provision of services, licensing of patents and know-how, and granting of loans. The prices charged for these transfers do not necessarily represent a result of the free play of market forces, but may diverge from the prices which would have been agreed upon in an open market. 3/ Multinational enterprises may adopt higher or lower transfer prices to minimize tax (e.g., by selling goods to an associated company in a low-tax country at lower prices), or they may adopt them for other reasons, such as minimizing customs duty liability, lowering exchange rate risks, circumventing restrictions on remittance of profits, or achieving other business objectives (e.g., motivating member companies, penetrating a new market, or improving the financial appearance of certain member companies)--even with the result that total tax liability for the whole group may become higher. 4/ However, whatever the reason, the higher or lower price can result in shifting profits from one company to another within the group and consequently the tax liability of the relevant companies would be distorted. Since national tax authorities need to determine a proper level of taxable profits of the associated companies operating within their respective jurisdictions, transfer pricing policies of multinationals are of great importance. 5/

Transfer pricing is an issue, as far as the separate accounting rule applies to the associated persons. Separate accounting is the normal practice for distinct legal entities (the exception is when unitary apportionment is applied, cf. Ch. VI:3 below). It is also the general rule for the computation of foreign branch profits (cf. Art. 7:2 of the OECD model treaty). Taxation of these profits, therefore, raises the same transfer pricing problems as the taxation of foreign subsidiaries. 6/

1/ For a full description, see OECD (1979) and Plasschaert (1979).

2/ OECD (1979), paragraph 1.

3/ OECD (1979), paragraph 2.

4/ See, e.g., Plasschaert (1979, 1985); Arpan (1972); Tang (1979); Benke and Edwards (1980); and Chudson (1985).

5/ OECD (1979), paragraph 3.

6/ One might add that even if unitary apportionment is applied, transfer pricing problems might come in through the backdoor, to the extent apportionment is made on the basis of turnover and turnover includes transactions between associated firms or between a branch and its head office.

While multinational enterprises can bring substantial benefits to home and host countries by contributing to the efficient utilization of capital, technology, and human resources among the countries, their operations may lead to abuse of economic power and to conflicts with national policy objectives. In view of this, the 1976 OECD Guidelines for Multinational Enterprises lay down standards for the activities of multinational enterprises. 1/ The guidelines state that enterprises should refrain from making use of the particular facilities available to them, such as transfer pricing, for modifying in ways contrary to national laws the tax base on which members of the group are assessed. They also state that enterprises should publish, on a regular basis, the policies followed in respect of intragroup pricing.

Apart from such matters of conduct, appropriate pricing and accounting practices would also help multinational enterprises improve their efficiency in the allocation of resources and management of member companies.

2. Tax avoidance and evasion through the use of tax havens

One of the most important types of international tax avoidance and evasion occurs through the use of tax havens. Large differences in tax burdens between high-tax countries and tax havens, together with some tax haven features such as strict secrecy and refusal to cooperate with foreign tax administrations, can induce transfer pricing manipulation or, at least, open up opportunities for it. 2/ To the extent that harmonization of corporate tax systems among high-tax countries can be achieved and corporate tax rates can converge internationally, taxpayers will have fewer incentives to allocate income fictitiously to avoid or evade taxes. Nevertheless, the above-mentioned problems caused by tax havens will remain.

Tax authorities have taken many types of measures to curb tax avoidance and evasion through the use of tax havens. 3/ In cases where multinational enterprises establish in tax havens "conduit companies" that have no real activities and are solely aimed at income channelling objectives, some juridical rules usually exist so that tax laws can be applied in light of the economic reality of transactions. Some countries have further enacted special legislation that treats most income accrued by controlled affiliates incorporated in tax havens as current income of the parents and makes it taxable in the home country even if the income is not remitted. This legislation was first adopted in the United States, then in Germany, Canada, Japan, France, and the United Kingdom.

Although transfer pricing legislation is not focused on transactions with tax havens, it is also an important instrument in preventing the

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1/ The Guidelines and related material are available in OECD (1986).

2/ For further discussions on tax issues related to tax havens, see OECD (1987).

3/ See OECD (1987).

artificial shifting of income to related companies established in tax havens or low-tax countries. The above-mentioned White Paper reveals the U.S. authorities' concerns about inappropriate pricing practices for transactions with entities in tax havens and about the administrative difficulty of obtaining access to information located in tax havens. The 1986 legislation and the subsequent measures taken in the United States for strengthening transfer pricing rules and their implementation were motivated by these problems, but eventually covered not only transactions related to tax havens but also transactions related to any other countries. The tax authorities in many high-tax countries have expressed their concern about these measures, as indicated below. However, stricter rules and implementation applied only to tax haven cases would be accepted internationally with less difficulty.

3. Elimination of economic double taxation

Apart from the cases related to tax havens, when an adjustment is made by the tax authorities of a country to transfer prices for tax purposes, the adjustment (usually called an "initial adjustment"), if it increases the taxable profits in that country, may result in economic double taxation, in the sense that the same profits have already been reported to another country by an associated company. 1/ To eliminate economic double taxation, it is necessary for the tax authorities in the latter country to make an appropriate adjustment to the transfer prices (usually called a "corresponding adjustment") in response to the initial adjustment. The procedures for corresponding adjustments depend on the mechanism for double taxation relief provided by the tax treaty between the two countries, though in some cases domestic rules may provide unilateral relief for economic double taxation without involving the tax authorities of other countries.

As tax authorities are intensifying transfer pricing adjustment practices, the need for a more efficient system of eliminating double taxation is increasing. Under existing international tax treaty provisions, the elimination of double taxation depends on how successfully the relevant competent authorities can reach an agreement on an appropriate transfer price through their negotiations. If the taxing approaches of national tax authorities differ, the problem of double taxation could remain unsolved. This is why international coordination among tax authorities as well as international dialogues between tax authorities and taxpayers are frequently advocated in this area.

The Appendix deals with the issues regarding elimination of double taxation arising from transfer price adjustments.

1/ The term "economic" double taxation, i.e., the taxation by two states of the same income or profits _in the hands of two separate but associated persons_, is contrasted with "juridical" double taxation, i.e., the taxation by two states of the same income and profits _in the hands of the same person_ (OECD (1984), the first report, paragraph 5).

III. Arm's Length Price Principle

This section first explains an internationally agreed principle on the treatment of transfer pricing, that is, the arm's length price principle, and then analyzes the existing international guidelines for its application and the national rules in several industrial countries.

1. Arm's length price principle and international guidelines for its application

It is internationally acknowledged that in calculating for tax purposes the profits of a company that engages in transactions with associated companies, the prices applied to these transactions should be arm's length prices, that is, prices which would have been agreed upon between unrelated parties engaged in the same or similar transactions under the same or similar conditions. 1/ This arm's length price principle is the principle endorsed in the 1977 OECD Model Double Taxation Convention on Income and Capital and the 1979 United Nations (UN) Model Double Taxation Convention between Developed and Developing Countries, and included in modern bilateral tax treaties agreed upon by OECD or non-OECD countries. 2/

Although there is thus an international agreement in principle, there can be much variation in practice regarding how this principle is applied to specific cases. If national tax authorities differ in their approach, a problem of double taxation may arise. To avoid this, efforts are being made to minimize national variations. The 1979 OECD Report on Multinationals and Transfer Pricing, the subsequent OECD work on transfer pricing issues, and the work done by the UN Group of Tax Experts represent the major international attempts to reconcile the national variations and to provide guidelines enabling national administrations to adopt harmonious approaches. 3/

The 1979 OECD Report provides guidelines for determining arm's length prices in specific cases, by endorsing the following specific methods:

- The comparable uncontrolled price (CUP) method (direct reference to prices in comparable transactions between parties independent of each other);

1/ OECD (1979), paragraph 3.
2/ See Article 9(1) of the OECD and UN Model Conventions and equivalent articles of bilateral tax treaties. The issue of business income allocation and transfer pricing can similarly exist regarding transactions between head offices and their permanent establishments. In the OECD and UN Models, Article 7 covers this issue separately, but it also adopts an arm's length price rule similar to Article 9.
3/ Collins (1987a).

- The retail price (RP) method (the final selling price less an appropriate markup determined by reference to markups in comparable uncontrolled transactions);

- The cost plus (CP) method (the cost of providing the goods or services plus an appropriate markup determined by reference to markups in comparable uncontrolled transactions).

All three methods rely on finding comparable transactions between unrelated parties and determine an appropriate price either directly or by reference to appropriate markups in the comparable uncontrolled transactions. When none of the methods can be applied in the absence of comparables, the 1979 OECD Report accepts that other reasonable methods (generally referred to as "fourth methods") can be used, but provides little guidance on the methodology of fourth methods. In fact, tax authorities often devise and apply ad hoc methods to resolve these cases, 1/ but main approaches would be the following:

- The rate of return on assets or equity approach (the rate of return on assets or equity is compared between the taxpayer in question and other companies with similar functions);

- The rate of return on operating costs approach (the rate of return on operating costs is compared between the taxpayer in question and other companies with similar functions);

- The profit split approach (total profits are split between the related parties in a ratio deemed appropriate).

The above-mentioned methods are typically applied to transfers of tangible goods, and some special consideration may be necessary for other types of transactions. Regarding the transfer of intangible property (e.g., patents, know-how, and trademarks), provision of intragroup services, and loans, the 1979 OECD Report provides the following guidelines:

- Transfer of intangible property: In determining the amount of an arm's length consideration, the standard applied is the amount that would have been paid by an unrelated party for the same intangible property under the same circumstances; where a sufficiently similar transaction involving an unrelated party cannot be found, or does not provide satisfactory evidence, other methods have to be used to test whether the price actually paid by the licensee is acceptable to the tax authorities. 2/ The 1979

1/ Several studies in the United States show that in 30-40 percent of the total cases the IRS used fourth methods (see U.S. General Accounting Office (1981), U.S. IRS (1984), and U.S. Treasury Department and IRS (1988) p.22).

2/ OECD (1979), paragraphs 94 and 98 for patents and know-how. The use of trademarks is discussed separately in paragraph 137, but the conclusions are similar to those shown in the text.

OECD Report, however, provides little guidance on other methods that can be applied to the transfer of intangible property.

- Provision of services: To determine the amount of the consideration under the arm's length price principle, the open market value of the services rendered would have to be established; where it is not possible to compare the service fee charged by an associated company with the price charged in a sufficiently similar open market transaction, a cost-oriented method may be helpful in providing an approximation to arm's length prices. 1/

- Loans: The arm's length interest rate is the rate of interest that is charged or would have been charged at the time the indebtedness arose between unrelated parties under similar circumstances; in deciding what is a comparable or similar loan, it is necessary to take into account amounts and maturities, the nature or purpose of the loan, the currencies involved, the exchange risks, the security involved, and the credit standing of the borrower. 2/

2. National rules

Table 1 summarizes the outline of transfer pricing rules in six industrial countries (Canada, France, Germany, Japan, the United Kingdom, and the United States). 3/ Although these rules have underlying similarities to the OECD guidelines, they also have some variations.

a. Forms of rules

In most of the six countries, the statutory laws authorize the tax authorities to adjust the profit of entities in a multinational group for tax purposes by adjusting to the arm's length price the prices actually used in the transactions between those entities. One variation is the U.S. IRC, which grants the IRS the broad authority to reallocate income and provides the arm's length price rule not in the statute but in the regulations thereunder.

Statutory laws usually provide only the arm's length price rule; they provide no further rules on specific pricing methodologies. An exception

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1/ OECD (1979), paragraphs 164 and 165.

2/ OECD (1979), paragraphs 198 and 199.

3/ For a full description, see the national legislation, regulations, and guidelines mentioned in the text, and the material included in International Bureau of Fiscal Documentation (1987-): Boidman (1987) for Canada; Goldsmith (1988) for France; Jacob (1987) for Germany; Collins (1987b) for the United Kingdom; Horst (1987) for the United States; and Collins (1987a) for analysis and comparison. For Japan, see Kawada (1989a) and Thomas (1989).

Table 1. Comparison of Transfer Pricing Rules 1/

	Canada	France	Germany	Japan	United Kingdom	United States
Statutes providing for the arm's length price principle	Income Tax Act §69(1)-(3)	Code Général des Impôts (CGI) §57	Aussensteuergesetz (AStG) §1	Special Taxation Measures Law (STML) §66(5)	Income and Corporation Taxes Act (ICTA) §§770-773	Internal Revenue Code (IRC) §482 broadly grants income allocation
Pricing guidance or rules from tax authority	Information Circular No.87-2	Administrative Commentary (Doc. Adm. FE4A 1210 et seq.)	Letter of the Federal Minister of Finance (IVC5-S1341-4/83)	STML; further details provided by Enforcement Order §39(12) under STML.	Little formal guidance, except a brief note by Inland Revenue	Regulations under IRC §482
Existence of well-developed body of case law	Very little case law of late	Yes	Yes	Not current	Yes	Yes
Are rules applied to domestic relationships?	Yes for sales of tangibles and intangibles, but not for services	No	No, but rules on constructive profit or capital distributions are applied.	No, but excess payments are deductible as contributions only within a ceiling.	Yes	Yes
Control (a) Share percentage rules (b) Does it include "de facto" control?	Not defined in the statute. (a) More than 50% from case law. (b) Yes from case law.	(a) Majority (b) Yes	(a) 25% or more (b) Yes	(a) 50% or more (b) Yes	(a) Not specified (b) Yes	(a) Not specified (b) Yes

Table 1. Comparison of Transfer Pricing Rules 1/ (concluded)

	Canada	France	Germany	Japan	United Kingdom	United States
Pricing methods specified in national rules (numbering shows the sequence of application)	1)Primary method (CUP) 2)Secondary methods(RP&CP) 3)Other methods	Not specified. The 1979 OECD Report is in practice taken into account.	1)Standard methods (CUP&RP&CP) 2)Other methods	1)CUP&RP&CP 2)Other methods	Not specified. Inland Revenue is guided by the considerations set out in the 1979 OECD Report.	1)CUP 2)RP 3)CP 4)Other methods
Types of transactions for which special considerations are set out in national rules	Management or administrative services; R&D; use of intangibles	Payment of royalty; loan and waiver of claims; division of commercial expenses	Transfer of services; interest and similar remuneration; transfer of intangibles	None	None	Loans and advances; performance of services; use of tangibles; transfer or use of intangibles

1/ Originally taken from Simon (1991) and revised by the author. For details on each country's rules, see International Bureau of Fiscal Documentation (1987-).

here is Japan, where the Special Taxation Measure Law provides for specific pricing methodologies.

In those countries where the statutory law does not detail the rules of transfer pricing, tax authorities have increasingly provided guidance of one sort or another to enable both tax authorities and taxpayers to operate with certainty, though guidelines and regulations thus provided vary in the amount of detail and in their force. 1/ In the United States, the 1968 regulations under Section 482 of the IRC set detailed pricing rules. The 1983 German Transfer Pricing Guidelines, which are authoritative against the tax authorities but not against the taxpayer, also provide detailed rules. The Canadian administrative guidelines, issued in 1987 as the Information Circular 87-2, are also detailed. On the other hand, the 1981 French Administrative Commentary (Doc. Adm. FE4A1221) is less detailed; 2/ in the United Kingdom, little formal guidance is provided. 3/ However, the considerations set out in the 1979 OECD Report would give some guidance in the latter group of countries, since their tax administrations take into account those considerations in their practice.

In addition to the statutory law, there is a well-developed body of case law in many countries, which provides guidance on some issues.

b. Scope of application

One variation among national rules on transfer pricing is that they may be applied only to international relationships or to domestic as well as international relationships. While statutory laws cover both relationships in Canada, the United Kingdom, and the United States, they cover only international relationships in France, Germany, and Japan. However, even in the latter group of countries, some general rules on profit and income tax may perform a similar function regarding domestic relationships. 4/

1/ Collins (1987a).

2/ For example, it does not specify any pricing methods such as the CUP, RP, and CP, nor the order of preference in applying such methods.

3/ In the United Kingdom, a brief note available at Inland Revenue expresses the tax authorities' view and provides some guidance, though it has no legal force.

4/ In Germany, income allocation concerning constructive profit distributions and constructive capital distributions is applied to domestic relationships; in Japan, excess payments can be taxed by treating the excess amount as the taxpayer's contributions to the related entities, since contributions are deductible as expenses only within a certain limit.

c. Definition of control

Except for some special cases, 1/ tax authorities can adjust transfer prices only when one of the parties in question is controlled by the other, or they are under a common control ("sister" companies). Control is, therefore, an important concept in transfer pricing rules. Under the national rules of the above-mentioned countries, control includes both legal control--usually defined by some shareholding percentage--and de facto control. Regarding the shareholding percentage rules, a company in which more than 50 percent of the voting shares are held, directly or indirectly, by another company would generally be regarded as controlled. Some countries, however, would regard a smaller shareholding as effectively controlling. In Germany, the Aussensteuergesetz (International Tax Law) provides for a "25 percent or more" rule; in Japan, the Special Taxation Measure Law provides for a "50 percent or more" rule.

d. Methodology for establishing transfer prices

Under national rules, it is common that the tax authorities can adjust the profits of entities in a multinational group for tax purposes in light of the arm's length prices. Moreover, they accept, typically regarding transfers of tangible goods, that there are three standard methods and that other (fourth) methods are used where none of the three standard methods is applicable.

However, countries vary in the priority they give to these methods. In the United States, the CUP, RP, CP, and other methods are applied in this order of priority. 2/ Canada treats the CUP as the primary method, the RP and CP as secondary methods (with no priority specified between the two methods), and gives the lowest priority to other methods. In Germany and Japan, no priority is accorded among the three standard methods, but other methods are applied only when the standard methods cannot be used. In the United Kingdom, no priority is accorded, but any method or combination of methods which produces a satisfactory result is accepted. 3/ In practice, however, these differences may be more apparent than real in the majority of cases, 4/ because there are signs that the authorities are applying these methods or combination of methods rather flexibly.

In some countries, such as Japan, the above-mentioned pricing methodologies are applied to all types of transactions in a multinational enterprise. However, in other countries, special rules for some types of

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1/ In France, for example, the tax authorities can adjust the prices in the absence of control, when payments are made to entities in tax havens.

2/ However, recently proposed regulations, which are discussed in Section VI, do not put any priority between the RP and CP.

3/ See a brief note on transfer pricing, available at Inland Revenue.

4/ Collins (1987a).

transactions--typically those related to services, intangibles, and loans--are provided in their regulations or guidelines.

3. Remaining issues

As pointed out above, there are two major issues concerning the methods for establishing transfer prices, on which little clear guidance is provided internationally: (a) under what circumstances and how fourth methods should be used, and (b) how intangible property should be valued. These issues are closely related, because, in a typical transaction within a multinational enterprise, unique intangible property is transferred simultaneously with the tangible goods and services that are sold or provided. In this case, finding comparable transactions with the transfer of the same intangible property is most difficult due to the uniqueness of the intangible property. To apply the standard methods, starting from prices in some comparable transactions without the transfer of the same intangible property, appropriate price adjustments must be made reflecting the value of the intangible property. Whether the standard methods can be applied to this case or not, therefore, greatly depends on how successfully the intangible property can be valued.

The recent discussions on these issues are reviewed in Section VI.1.

IV. Surveillance of Transfer Pricing

This section deals with administrative issues regarding surveillance of transfer pricing. Table 2 summarizes tax administration practices for surveillance of transfer pricing in the above-mentioned industrial countries. 1/ Examining transfer pricing of multinationals is a part of international tax examinations, which are quite different from domestic tax examinations. Also, administrative techniques for examining transfer pricing, which require sophisticated economic/legal analyses that combine technical legal transfer pricing principles with economic valuation principles and techniques, 2/ are rather different from conventional techniques for detecting tax fraud and evasion. Consequently, special attention should be paid to the administrative methods for surveillance of transfer pricing.

1/ For detailed information on tax administration practices for surveillance of transfer pricing in each country, see the material included in International Bureau of Fiscal Documentation (1987-). Also see the material provided by the competent authorities of these countries at the International Tax Institute Seminar, June 27-28, 1988 (International Tax Institute (1988)).

2/ Doran (1990). He is a former Associate Chief Counsel (Technical and International) of the IRS.

Table 2. Comparison of Tax Administration Practices for Monitoring Transfer Pricing 1/

	Canada	France	Germany	Japan	United Kingdom	United States
Organization for international taxation - centralization - use of economists, etc.	International audit groups in major district offices, under the functional direction of the International Audit Division at the head office.	Major audits are handled by a specialized body with nationwide responsibility ("Direction des Verifications Nationales et Internationales").	Federal personnel assist state authorities in resolving international tax issues by assuming advisory functions in interviews with taxpayers or by conducting audits themselves.	Special divisions at headquarters and at regional bureaus, exclusively in charge of the examination of transfer pricing. Close monitoring at headquarters.	A head office unit advises local offices on transfer pricing matters. Important matters may be dealt with by the head office unit.	Program direction and control by the Office of the Assistant Commissioner (International) and assistance by the Office of Associate Chief Counsel (International). Use of economists for larger transfer pricing cases; industrywide pricing program.
Time limitations for auditing	Generally 3 years, but 6 years for multinational intercompany transactions.	3 years	4 years	Generally 3 years, but 6 years for audits of transfer pricing cases.	6 years	3 years, but 6 years in the case of understatement of 25% or more. The time may be extended with the consent of the taxpayer.

Table 2. Comparison of Tax Administration Practices for Monitoring Transfer Pricing 1/ (continued)

	Canada	France	Germany	Japan	United Kingdom	United States
Information requirements	File an annual report (Form T106(E)). Monetary penalty in the case of noncompliance. The administration may issue a formal document request for foreign-based information. The administration seeks permission from third parties to disclose their information to the taxpayer included, except for court proceedings.	n.a.	Determine factual circumstances existing abroad and supply documentary evidence located abroad. Income may be adjusted by an estimate in the case of noncooperation.	File an annual report (Form 16-3); endeavor to obtain records or books held by the foreign-affiliated company. In the case of noncompliance, income adjustment on the basis of the gross margin ratio of similar companies is presumed valid. Examination of third parties in the case of taxpayer failure to provide enough information.	Produce information on transfer prices of its own or other companies; produce books and accounts on related party transactions; for examinations, produce other documents or records relevant to a transfer pricing adjustment. Monetary penalty may be applied in the case of noncompliance.	File an annual report (Form 5471 or 5472); maintain books and records on related party transactions. A formal document request or summons may be issued for foreign-based information. Requirement of agent authorization. Monetary penalty or discretionary income adjustment in the case of noncompliance.
Burden of proof	Taxpayers	Administration	Taxpayers, for claiming deductions; administration, for adjusting income.	Administration	Taxpayers	Taxpayers

Table 2. Comparison of Tax Administration Practices for Monitoring Transfer Pricing 1/ (concluded)

	Canada	France	Germany	Japan	United Kingdom	United States
Systems to assure predictability or flexibility of taxation - Advance ruling - Safe harbor - Set off	No advance ruling will be issued on factual matters related to intercompany pricing. No safe harbor.	No advance ruling. No safe harbor.	Advance rulings as a general rule, but they may have only a limited value for transfer pricing. No safe harbor, except possibly under a bilateral tax treaty. Intrayear and multiyear (within 3 years) set-offs of detriments suffered.	Preconfirmation system. No safe harbor.	No advance ruling. No safe harbor.	Advance pricing agreements. A safe harbor for interest rates. Intrayear set-offs.

1/ For details on each country's practices, see International Bureau of Fiscal Documentation (1987-).

1. Centralized administrative system

In some countries, administrative systems for international examinations in general or for examination of transfer pricing in particular have become more centralized in recent years.

In the United States, to place all international activities under a single executive in its national office, the IRS established the Office of the Assistant Commissioner (International) in 1986. This office was intended to provide centralized program direction and control, as well as high level executive attention to international tax matters. 1/ Early that year, in the Office of Chief Counsel of the IRS, which deals with legal issues, the Office of Associate Chief Counsel (International) was created. The Counsel also created a network of attorneys at the regional level to assist international examiners in developing significant international tax cases, including transfer pricing cases, and to litigate these cases. These efforts represent a far greater concentration of expertise on international issues by the Office of Chief Counsel. 2/

In Canada, the International Audits Division was created at the head office in 1988 to develop audit guidelines for international transactions, review the tax administration's positions on tax reassessments, train international audit specialists, litigate international cases, resolve competent authority cases, and exchange information with treaty partners. 3/ Concurrently, international audit groups were established in major district offices under the functional direction of this division. 4/ Thus, much coordination has been cultivated between the head office and district offices (and assessors) in developing programs and approaches to identifying transfer pricing issues. 5/

In Japan, where transfer pricing legislation was enacted in 1986, new divisions exclusively in charge of the examination of transfer pricing have been set up at National Tax Administration headquarters and at regional taxation bureaus, and a close monitoring system at headquarters has been adopted. Under the system, the new division at headquarters selects transfer pricing cases, analyzes them, and determines tax assessments. During this process, field audits are conducted by regional taxation bureau examiners under the headquarters' supervision. The reasons why Japan adopted this close monitoring system are as follows: 6/

1/ Woodard (1988).
2/ Woodard (1988).
3/ Calderwood, a former Director of the International Audits Division, Revenue Canada, Taxation, in International Tax Institute (1988).
4/ Calderwood in International Tax Institute (1988).
5/ Boidman (1987).
6/ Kawada (1989a).

- Since transfer pricing examinations are a new type of examination, examiners will need time to gain experience;

- Headquarters' involvement will ensure consistency in transfer pricing examinations;

- Transfer pricing examinations will probably require competent authority procedures which are handled only at headquarters.

2. Use of economists

In the United States, tax examiners engaged in larger transfer pricing cases are assisted by economic specialists (economists) in obtaining the relevant facts and determining transfer prices sustained on appropriate economic analysis. Within the last several years, the IRS has substantially increased the number of economists who assist the examiners. While there is criticism that the use of economists is time-consuming and costly (e.g., many taxpayers also have to hire their own economists to defend their pricing against the IRS economists), the IRS responds that the early use of economists can prevent erroneous adjustments and thus save both the taxpayers and the Government time and money. 1/

3. Industrywide pricing program

In the United States, in an effort to ensure uniform and consistent application of Section 482 of the IRC among companies within the same industry, the IRS has initiated industrywide pricing programs in certain key industries. 2/ For example, the Petroleum Industry Program in the Southwest Region is charged with the responsibility of resolving transfer pricing issues associated with foreign-produced crude oil and refined products, and the Electronic Component Industry Program in the Western Region is studying marketing and distributing activities associated with electronic components imported into the United States.

During the course of these studies, taxpayers may be requested to provide information on an industrywide basis, and analysts working within these programs may liaise with other governmental agencies for purposes of securing and analyzing statistical information. In addition, industrywide exchanges of information are occasionally conducted with foreign administrations to secure comprehensive data on worldwide industry practices and operating patterns. The IRS points out that these programs provide benefits through the development of expertise within the IRS. 3/

1/ U.S. Treasury Department and IRS (1988), p. 25.
2/ U.S. IRS (1988).
3/ U.S. IRS (1988).

4. Time limitations

In general, examinations of transfer pricing cases are more time-consuming than other tax cases. Examiners have to spend more time gathering pricing information (in many cases, the information is located abroad), making economic analysis, and discussing cases with taxpayers. Some tax authorities in the countries with shorter time limitations for tax audits feel that their time is too short for transfer pricing cases, or that their time limitations place them at a disadvantage internationally. In the United States, the limitation is three years (six years if income is understated by 25 percent or more), but a system by which the time can be extended with the consent of the taxpayer is often used. In Canada, the 1988 tax reform extended the three-year general time limitation to six years for multinational intercompany transactions. Similarly, in Japan, where the general limitation is three years, the 1991 tax law revision extended the limitation to six years for audits of transfer pricing cases. 1/

5. Information requirements

In determining appropriate transfer prices, it is essential that the tax authorities have access to the relevant information. The 1988 U.S. White Paper points out that the failure of taxpayers to document the methodology for establishing transfer prices and their delays in supplying (or failure to supply) information significantly hamper the administration of Section 482 of the IRC; 2/ the White Paper proposes stricter rules on the taxpayer's obligation to provide pricing information and imposition of penalties if necessary. 3/ The issue of information requirements is also vital to taxpayers, not only because inappropriate information burdens can create excessive business costs but also because pricing information is usually highly confidential for their business purposes.

a. Annual reporting

In some countries (e.g., Canada, Japan, and the United States), taxpayers who have transactions with related nonresident persons are required to file, in addition to their tax return, an annual report on a prescribed form to disclose information on transactions with each related person, such as sales and purchases of tangible property, rent, royalties, commissions, interest, and dividends paid or received, intercompany loans or advances, and investments.

1/ The time limitation is three years in France, four years in Germany, and six years in the United Kingdom.

2/ U.S. Treasury Department and IRS (1988), p. 13. These experiences have been shared by the Canadian authorities (see Calderwood (1988)).

3/ As discussed below, most of these proposals have been adopted by the subsequent revisions of the IRC.

b. Foreign-based information

At the time of examination, taxpayers are required to provide more detailed data and information. As the above-mentioned note by the U.K. Inland Revenue points out, there is no standard list of questions, but each case is looked at in the light of its own special features. Practically speaking, information to be collected is identified in discussions between tax examiners and taxpayers.

One of the key issues for tax authorities is how to collect the relevant information that is located abroad (e.g., information on related companies abroad). In most countries, taxpayers are subject to some requirements for collecting and providing information maintained by related companies abroad, but there are limits on enforcement because the related companies abroad are not under the jurisdiction of the country whose tax authorities initiate the examination.

In Germany, the parties involved are required to determine factual circumstances existing abroad themselves and to supply documentary evidence located abroad, exhausting all the legal and actual possibilities of obtaining evidence which are open to them. In the case of noncooperation, the tax office may adjust the income by making an estimate. 1/

In Japan, the tax authorities can request that a company disclose or produce the records or books, or copies thereof, of its foreign affiliates. The requirement is only that the company "endeavor" to obtain these documents; there are no penalties for noncompliance. However, if the company does not provide the documents without delay, the authorities can determine the company's income or losses by using the RP or CP method, based on the gross margin ratio of similar companies engaged in the same type of business activities and whose scale and other contents of the business activities are similar. The price thus determined is presumed valid and the company challenging its validity must produce supporting evidence.

In the United Kingdom, 2/ companies are required to produce information on their own transfer prices and also on those of other companies whether such companies are associated with them or not. The U.K. resident companies are further required to produce books and accounts where they have had transactions with a 51 percent subsidiary resident outside the United Kingdom. They are also required to produce such information where the transactions take place between U.K. resident and non-resident companies both of which are their 51 percent subsidiaries. In addition, companies are required to produce for examination at their premises books, accounts, and other documents or records relevant to a transfer pricing adjustment. Monetary penalties can be applied for noncompliance, but rarely are.

1/ See the 1983 German Transfer Pricing Guidelines.
2/ See Collins (1987b) and Section 772 of the U.K. Income and Corporation Taxes Act.

c. Exchange of information based on tax treaties

One method of gathering information abroad beyond national jurisdictions is to use a country's tax treaty article on the exchange of information. Under this article, competent authorities can make a "specific" request, usually in writing, for information from the competent authorities in treaty partner countries. 1/ Although this is an important source of information for tax administrations, indications are that it has been only a partial solution to the information access problem. It can be an effective measure only in situations where (1) the information is located in a treaty partner country, (2) the partner country is cooperative, (3) the requesting authorities know that the information in fact exists as well as where it is located, and (4) the requesting authorities have sufficient time to be able to wait for a response. 2/ Data show that the number of specific requests is not very large. 3/

d. Extraterritorial power to gather foreign information--recent developments in the United States

Apart from the use of the information exchange article in a tax treaty, the issue of how extensively the tax authorities can use extraterritorial power to gather foreign information remains controversial. This discussion has been stimulated by the issuance of the 1988 White Paper and subsequent legislation in the United States. 4/

In the United States, in addition to a general requirement to maintain adequate books and records--provided by Section 6001 of the IRC--Section 6038 of the IRC requires that any U.S. person who owns more than 50 percent of a foreign corporation file an annual report on transactions between the related parties on Form 5471. Section 6038A of the IRC, whose coverage has been extended by the recent legislation, also requires similar reporting on

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1/ In addition to "specific" exchanges of information responding to such requests, "automatic" exchanges (i.e., information on such payments as cross-border dividends, interest, rent, royalties, wages, or pensions is exchanged based on bilateral arrangements, without any further specific requests), and "spontaneous" exchanges (i.e., tax authorities forward information spontaneously when they discover information that may be useful to their treaty partners) are made.

2/ McCart (1988).

3/ Between Canada and the United States, during the period from October 20, 1987, to September 1, 1988, 21 requests were made by the United States; during the period from October 2, 1987, to September 1, 1988, 96 requests were made by Canada (McCart (1988)). As for Germany, in 1988, information was exchanged in response to 120 requests made by its treaty partners and 92 requests by Germany (Bohnert (1990)).

4/ The Revenue Reconciliation Act of 1989 and the Omnibus Reconciliation Act of 1990. For discussions on these acts and the regulations thereunder, see, e.g., Spector (1991); Cole (1990); Liebman (1991); and Hirsh (1991).

Form 5472 by any foreign corporation that conducts business in the United States and any domestic corporation that is 25 percent or more owned by a foreign person (those corporations subject to Section 6038A are called "reporting corporations"). 1/ Moreover, as a result of the legislation, reporting corporations whose gross receipts and related party transactions exceed a certain threshold level are required to maintain (and in some cases create) 2/ appropriate books and records relating to transactions with related foreign parties, and move them to the United States within 60 days of a request by the IRS. Failure to furnish information or maintain records results in substantial monetary penalties.

At the time of examination, in addition to ordinary data and information requests, the IRS agents can resort to the following more formal measures to obtain the information.

- Formal Document Request (Section 982 of the IRC): A taxpayer who, without reasonable cause, fails to produce the requested foreign-based documents within 90 days may be prevented from introducing the documents in any subsequent court proceedings. 3/

- Administrative summons (Section 7602 et seq. of the IRC): A taxpayer who fails to obey the IRS summons to appear, testify, or produce books/records may be forced to obey or be punished.

Regarding the IRS summons, the above-mentioned legislation requires each foreign person related to a reporting corporation to authorize the reporting corporation to act as the related party's agent. Consequently, the IRS summons to provide foreign-based documents and testimony involving a U.S. taxpayer can be served on related foreign persons through the U.S. taxpayer. For noncompliance with the requirement of agent authorization or failure to obey a summons, the IRS may determine the reporting corporation's taxable income from related party transactions at its sole discretion.

e. Information on comparable transactions

Another issue is how to collect information on comparable transactions and how to use it. If the taxpayer in question has transactions with unrelated parties, information on such comparable transactions may be collected through the taxpayer. If he/she does not, however, some

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1/ Previously, only 50 percent foreign-owned foreign corporations conducting business in the United States and 50 percent foreign-owned domestic corporations were subject to Section 6038A.

2/ Spector (1991). According to the regulations under Section 6038A, (a) accounting records sufficient to document the U.S. tax effects of related party transactions and (b) records sufficient to produce "material profit and loss statements" of the reporting corporation and its related parties must be created and retained if they are not otherwise maintained.

3/ Canada introduced the same system in 1988.

independent information on comparables has to be collected. Some data for publicly owned companies may be collected easily, but usually they are not very detailed. Even if some information is voluntarily provided by the parties of comparable transactions, such information is often confidential and cannot be disclosed to the third party, that is, the taxpayer. Although practices used by tax authorities in each country are not very clear, some have national rules covering this issue.

One such country is Canada, whose Information Circular 87-2 stipulates that the Revenue Department will seek written permission from third parties to disclose the information to the taxpayer involved, but that once court proceedings have been initiated, the Revenue Department is permitted to release it. In Japan, the tax law was revised in 1991 to authorize the tax administration to conduct examinations of third parties engaged in businesses similar to that of the taxpayer in question, when the taxpayer fails to provide enough information to determine an arm's length price.

6. Burden of proof

In relation to the information requirements for the examination of transfer pricing, account should be taken of the rules on the burden of proof, that is, whether taxpayers have to prove that the tax authorities' assessment is incorrect or the tax authorities have to prove that their assessment is correct. In Canada, the United Kingdom, and the United States, the authorities' assessment is presumed to be correct, and taxpayers have the burden to disprove it. The 1988 U.S. White Paper explains that taxpayers are almost always familiar with--and in exclusive possession of--the relevant facts, and that to place the burden of proof on the Government would be unworkable. 1/ In France and Japan, on the other hand, tax authorities have to prove that the prices used by taxpayers are not arm's length prices. 2/ In Germany, under general rules of the burden of proof, taxpayers claiming deductions have to establish that the expenditure corresponds to an arm's length price, and the administration adjusting their income has to establish that their receipts were below the arm's length consideration. 3/

7. Penalty

Although, in principle, general rules on penalty or additional tax in each country would be applicable to tax deficiencies resulting from inappropriate intercompany pricing, some tax authorities have been cautious about applying them to transfer pricing cases. In the United States, for example, the IRS only infrequently imposed penalties in connection with

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1/ U.S. Treasury Department and IRS (1988), p. 77.

2/ In Japan, as shown above, the burden of proof could be shifted in the case of taxpayer noncompliance with the information requirements.

3/ Jacob (1987). He was a Counselor (fiscal) of the Embassy of the Federal Republic of Germany, Washington, D.C.

transfer pricing adjustments, though the 25 percent penalty for substantial understatement of tax (Section 6661 of the IRC) could have been applied to them. 1/ The 1990 U.S. legislation that includes a comprehensive reform of the civil penalty system has adopted a 20 percent (sometimes 40 percent) penalty for substantial valuation misstatement regarding Section 482 of the IRC, and has defined the cases to which the penalty is applied. However, it is uncertain at this stage how this new penalty will be applied in individual cases. 2/

V. Systems to Improve Predictability or Flexibility of Taxation

This section deals with various systems proposed or introduced to improve predictability or flexibility of taxation when transfer pricing is an issue. One argument against transfer pricing legislation is that, even if detailed rules are written in the form of regulations or guidelines, actual application of such rules to each case is not predictable, with the result that taxpayers may be required to incur excessive compliance costs. It is also argued that since actual application of the arm's length price principle and the precise determination of an appropriate price in light of this principle are difficult, too strict application by tax authorities could result in an arbitrary tax adjustment and excessive interference with free economic activities. In this context, various systems have been proposed or introduced to improve predictability or flexibility of taxation. 3/

1. Safe harbor

One of the most common suggestions for solving the problem of uncertainty is to adopt safe harbor rules, which indicate that prices falling within certain ranges would be accepted without question. Instead of the absolute safe harbors that grant taxpayers total freedom from tax adjustments, conditional safe harbors that--in countries where taxpayers have the burden of proof--produce a rebuttable presumption or a shift in the burden of proof in the taxpayers' favor may be proposed. In addition to providing certainty, if they work as intended, safe harbors could reduce costs of enforcing compliance by eliminating examination of insignificant cases and allowing the tax authorities to concentrate on cases that warrant closer scrutiny.

1/ U.S. Treasury Department and IRS (1988), pp. 17-18.

2/ According to the new code Section 6662 of the IRC, taxpayers can avoid penalty by showing that there was "a reasonable cause" for their price determination and that they acted "in good faith" with respect to the price. McIntyre (1991a, 1991b) points out that these guidelines are rather indefinite and could cause considerable uncertainty.

3/ These systems are proposed or introduced within the framework of the transfer pricing approach. As for the proposal or adoption of some alternative approaches to international income allocation, see Section VI.

While various safe harbor rules have been proposed on the taxpayer's side, 1/ the tax authorities in several countries have mixed views on them. While admitting their merit in providing certainty and in reducing disputes over appropriate prices, 2/ the authorities point out some technical difficulties. The 1979 OECD Report, for example, states that safe harbors are likely to be arbitrary since they will rarely fit exactly the varying circumstances even of companies in the same trade or business; to minimize this arbitrariness, a considerable amount of skilled labor would have to be allocated to collect, collate, and continuously revise a pool of information on prices and pricing developments. 3/ The Report also states that safe harbors in one country may create difficulties in others. A German authority explains that safe harbors are of little value if they are not coordinated internationally, and that the 1983 German Transfer Pricing Guidelines therefore do not make reference to safe harbors, though this is not to say that the German competent authority will not consider safe harbor approaches on a bilateral basis. 4/ In the United States where only a safe harbor for interest rates (100 percent to 130 percent of the applicable federal rate) is regulated (Regulation 482-2(a)(2)(iii)), 5/ the 1988 White Paper did not recommend any additional safe harbors though it did not reject the possibility that useful safe harbors could be developed. 6/ The recently proposed regulations under Section 482 of the IRC did not include any additional safe harbors either, but, perhaps reflecting the authorities' middle-of-the-road position, they invited specific comments on the feasibility of a safe harbor approach and its structure. The final regulations may well move further, depending on the nature of comments received. 7/

1/ See U.S. Treasury Department and IRS (1988), pp. 75-77. The examples of those proposals are categorized as follows:

1) Safe harbors based on industrial norms;

2) Safe harbor rules based on certain profit split ratios;

3) Safe harbor rules based on applicable tax rates (safe harbors are available if the tax rate in the foreign jurisdiction exceeds a certain level, say, 90 percent of the tax rate of the home country);

4) Prior settlement test (when a specific pricing method is accepted in a prior examination, the burden is on the tax authorities to show that the pricing method is unacceptable).

2/ For example, OECD (1979); U.S. Treasury Department and IRS (1988); and Fukui (1989).

3/ OECD (1979), paragraph 16.

4/ Jacob in International Tax Institute (1988).

5/ A safe harbor computation of an arm's length rental for the use of tangible property was also regulated in Regulation 482-2(c)(2)(ii), but it was repealed in 1988.

6/ U.S. Treasury Department and IRS (1988), p. 78.

7/ King (1992).

2. Preconfirmation or advance pricing agreements

To give clear guidance to taxpayers in advance, a system of preconfirmation by tax authorities or advance agreements between tax authorities and taxpayers on appropriate prices has been proposed. Although many countries have a general system of advance rulings on tax issues, they think the issuance of advance rulings on factual matters related to intracompany pricing arrangements is difficult or that the rulings, even if issued, have only a limited value. However, some countries have set up a system that is designed solely to resolve transfer pricing issues.

Japan set up a preconfirmation system for transfer pricing when it introduced its transfer pricing legislation in 1986. Under that system, a taxpayer proposes in advance to the tax authorities the method for determining an arm's length price that the taxpayer thinks is most reasonable. The tax authorities then study the proposed method by analyzing the relevant data and information including those provided by the taxpayer. If the authorities find the proposed method reasonable, they confirm it and are bound by the confirmation.

The United States began using a similar advance price agreement system for transfer pricing in 1991. 1/ According to the Revenue Procedure 91-22, the system is designed to produce an understanding between the IRS and the taxpayer on three basic issues: (a) the factual nature of the intercompany transactions to which the advance price agreement applies; (b) an appropriate transfer pricing methodology to apply to the transactions; and (c) the expected results of applying the methodology to the transactions. Where an understanding is reached, the IRS will regard the results of applying the methodology as satisfying the arm's length standard, and will not contest the application of the methodology to the subject matter of the advance price agreement. After an agreement is adopted, IRS examination will be limited to ascertaining whether the taxpayer has complied in good faith with the terms and conditions of the agreement, whether the representations made in the agreement remain valid and accurate, whether correct data and computations have been used in applying the pricing methodology, whether the assumptions underlying the agreement remain valid, and whether the pricing methodology established in the agreement has been consistently applied. One of the important features of the system is that in situations where the relevant transactions affect the tax liability of a related company in one or more foreign countries with which the United States has an income tax treaty, it contemplates involvement of the

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1/ For details on the U.S. procedure, see Reavy and Elliott (1991); Andrus, Bennett, Merrick, Meyer, Swenson, and Terr (1991); Fuller (1991); Liebman (1991); and McLennan (1992).

competent authority process in reaching an agreement. 1/ It is also anticipated that when a foreign country has a similar system, the IRS will process foreign-initiated requests under the same procedures that apply to U.S.-initiated requests.

It is argued that these systems are not very practical or useful from taxpayers' point of view. Taxpayers must submit their transfer pricing practices to the tax authorities' scrutiny and provide voluminous sensitive information; the process may be cumbersome and time-consuming; the agreement will cease to bind the tax authorities if a critical assumption of the agreement has changed; and the systems do not help to successfully resolve cases if the stance of the tax authorities is not flexible enough to accept taxpayers' methodologies. 2/ However, these systems provide an important opportunity for taxpayers to resolve potential intercompany pricing controversies in advance, without the need for serious audit disagreement, appeals negotiations, or litigation. 3/ If the relevant foreign tax authorities are successfully involved in the process, it would help avoiding double taxation in advance. From the viewpoint of the tax authorities, these systems could provide a more efficient means of resolving transfer pricing issues by reducing the number of appeals and litigations and saving time at the examination level. 4/ As a practical matter, the tax authorities may be able to obtain information from taxpayers more smoothly than through audits. 5/ In any event, time will tell if these systems are successful in resolving transfer pricing cases.

3. De minimis rule

The assessment of an arm's length price often depends on careful judgment and the resolution of many, perhaps conflicting, considerations between the tax authorities and the company concerned. 6/ Even after lengthy negotiations, it may be impossible to determine precisely an appropriate price. Consequently, it is argued that if the prices actually paid can be substantiated by acceptable evidence as being arm's length prices, there would be no justification for making merely minor or marginal

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1/ Reportedly, an agreement was reached between Australia and the United States to facilitate advanced determinations (Liebman (1991)), and several other countries indicated that they would participate in the process (Reavey and Elliott (1991)).

2/ Contrary to these arguments, some taxpayers with their experiences in obtaining advance pricing agreements point out that the process was not at all burdensome and that the data required to submit was not much. See, e.g., a remark by Eric Ryan, Director of Taxes for Apple Computer, in Eliot (1991), and Mogle, Chief Tax Officer for General Motors (1991).

3/ Andrus et al.(1991).

4/ Reavey and Elliott (1991).

5/ Reavey and Elliott (1991).

6/ OECD (1979), paragraph 15.

adjustments to them for tax purposes. 1/ Furthermore, an explicit de minimis rule is often proposed under which the tax authorities refrain from making a transfer pricing adjustment if the tax amount adjusted or the difference between an actual price and an appropriate price is below a certain level. A bilateral de minimis agreement could also be reached between the competent authorities of two countries, under which they would not negotiate cases including small amounts and the authorities in the country where the initial tax adjustment was made would withdraw the adjustment. 2/

4. Set-offs

Assume that a benefit provided to one company in country A in its transaction with a related company in country B is balanced to some degree by a different benefit provided by that one company to the related company. The companies may claim that the benefit received should be set off against the benefit provided as full or partial payment for it so that only the net gain or loss on the transaction need be taken into account in assessing their tax liability. 3/ If the arm's length price principle is applied strictly on a transaction-by-transaction basis, tax adjustments are made even in this case probably in both country A and country B. However, since this kind of set-off arrangement is sometimes encountered between unrelated parties, it could not be argued in principle that the arrangement is unacceptable between associated enterprises. 4/

The issue is how far this sort of set-off could be accepted in practice by national tax authorities. Although guidelines in some countries (e.g., Canada) provide that the arm's length price principle is applied on a transaction-by-transaction basis, it is not clear how this rule is applied to each case in terms of set-offs. The U.S. Regulation 482-1(d)(3), on the other hand, explicitly accepts intrayear set-offs. Under this regulation,

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1/ OECD (1979), paragraph 15.

2/ Kawada, a former Director of Office of International Operations, National Tax Administration, Japan, in International Tax Institute (1988) mentions that a bilateral agreement exists between the United States and Canada, and that his authorities are very much interested in having similar agreements with their major treaty partners. He also mentions that it is desirable to set a safety zone (if the margin ratio of the corporation in question falls within a reasonable range around the average of the comparables, the tax authorities should refrain from making a transfer pricing adjustment).

3/ The set-offs may involve more than two parties (e.g., company A accepts a detriment in its transaction with related company B because it is compensated by benefits received in transaction with related company C within the same group). This "group set-off," which requires determining whether all transactions involved lead to an adequate overall balance, would usually be unacceptable for tax authorities.

4/ OECD (1979), paragraph 20.

however, set-offs are accepted only on a year-by-year basis, and multiyear set-offs against excessive related party income derived in other taxable years are not permitted. The system of multiyear set-offs could provide more flexibility of taxation, though. Even between unrelated parties, their trade relations can be longer-term. Unexpected losses incurred by one party this year could be taken into consideration in the negotiations for next year's dealings with the consequence that their longer-term profits are eventually balanced. In Germany, multiyear set-offs of detriments suffered against benefits received within three consecutive years are accepted by the 1983 Transfer Pricing Guidelines.

VI. Recent Discussions on Pricing Methodologies and Some Alternative Approaches to International Income Allocation

Even with the systems to improve the predictability or flexibility of taxation which were discussed in the preceding section, the argument remains that the application of the arm's length price rule to actual cases is difficult. This concern has been stimulating arguments for reviewing the arm's length price principle or replacing it with some other approaches to international income allocation.

This section first reviews the recent discussions on the "commensurate-with-income" standard provided by the 1986 U.S. legislation, and on the pricing methodologies subsequently proposed in the 1988 White Paper and the 1992 draft regulations under Section 482 of the U.S. IRC. It then reviews some taxation techniques, including unitary apportionment, which have been adopted or proposed as alternative methods for international income allocation. Finally, it touches upon the issue of cost-sharing arrangements for research and development.

1. The "commensurate-with-income" standard and methodologies proposed thereunder

There are vigorous discussions currently under way on methods for establishing transfer prices, initiated by the amendment of Section 482 of the U.S. IRC in 1986. The 1986 Tax Reform Act amended Section 482 to require that payments to a related party for a transfer or license of intangible property be "commensurate with the income" attributable to the intangible. Since then, there has been much speculation and anxiety about the meaning of this language. 1/

The 1988 White Paper discusses in detail the "commensurate-with-income" standard. It describes the primary difficulty addressed by the legislation--the transfers of high profit intangibles that are unique and typically not licensed to unrelated parties. 2/ In these situations,

1/ Dolan (1990).
2/ U.S. Treasury Department and IRS (1988), pp. 46-47.

although it is difficult to find comparable third party transactions, taxpayers often try to justify their royalty rates by simply using comparisons with industry averages. In addition, they might look solely at the purportedly limited facts known at the time of the transfer, or do not consider the potential profitability of the transferred intangible (as demonstrated by post-agreement results). By confining the analysis of an appropriate transfer price to the time the transfer was made, taxpayers could transfer a high profit potential intangible at an early stage and attempt to justify use of an inappropriate royalty rate by claiming they did not know that the product would become successful.

The White Paper further explains that the application of the "commensurate-with-income" standard adopted in the legislation requires the following two practices to determine appropriate prices.

- Functional analysis: To determine taxable income of related parties in the absence of comparables, an approach traditionally called a "functional analysis" should be used. In this approach, the functions performed and the economic costs and risks assumed by each party to the transaction are analyzed, and the income from the use of the intangible is allocated in accordance with the relative economic contributions and risk taking of the parties.

- Periodic adjustments: To determine appropriate compensation for the intangible, actual profit experience should be focused, and therefore periodic adjustments should be made to the compensation to reflect substantial changes in profitability of intangibles, as well as changes in the economic activities performed and economic costs and risks borne by the related parties in exploiting the intangibles.

Based on this understanding of the 1986 Tax Reform Act, the White Paper further proposes a series of methodologies--the basic arm's length return method (BALRM), often referred to as the "ballroom" method--to be used to evaluate transactions involving intangible property. Under the BALRM,

- Total income from the relevant line of businesses is first determined;

- The line of businesses is then broken down by activity or function, and the factors (e.g., assets and expenses) used by the party performing a set of simple functions are measured;

- Income attributable to those functions is determined by identifying rates of return on assets or expenses of unrelated entities performing similar economic activities and assuming similar economic risks, and applying the comparable rate of return to the assets or expenses of the related party;

- After assigning the income thus determined to the party performing the functions, any residual income is assigned to the other party which performs complex economic functions, such as developing significant intangibles and bearing significant economic risks;

- An appropriate royalty rate or other transfer price is set to achieve the income allocation thus derived, without valuing the intangibles themselves;

- The appropriate price thus determined is reviewed periodically.

When both parties perform complex functions (both parties have significant intangibles), the BALRM is applied to the measurable assets or expenses of the two parties and the remaining income is split between the two parties based upon the relative values of their unique intangibles (Profit Split Addition to the BALRM). In this case, it is necessary to determine the relative value of significant intangibles, but not the absolute value.

The White Paper's proposal of the BALRM has stimulated worldwide discussions on the methodologies for establishing transfer prices. 1/ In cases where unique intangibles are transferred together with tangibles, "exact comparable transactions" with the transfer of the same intangibles hardly exist. To apply the three standard methods to these cases, starting from prices in some comparable transactions with the transfer of similar intangibles (the White Paper calls them "inexact comparable transactions"), appropriate price adjustments must be made reflecting the difference in the value of the intangibles. However, the valuation of the intangibles is difficult, and, as mentioned earlier in Section III, the existing international guidelines and national rules provide little guidance on this. The White Paper's position is that in cases where no "exact comparable transactions" exist, fourth methods summarized as BALRM or Profit Split Addition should be used more widely, rather than determining an appropriate price on the basis of "inexact comparable transactions." 2/ Here, focus

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1/ Numerous articles have been written by practitioners as well as economic scholars; the following are only a few: Berry (1989); Bischel (1988); Bonny and Sherwood (1989); Carlson, Fogarasi, and Gordon (1988); Frisch (1989); Fuller (1988); Levey, Ruchelman, and Seto (1989); Purvis, Panich, and Moore (1989); Schindler and Henderson (1989); Stoffregen, Higinbotham, Asper, and Wexler (1989); Sunley, Maguine, and Wills (1989). For comments made from a taxpayer's viewpoint, see, e.g., International Chamber of Commerce (1989) and Union of Industrial and Employers' Confederations of Europe (1989). For comments by tax authorities in other countries, see Calderwood (1988, 1989a); Hunter (1989); Fukui (1989); and Kawada (1989b). As for responses by IRS officials, see Matthews (1989).

2/ U.S. Treasury Department and IRS (1988) allows the use of inexact comparables only when differences between intangibles in question and inexact comparables are definite and ascertainable. Also, it mentions that the use of inexact comparables should not be given priority over the BALRM or Profit Split Addition.

is no longer on the arm's length price of each transaction or product. An appropriate price is determined only indirectly by allocating the entire income of a line of businesses (but not income from each transaction or product) among related parties on the basis of some profit indicators. Many authors have expressed concern that such fourth methods will result in an arbitrary or judgmental allocation of income. The rate of return analysis under the BALRM would not be as easy as the White Paper assumes, since the rate of return varies among companies according to their efficiency, situation, strategy, type of product, and so on. If this method is used without fine analysis, the result could be inaccurate. Moreover, the profit split analysis under the BALRM could be very judgmental in the absence of any reasonable standard for determining an appropriate split ratio. 1/

The idea of periodic adjustments is even more controversial. While the White Paper explains that the practice of periodic adjustments is consistent with what unrelated parties would do, there is a strong argument that it is not the practice engaged in by unrelated parties and that periodic adjustments are inconsistent with the arm's length price principle. 2/

Taking into account comments on the White Paper received from the public and foreign authorities, in January 1992 the U.S. Treasury and IRS proposed a revision of the regulations under Section 482 of the IRC which regulate the methodologies for establishing transfer prices. 3/ The methodologies set forth by the proposed regulations have much in common with those proposed in the White Paper, in spite of differences in terminology. The proposed regulations have retained the concept of exact and inexact comparables, though they are now termed "matching transactions" and

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1/ See Fukui (1989). He, a former Deputy Commissioner for International Affairs, National Tax Administration, Japan, argues that even in those cases where intangibles are transferred with tangibles, one should try hard to seek some comparable transactions, albeit inexact, and use the CUP, RP, and CP methods as much as possible while making appropriate price adjustments reflecting differences between the transaction in question and the comparable transactions. He considers that the price adjustments are to be made not only for quantifiable but also for unquantifiable differences by setting up a certain allowance.

2/ See Calderwood (1988, 1989a); Fukui (1989); International Chamber of Commerce (1989); and Union of Industrial and Employers' Confederations of Europe (1989).

3/ Numerous articles have been or are being issued on the proposed regulations. See, e.g., Turro (1992a); Hannes(1992); King (1992); O'Grady (1992); and Fuller and Aud (1992).

"comparable adjustable transactions." 1/ They also retained the concept of periodic adjustments. In the absence of comparables, similarly to the BALRM (or its variation) proposed in the White Paper, the "comparable profit method" set forth in the proposed regulations tests the profitability of taxpayers by comparing their profit indicators (e.g., return on assets, margins, and profit splits) with those of uncontrolled parties. There is, however, an important difference between the two methods. While the BALRM (or its variation) specifies a single set of methodologies to be applied and estimates a single point of acceptable income, the comparable profit method constructs an interval of acceptable income on the basis of convergent results obtained by applying different profit indicators to a single uncontrolled party or by applying one or more profit indicators to different uncontrolled parties.

The proposed regulations are not final. Comments have been invited from the public and foreign authorities and will be considered before adoption of the final regulations. Further extensive discussions are therefore expected on this issue.

2. Some taxation techniques adopted to deal with the difficulty of applying the arm's length price principle

The difficulty of applying transfer pricing rules to particular cases, which is experienced to some extent by every tax administration in advanced industrial countries, would be much more serious in developing countries whose administrations in most cases have only limited resources. Transfer pricing is, however, an important issue for developing as well as developed countries. Taxation of foreign-related businesses often represents such a substantial part of total tax revenue in developing countries that it is not just a matter of tax equity but one of economic necessity to be able to tap the tax potential of multinational enterprises. 2/

To deal with this problem, some simpler taxation techniques are often used in developing as well as developed countries, 3/ though their consistency with international tax rules, represented by the OECD and the UN Models and bilateral tax treaties, is sometimes questionable.

a. Notional prices. Notional or posted prices are occasionally fixed for intracompany transactions by a host country, with or without negotiation with multinationals, for the purpose of determining income subject to tax.

1/ Similarly to the White Paper, while the proposed regulations give the first priority to the matching transaction method, they do not necessarily give priority to the comparable adjustable transaction method over other methods. That is, the prices determined by the comparable adjustable method have to be verified by reference to the result derived by the comparable profit method described below.

2/ Mutén (1991).

3/ See Casanegra de Jantscher (1980); Chudson (1985); and Mutén (1991).

The classic example, though no longer relevant, was the posted price for crude oil exported from Arab countries. 1/ In Jamaica, to avoid a transfer pricing problem, income from bauxite mining is assessed on the basis of assumed net profits per ton of bauxite, which are derived from a transparent set of market price indicators.

b. Presumptive tax. Some countries have established presumptions of income for certain activities, usually on the basis of a percentage of gross receipts, where the use of the transfer pricing method is difficult. For example, in Argentina, net income is presumed to be 10 percent of gross receipts for international transportation, news agencies, and insurance companies; in Brazil, a 20 percent presumption is applied to import and export, mining, and transportation. In response to such taxing practices, some tax treaties include an article which provides that the amount of the profits so derived shall not exceed a certain percentage of the gross receipts. 2/

c. Taxation of intercompany transfer payments. A substantial withholding tax on intercompany royalties, interest, and service fees imposed by a number of countries could be considered as a measure taken to deal with the problem that these intercompany payments offer an opportunity to shift profits. Some countries (e.g., Brazil and Colombia) have further disallowed or restricted the size of the deduction of intercompany royalties, commissions, and fees as a business expense, treating these payments as profits.

d. Unitary apportionment. In some countries (e.g., Chile), the tax authorities are allowed to discard the transfer pricing method when the result of applying it would be unrealistic or unsatisfactory, and to assess the income of a domestic entity in a multinational group by unitary apportionment, that is, by apportioning to the entity a fraction of the worldwide income of the multinational group according to certain objective factors, such as sales, payroll, property, or a combination of these.

3. Unitary apportionment for international income allocation

Because of the difficulty of applying the transfer pricing method, unitary apportionment is frequently proposed as an alternative general method for international income allocation. Bird (1988), pointing out that the present transfer pricing approach has by now received a fair test and has clearly failed that test, concludes-

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1/ Chudson (1985).

2/ For example, the Netherlands-Singapore and Netherlands-Australia Treaties limit the profits from shipping and air transport to 5 percent of the gross receipts.

> "As every country which has seriously attempted to cope with its international tax problems has discovered, there is no effective way to deal with many intercountry allocation problems except through some type of formula apportionment of the tax base."

Vann (1991) also mentions that formula apportionment "would be a more satisfactory procedure than the resolution of differing views of the appropriate arm's length price by agreements between national tax authorities."

Nevertheless, considerable criticism has been directed at the unitary method. 1/ The method ignores differences in profitability among different parts of an enterprise. Establishing an internationally acceptable formula is not an easy task given the differences in development among countries. There are also a number of technical difficulties--how to define the coverage of the unitary business and how to measure factors in countries with different accounting practices and currencies.

Developing countries normally avoid the unitary apportionment system, except where it is included in a tax code as a warning to induce cooperation from multinationals in applying the transfer pricing method. The above-mentioned technical difficulties would be much more serious for less-equipped tax authorities in developing countries. Moreover, these countries would have difficulties in deciding on apportionment keys: the traditional keys--sales, payroll, and property--could be all unfavorable for developing countries; however, if they could work out other favorable keys, they would have difficulty making the rest of world accept them. 2/

Examples of actual application of the unitary apportionment are found in some states in the United States. 3/ The states that impose a corporate income tax use some type of formula (in most cases, the above-mentioned three-factor formula) to apportion business income among the states in which the corporation operates. While most states only apportion business income of the corporation doing business within the state, some states have adopted a worldwide combined reporting (WWCR). Under this system, the formula is applied not only to the income of the corporation doing business within the state, but also to the income of any related corporation whose activities outside the state contribute to or are dependent upon the activities within the state. 4/ Here, the formula is applied to foreign as well as domestic operations.

1/ For a survey of these arguments, see Casanegra de Jantscher (1980); Kopits and Mutén (1984); and Mutén (1988).

2/ Mutén (1991).

3/ For recent information on this issue, see, e.g., Rothschild (1991); Kaplan (1991); and Corrigan (1992).

4/ Rothschild (1991).

The WWCR was used by a number of U.S. states, but under pressure from foreign governments, the international business community, and even the Federal Government, most of them have now modified their mandatory WWCR at least to allow taxpayers to limit the income base to that earned within the United States (a limitation which is referred to as the "water's edge" limitation). 1/ California, which has been applying the WWCR most conspicuously, has also allowed multinational taxpayers this option since 1988, but has required that the electing corporations pay a special election fee.

The constitutionality of the WWCR has been tested in some court cases. Most recently, the November 30, 1990 decision of an appellate court in California in the well-known Barclays Bank case held that the state's WWCR method as applied to foreign-based unitary groups is unconstitutional because it not only implicates foreign policy issues, which must be left to the Federal Government, but also violates a clear federal directive. 2/ This decision, however, was reversed on May 11, 1992 by the California Supreme Court, and the case has been remanded back to the appellate court for further consideration. 3/ Much more time will elapse before this issue is concluded, most likely through a final judgment of the U.S. Supreme Court.

4. Cost-sharing arrangements

In transfers of intangible property, one income (cost) allocation practice used by multinationals is cost-sharing arrangements among associated companies, especially for research and development (R&D) expenditures. Cost-sharing arrangements are those under which members of the group agree to share the actual costs and risks of R&D undertaken for the benefit or expected benefit of each of them. 4/ Each participant shares the costs and risks and in return is entitled to share any usable results of the R&D. Because each participant owns specified rights to the intangibles developed, no royalties are paid by the participants; thus, they may be able to avoid the issue of valuing intangibles. The 1979 OECD Report stated that although this method of recouping R&D costs was not very common, it had been used over recent years by several large multinational enterprises that had extensive and costly worldwide research

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1/ Kaplan (1991).

2/ For details on this decision, see Rothschild (1991).

3/ Despite a number of statements of opposition from the Federal Government in the form of presidential statements, press releases, official letters and reports, and testimony, the Supreme Court decided that they are not sufficient to overcome the contention of California's Franchise Tax Board that other actions and inactions of Congress constitute a federal directive that favors the WWCR. For details on this Supreme Court decision, see Corrigan (1992).

4/ OECD (1979), paragraph 103.

activities. 1/ Recent trends among tax authorities to strengthen their transfer pricing rules on intangible goods may make the use of cost-sharing arrangements more attractive to taxpayers in future, although this possibility, of course, depends on each country's tax treatment of cost-sharing arrangements.

Cost-sharing payments by each member of a cost-sharing contract are deductible as an expense, or charged to a capital account and written off in later years--depending upon the tax laws of the countries concerned--but such tax treatments are allowed only when the cost-sharing contract is recognized for tax purposes. To date, tax authorities in many countries appear to have little experience with cost-sharing arrangements, but a few countries have specifically addressed cost-sharing arrangements in their transfer pricing regulations or guidelines.

An example of relatively detailed rules on cost-sharing arrangements is found in the 1983 German Transfer Pricing Guidelines. 2/ The main rules of the guidelines are the following:

- The cost-sharing contract has to be concluded in advance in unambiguous terms and then actually carried out.

- The contract has to establish on the part of the taxpayer a specific right, definite in both nature and scope, to benefit from the R&D activities. The taxpayer has to actually use or be expected to use the results of the R&D in its commercial activities.

- The contract has to base the sharing arrangement on the costs (direct and indirect) that are attributable to the R&D activities and arise in the accounting year. The costs must be clearly distinguishable by reference to the contract.

- The contract has to include appropriate apportionment formulas corresponding to the extent to which the taxpayer actually benefits or can be expected to benefit from the results of the R&D. The ratio given by the respective turnovers of the group members can only be applied as a basis if this is a useful standard for determining the actual or expected benefits for these members.

- The costs borne by the taxpayer itself within the scope of the contract have to be included in the shared costs and credited against the shared portion.

1/ OECD (1979), paragraph 102.
2/ The Canadian Information Circular 87-2 and the U.S. regulations under Section 482 also provide some guidelines, but in less detail. On Italy, Maisto (1989) provides some useful information.

- A profit markup on shared costs cannot be recognized for tax purposes in view of the absence of entrepreneurial risk. However, this does not rule out the possibility that, within the framework of the full-cost computation, an appropriate amount for interest on capital invested as well as a contribution to executive and general administrative expenses can be included in the shared costs.

As shown in the German guidelines, the major concerns of tax authorities would be the reasonableness of coverage of the cost-sharing contract in terms of products or participating members, calculation of the R&D costs and basis for allocating the costs to the members, and entitlement to any profit markup on the activities of the member conducting the R&D function.

The proposed U.S. regulations under Section 482 of the IRC (see Section VI.1) detail the rules on cost-sharing arrangements, together with those on transfer pricing methodologies. In addition to the above-mentioned points, it shows the authorities' concern about inclusion of fully developed intangibles in the contract and inappropriate treatment of new participation or withdrawal. It also shows the view that the cost-sharing contract is subject to the requirement of periodic adjustments discussed in Section VI.1 above.

The 1979 OECD Report contains some guidelines for cost-sharing arrangements, but not in great detail. As there is some concern that countries will differ regarding the acceptability of such arrangements, this would be an area which could usefully be kept under review by international bodies. 1/

Another important issue regarding the tax treatment of cost-sharing arrangements is whether withholding tax on royalties can be applied to the cost-sharing payments. The 1979 OECD Report sets forth the view that the payments should not be taxed in the country of source; Germany, Canada, the United States, and Italy follow this rule. However, this view is not necessarily shared by everyone, notably the many developing countries that may wish to apply their withholding tax on royalties to the cost-sharing payments.

VII. Conclusion

Tax authorities in several countries have intensified their surveillance of transfer pricing in recent years. Concurrently, international discussions on methods for determining arm's length prices are being renewed, especially in the area of application of fourth methods and valuation of intangible property where the existing international rules do not provide sufficient guidelines. Developments have also taken place in

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1/ Collins (1987a).

the way in which tax administrations monitor transfer prices. Reflecting the increasing attention of tax authorities to international tax matters, some countries have introduced more centralized administrative systems and more powerful administrative tools--for example, longer time limitations and some extraterritorial measures for collecting foreign-based information.

In response to these developments, many concerns have been expressed--not only by taxpayers but also by tax authorities. If transfer pricing rules are applied arbitrarily, it could result in excessive interference with free economic activities and harm foreign investment. It is true that, strictly speaking, no law limits national tax jurisdiction under the present international tax system, and that each country may adopt whatever taxing rules or practices it sees fit. 1/ However, incorrect application of transfer pricing rules in one country could lead to counter measures in another country, with the result that international capital flows are distorted. In addition, under the existing international tax treaty provisions where the elimination of double taxation depends on how successfully the relevant competent authorities can reach an agreement to settle the cases, the problem of double taxation could remain unsolved as a result of differences in the taxing approach of national tax authorities. Consequently, international coordination among tax authorities as well as international dialogues between tax authorities and taxpayers will become much more important in future.

One argument against the transfer pricing approach is that, even if detailed rules are written in the form of regulations or guidelines, it is difficult to apply such rules to actual cases and to determine precisely the arm's length prices. In light of this, tax authorities should be required to take a prudent attitude in their transfer pricing examination practices. At the same time, efforts should be made to improve the predictability of taxation as much as possible. In this context, the system of advance pricing agreements involving prediscussions between competent authorities could be an important tool for resolving transfer pricing cases in advance.

In spite of the above-mentioned efforts, the argument remains that the application of the arm's length price rule is difficult and unpredictable. Unitary apportionment is thus frequently proposed as an alternative method for income allocation. Admittedly, however, it is unlikely that there will soon be an international consensus for a move to this approach. Considerable criticism has been directed at this method on theoretical as well as technical grounds. Establishing an internationally acceptable formula is not an easy task given the differences in development among countries. However, against the background of growing demands for clearer international tax rules, this issue will continue to be an important topic in international tax circles.

1/ Bird (1988).

A transfer pricing policy is an important issue for developing as well as developed countries. Since taxation of foreign-related businesses often represents a substantial part of total tax revenue in developing countries, it is not just a matter of tax equity but also one of economic necessity to be able to tap the tax potential of multinational enterprises. On the other hand, these countries are seriously beset by practical difficulties in applying transfer pricing rules, because their administrations in most cases have only limited resources to cope with complicated international tax issues. Therefore, some simpler taxation techniques are often used in developing countries, although their consistency with international tax principles is sometimes questionable.

At this stage, there is much uncertainty about the impact that the recent discussions on transfer pricing issues will have on developing countries. Perhaps, as more sophisticated international tax principles are constructed for international income allocation, the problem of insufficient administrative resources in developing countries will become more serious. In any event, when a new international consensus is eventually established through these discussions, appropriate attention should be paid to the issue of taxing practices in developing countries.

Elimination of Double Taxation

This appendix deals with the issue of eliminating economic double taxation arising from the adjustment of transfer pricing by tax authorities.

1. Procedures for corresponding adjustments

When an adjustment ("initial adjustment") is made to transfer prices for tax purposes by the tax authorities of a country, the procedures for a "corresponding adjustment" in another country to eliminate the resultant double taxation depend on the mechanism of double taxation relief provided by the tax treaty between the two countries. In some cases, however, domestic rules may provide unilateral relief for economic double taxation without involving the tax authorities of other countries. 1/ When the bilateral tax treaty has a provision corresponding to Article 9(2) of the OECD Model, 2/ the treaty partners are required to make a correlative adjustment following that provision. However, there is a certain limitation to the scope of Article 9(2). A corresponding adjustment under this provision is mandatory only if, and to the extent that, the relevant tax authorities agree with the adjustment of the price made by the tax authorities of the other country. 3/ Therefore, if the authorities of the two countries have different views on what the appropriate arm's length price is, the relief available under Article 9(2) is not complete but competent authority procedures may have to be initiated in order to reach an agreement. On the other hand, even when the bilateral treaty does not contain a provision similar to Article 9(2), most countries consider that economic double taxation resulting from transfer pricing adjustments is not in accordance with the spirit of the double taxation treaty and that it falls within the scope of the competent authority procedures set up under a

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1/ In France, pursuant to case law, a French undertaking whose related undertaking in foreign countries has been subject to an adjustment to the arm's length price may file a claim domestically to obtain a reduction of the tax base (Goldsmith (1988)). In Germany, the tax administration can make downward adjustments as the result of unilateral findings that the taxpayer received nonarm's length benefits, although downward adjustments in implementing competent authority agreements are by far more frequently encountered (Jacob (1987)).

2/ Article 9(2) of the OECD Model states, "Where a contracting State includes in the profits of an enterprise of that State profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits."

3/ OECD's Commentary on the Articles of the Model Convention (OECD (1977)).

provision equivalent to Article 25 of the OECD Model. 1/ Consequently, whether following Article 9(2) or Article 25, often correlative adjustments are made in the implementation of the agreement reached in competent authority procedures.

2. Limitations to competent authority procedures

Details on competent authority procedures are not discussed at length here. Here the focus is on several aspects of the procedures which have been identified as weak and have been examined intensively in recent years. 2/ The following are often considered limitations to the existing competent authority procedures.

a. Time limitations for corresponding adjustments

Since longer time limitations are often allowed for transfer pricing examinations (e.g., six years, or maybe much longer if the time is extended with the consent of the taxpayer), it is possible for the original upward tax adjustment by a country' tax authorities to be made many years after the tax year in question. In such cases, the treaty partner country may reject the competent authority procedure because the time limitation (for downward adjustments) in that country has expired. To solve this problem, tax treaties can adopt either of the following two approaches. In one approach, tax treaties can have an article that waives the domestic time limitation for downward adjustments in the treaty partner country. 3/ Even in such cases, however, the partner country, in practice, may not accept the tax adjustment in the competent authority procedure because the country no longer can obtain enough information to judge appropriate prices. In the other approach, tax treaties or bilateral agreements can set a shorter time limitation for initial tax adjustments than those set by domestic laws. 4/

1/ Some countries consider that when Article 9 contains no paragraph 2, no provision in the treaty imposes a requirement on them to revise their assessment because, in their view, Article 25 does not apply in such cases. In those countries, however, a way to remedy economic double taxation is usually found, either on the basis of domestic provisions or by the exercise of discretionary power which some tax authorities possess to relieve the most severe cases (OECD (1984), the first report, paragraph 79).

2/ For information on practices of competent authority procedures in major industrial countries, see International Tax Institute (1988). Also, see Calderwood (1989b) for Canada; and Novack (1989) and McIntyre and Turro (1991), both for the United States.

3/ For example, the U.S.-Japan Tax Treaty. The OECD Model, which allows taxpayers to present cases within three years of the first notification of the action resulting in taxation, also employs this solution.

4/ For example, the U.S.-Canada Tax Treaty; the Canada-France Tax Treaty; and bilateral agreement under the old U.S.-Canada Tax Treaty.

In any event, as the 1984 OECD Report mentions, it is desirable to operate the system so as to minimize, as much as possible, the obstacles to the relief of double taxation. 1/ In this context, avoiding delays in tax examinations would be an important aim of tax authorities.

b. Delays in procedures

One of the weaknesses of competent authority procedures may be the time involved. International negotiations on such complex matters as transfer pricing can take a long time, and the process is often slowed by the taxpayer's delay in providing the necessary information. However, it is also true that many cases have been settled in a relatively short time, 2/ and, in recent years, the average time taken to resolve a case has been reduced considerably as a result of the authorities' efforts in expediting procedures. 3/

c. Proposals for mandatory corresponding adjustments subject to arbitration

Regarding competent authority procedures, it is pointed out that the taxpayer's position is weak because the authorities have no obligation to reach an agreement resulting in the elimination of double taxation. 4/ Thus, many proposals have been made to resolve international tax disputes through arbitration mandatorily or with the taxpayer's initiatives. 5/ From the taxpayer's point of view, arbitration would provide the certainty of a decision and perhaps reduce delays. 6/ Among the proposals, Shoup (1985) recommends arbitration--especially of transfer pricing disputes involving multinational enterprises--for the sole purpose of settling on a correct transfer price (not computing change in tax due). He also points out the benefits of arbitration for developing countries which suffer from the disparity in technical resources for handling transfer price problems between their tax administrations and multinational enterprises (or the developed countries' tax administrations)-

> "The case for arbitration of transfer pricing disputes under the income tax internationally seems uncertain, or weak, when the

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1/ OECD (1984), the first report, paragraph 25.

2/ OECD (1984), the first report, paragraph 90.

3/ Calderwood (1989b), regarding Canada, points out that the average time taken has been reduced to under two years.

4/ Lindencrona and Mattsson (1990).

5/ The Commission Proposal of the European Community in 1976; the proposal by Francke, Lindencrona, and Mattsson at the 1981 annual congress of the International Fiscal Association (IFA); Lindencrona and Mattsson (1981); the resolution by the International Chamber of Commerce (ICC) Council in 1984; and Shoup (1985). For a survey of these proposals, see Lindencrona and Mattsson (1990).

6/ See OECD (1984), the first report, paragraph 42.

taxing authorities are those of developed countries, especially countries that are linked by tax treaties. Even here, however, there may be a strong undercurrent of need for arbitration that has gone unrecognized... On the other hand, many of the disputes between a developed and developing country, or a developing country and an MNE (Multi-National Enterprise), could probably be settled much more expeditiously and more fairly if appeal to binding arbitration were possible."

In reality--although not much has happened mainly because of a hesitation by countries to transfer their power to decide upon the terms of a settlement to a body beyond their control-- 1/ some steps have recently been taken. In 1985, an arbitration clause was introduced in the draft German-Swedish Income Tax Treaty, although the treaty has not been signed due to reasons unrelated to the arbitration clause. 2/ Furthermore, an arbitration clause was included in the 1990 German-U.S. Treaty. The arbitration procedures provided in these treaties are not mandatory for the treaty countries, but are initiated when both countries agree. However, once the arbitration is initiated, the decision of the arbitration is binding. Although incomplete, these steps must be considered remarkable breakthroughs, in the sense that they indicate a new attitude on the part of sovereign countries concerning arbitration procedures.

In addition to these bilateral treaties, the European Community (EC) signed a multilateral treaty in 1990 to make the existing competent authority procedures more equitable and expeditious. 3/ Under the new system, if, within two years of the date on which the case was first submitted to one of the competent authorities, they fail to reach an agreement, they are required to set up an advisory commission to deliver an opinion on the matter. The commission must give its majority opinion within six months of the date the matter was referred to it. The competent authorities are then required to act within six months. They are entitled to agree to their own approach even if it differs from that of the advisory commission. However, if they cannot agree, the opinion of the commission becomes binding.

d. Secondary adjustments

It is also pointed out that tax treaties provide no relief for "secondary adjustments," that is, secondary tax consequences brought by transfer pricing adjustments. For example, assume that a payment is disallowed as an expense under transfer pricing rules because it is regarded

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1/ Lindencrona and Mattsson (1990).
2/ Lindencrona and Mattsson (1990).
3/ For details, see Turro (1991). The treaty has been signed by all 12 member states of the EC and is now under ratification procedures.

as the excess over the arm's length amount. 1/ Under some circumstances, tax administrations may feel that it is necessary to recategorize the excess for tax purposes. If the excessive payment has been made by a subsidiary to a parent company, there is a certain logic in regarding the excess as a dividend and subjecting it to withholding tax. If it has been paid by a parent company to a subsidiary, a similar logic may justify treating it as a contribution to the capital of the recipient company, with whatever taxation consequences may flow from that. Where the excess is paid to a "sister company," that is, a company controlled by the same person, then the logical consequence may not be so easy to discern. However, in general, in countries where excess payments from a subsidiary to a parent company would be treated as a dividend, the tendency is to treat such payments between sister companies also as dividends or, in some cases, as, initially, dividends paid to the common parent and, subsequently, as capital contributions from the parent to the sister company.

To avoid secondary adjustments, some countries, such as Canada and the United States, provide taxpayers with the option of having the foreign party repay to the domestic party the excess price paid without any further tax consequences. However, this sort of transfers may cause additional tax adjustments in other countries. To harmonize the country practices and to provide appropriate relief, the problems of secondary adjustments could usefully be reviewed further by international bodies. 2/

e. Interest on tax deficiencies

Double taxation may not be eliminated completely as a result of interest on tax deficiencies. The treatment of interest on tax deficiencies and on tax refunds is different in each country; for example, some countries pay interest on tax refunds, others do not. For those that do, the interest rates and the period to which the interest is applied are different. Consequently, even if double taxation regarding tax itself is eliminated through competent authority procedures and subsequent tax refunds in the country making a corresponding adjustment, some interest burden may remain. 3/ This seems inappropriate because the taxpayers paid the tax to one of the countries and thus did not have any chance of utilizing the fund for their benefit. In cases where a long time is spent on tax examinations

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1/ The following presentation in this paragraph is taken from Collins (1987a).

2/ Collins (1987a). An unpublished report on secondary adjustments approved by the Committee on Fiscal Affairs of OECD in 1990 provides useful guidance on this issue and a survey of country practices, although it does not succeed in recommending specific common solutions.

3/ In the case where tax is reduced in a country with interest on tax refunds and increased in another country with little or no interest charged on tax deficiencies, the taxpayer may receive some windfall profits.

or competent authority procedures, this interest burden could be huge. To solve this problem, several approaches are proposed: 1/

(1) Both countries would charge interest on deficiencies and pay interest on refunds in a competent authority case;

(2) Neither country would pay interest on refunds nor charge interest on deficiencies in a competent authority case;

(3) Interest would be disregarded during the period the issue is under the jurisdiction of the competent authorities;

(4) Tax adjustments would be telescoped to the current year to lessen or avoid interest obligations in a competent authority case;

(5) When the entity that received less than an arm's length consideration charges the over-compensated entity interest on the profits allocated, the interest would not be included in the profits of the former while it would be included in the expenses of the latter.

How flexibly the tax authorities or competent authorities can handle this issue largely depends on domestic laws regarding interest on tax deficiencies and refunds and on the legal status of competent authorities. The United States--where it is understood that the competent authority is empowered to unilaterally abate the interest normally charged on tax deficiencies--is exploring bilateral working arrangements following the above-mentioned options. 2/ Even among countries with a more restricted interpretation of the power of their competent authorities, Japan has revised its general law regarding interest on tax deficiencies and refunds to make it possible for its competent authority to adopt option (2) above. 3/

1/ Bergherm and Kawada in International Tax Institute (1988).
2/ Bergherm in International Tax Institute (1988).
3/ Kawada in International Tax Institute (1988).

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