



Working Paper 86

Problems of Transfer Pricing and Possibilities for Simplification

Sol Picciotto

November 2018

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Problems of Transfer Pricing and Possibilities for Simplification

Sol Picciotto

Summary

The defects in the rules for allocation of the income of transnational corporations (TNCs) are at the heart of the current crisis in international corporate taxation. This paper explains how these rules emerged and developed, becoming increasingly complex, as they have shifted from a general concern to ensure a fair and reasonable allocation of the profits of TNCs, to methods focusing on treating all intra-firm transfers as transactions to be priced by reference to comparables. This approach has been extended to allocations of shared factors of production (capital, intangibles, central services, risk), for which methods based on the transactional approach are particularly unsuitable. These methods are time-consuming and difficult to administer, and also have generally been found to be ineffective, both in theory and practice. They require resource-intensive examination of the specific facts and circumstances of individual taxpayers, needing skilled analysis, and depending on subjective judgement. Hence, a variety of simplified methods have been devised, which are surveyed and analysed in this paper, especially from the point of view of their suitability for developing countries. They include the Brazilian fixed margin method, safe harbour rules attempted notably by India, and sectoral profit attribution rules established by Mexico and the Dominican Republic, as well as other alternatives, such as a shared net margin method, and an alternative minimum tax. Although these are only palliatives pending more far-reaching reform, developing countries in particular should consider such approaches, adapted to their own circumstances, in any toolbox of measures for taxation of TNCs.

Keywords: allocation of profits; transfer pricing; transactional approach; transnational corporations; safe harbour; international corporate taxation.

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Acronyms

ALP	Arm's length principle
APA	Advance pricing arrangement
ASONAHORES	National Association of Hotels and Restaurants (Dominican Republic)
ATAF	African Tax Administration Forum
BEPS	Base erosion and profit shifting
BRICS	Brazil, Russia, India, China and South Africa
CbCR	Country-by-country reports
CFC	Controlled foreign corporations
CGI	Code Général des Impôts
CIAT	Centro Interamericano de Administraciones Tributarias (Inter-American Center of Tax Administrations)
CUP	Comparable uncontrolled price
FDI	Foreign direct investment
GAO	General Accounting Office (US)
INR	Indian Rupee
IRS	Internal Revenue Service (US)
MAP	Mutual agreement procedure
MNE	Multinational enterprise
NAFTA	North American Free Trade Agreement
OECD	Organisation for Economic Cooperation and Development
PE	Permanent establishment
PSM	Profit split method
R&D	Research and development
s.	Section
SNMM	Shared net margin method
TNC	Transnational corporation
TNMM	Transactional net margin method
TP	Transfer pricing
TPGs	OECD Transfer Pricing Guidelines
UNCTAD	United Nations Conference on Trade and Development
US\$	United States Dollar
WP6	OECD Working Party 6

Introduction

It has become recognised that the current international system for taxation of the profits of transnational corporations (TNCs) is in crisis. This recognition led to the launching in 2012 of an unprecedented effort to reform international tax rules, the project on base erosion and profit shifting (BEPS), by the Organisation for Economic Cooperation and Development (OECD). This project was given political backing in 2013 by the G20 world leaders (G20 2013). Although a package of reports was delivered in 2015, work has continued, now within the Inclusive Framework for BEPS, which has been thrown open to all states.

At the heart of this crisis lie the rules for allocating the income of TNCs among the countries where they do business. This is because they embody a central conundrum: tax is levied by national states, whereas TNCs operate as global firms. Hence, taxation of their business profits requires fair and effective rules to decide on the allocation of those profits among the various countries in which they have business activities. This section outlines the problems this has posed, which are spelled out in greater detail in the next section.

The methods for allocation of profits have come to be known as transfer pricing rules. Although TNCs operate in an integrated manner as single firms, they nowadays consist of many, often hundreds, of legally separate affiliates – companies and other entities (e.g. partnerships, trusts) – all under common ownership and central control.¹ Each tax authority naturally deals with the affiliates resident or doing business in that country, and it seems normal in determining the profits earned in the country to start from the accounts of those local entities.

However, since early last century national tax authorities have been given powers to adjust the accounts of entities if they formed part of an international corporate group, to ensure that the reported allocation of profits is appropriate. This is because companies under common control are, by virtue of that fact, not independent of each other. Hence, the relations between them are not like market transactions. Nevertheless, the standard which became internationally agreed in the 1930s for the adjustment of accounts was to compare them with those of similar independent firms. This standard has always been understood to be a fiction, and the power to adjust accounts was aimed at ensuring a fair and reasonable allocation of profit among the firm's various affiliates. From the 1920s to the 1970s this was done by applying two possible approaches: one based on comparable profits (applying a benchmark profit margin, for example, to turnover),² and the other fractional apportionment of the TNC's global profit.

Thus, many countries have long included in their primary tax legislation a general power to adjust the accounts of entities which are related to others in a multinational corporate group. This includes most African countries (see Appendix), which frequently included such provisions in laws going back to the colonial or early post-colonial period.

It is only much more recently that transfer pricing rules became more firmly fixed on the pricing of transfers between related entities, and on evaluating them by reference to comparable transactions between unrelated parties. This soon proved to be a deeply flawed approach. It requires tax authorities to conduct a detailed audit of each firm, needing specialised knowledge of its economic sector and business model. It entails subjective judgement and requires skilled staff. This poses a dilemma for revenue authorities, especially in poor countries, which find it hard to devote scarce resources to this task, although effective

¹ Analysis by the United Nations Conference on Trade and Development (UNCTAD) shows that although only 1 per cent of TNCs have over 100 affiliates, these TNCs account for over 60 per cent of value added by TNCs, and that the largest 100 TNCs have some 55,000 affiliates between them (UNCTAD 2016: 134-5).

² Described as 'empirical' methods in the Carroll report, see below, p.9 and Table 1.

taxation of TNCs is a key enforcement priority. It also means that the income declared and tax paid by large TNCs in each country has become a matter of ad hoc negotiation, lacking legitimacy as well as effectiveness. This inevitably creates conflicts and generates uncertainty for business.

Section 1 of this paper discusses in more detail how this came about, the problems it has caused, and the attempts to refine the rules to deal with these problems. While commentators often refer to this history, this section provides essential background for understanding the paradoxical processes which resulted in the present ad hoc and complex system, and the context of the arguments for new, simplified approaches. Section 2 of the paper goes on to survey the various attempts at and proposals for simplified methods, including case studies of some key countries: Brazil, India, Mexico and the Dominican Republic. Although these experiences indicate the problems caused for even advanced developing countries by the orthodox OECD approach,³ the BRICS countries (Brazil, Russia, India, China and South Africa) as a group have not yet played a cohesive role, so have not dislodged the mainstream consensus on this technical issue. The paper closes with some conclusions and recommendations. Pending a more radical reform of international tax rules, there is an urgent need for clear and easy to administer rules for the allocation of income of TNCs.

1 The evolution of transfer pricing controls

1.1 The independent entity concept and the arm's length principle

This section will trace the historical development of the rules to allocate the income of TNCs. An overview is provided in Table 1.

1.1.1 Origins

International tax rules originated in the work of the League of Nations in the 1920s (Picciotto 1992: ch. 1.4; Jogarajan 2018). This laid the groundwork for the system which grew rapidly in the second half of the last century, built around a network of bilateral treaties, based on a model convention (Picciotto 2013). The treaties allocate rights between states to tax income and capital, aiming mainly to facilitate international investment by preventing double taxation. Only more recently have the guardians of international tax begun to pay serious attention to how the rules can also ensure that companies pay tax where they have real economic activities.

The first model conventions were agreed at a conference convened by the League of Nations in 1928. At that time, international investment flows consisted mainly of portfolio investment, with investors in rich countries lending to foreign enterprises through corporate and government bonds and equity participations. Hence, it was agreed to allocate the primary rights to tax business profits (active income) to the country where the business was located, while the passive returns on investment (interest, dividends) should be taxed mainly in the country of residence of the investor.⁴

³ China, the largest of the developing countries in the BRICs group, began to pay serious attention to the transfer pricing problem only after 2008, and in the wider context of TNC tax avoidance (UN 2017a: ch. D2; Li 2012; Wang 2016). An indication of their experience was revealed when China's representative in the BEPS consultations on transfer pricing in March 2015 frankly asserted: 'The arm's length principle does not work.' See <https://www.youtube.com/watch?v=hjuhPtmTx64&feature=youtu.be>

⁴ The distinction at the time was between 'personal' taxes, such as the general income tax, and 'impersonal' taxes, which in many countries were schedular, i.e. distinguished between different kinds of activity, including industrial and commercial business. For more detail see Jogarajan 2018: ch. 3.

Table 1 From profit allocation to transfer pricing adjustments

Period	National measures	International actions
<p>1915-1968</p> <p>Allocation of income of TNCs, based on broad powers for tax authorities to adjust accounts.</p>	<p>UK, 1915: can assess related resident and non-resident entities based on percentage of turnover.</p> <p>US, 1928: can reallocate income of related entities 'to prevent evasion of taxes or clearly to reflect the income' (now section (s.) 482 of US Tax Code); regulations refer to the 'arm's length principle'.</p> <p>France, 1933: can adjust accounts of entities under common control to restore 'indirectly transferred' profits (now s.57 of Tax Code).</p>	<p>League of Nations model treaties, 1928: state can tax business profits of a resident company and of the 'permanent establishment' of a non-resident.</p> <p>Carroll report, 1933: finds states use (i) 'empirical methods' (e.g. standard profit margin as percentage of turnover), and (ii) fractional apportionment of TNC's global profits.</p> <p>League's Fiscal Committee, 1935: adopts model provision allowing adjustment of profits if conditions between related parties differ from those which would have been made by independent enterprises.</p>
<p>1968-1988</p> <p>Focus shifts to adjustment of transaction prices, also applied to joint factors of production (capital, intangibles, risk management), instead of treating them as overhead costs to be shared.</p> <p>Application by US states (e.g. California) of global formulary apportionment creates backlash from non-US TNCs, and political furor.</p>	<p>US Transfer Pricing Regulations, 1968: specify comparable uncontrolled price, cost plus or retail minus methods, with 'other' methods as fall-back.</p> <p>OECD Working Party, 1967: rejects US approach, deeming impossible the formulation of general rules for determining an arm's length price.</p> <p>Studies for US Treasury (1973), Congress (1981), IRS (1984) show that in practice 'comparables' are hard to find, resulting in frequent use of other methods. Congress urges Treasury to consider formulary apportionment.</p>	<p>Debate about power of TNCs, including transfer pricing, e.g. of drugs, results in report of UN Eminent Persons on TNCs in 1974. OECD Council calls for report on transfer pricing.</p> <p>OECD Committee on Fiscal Affairs Report on Transfer Pricing (1979) largely recommends approach of the US regulations of 1968.</p>
<p>1988-1994</p> <p>Emergence of OECD Transfer Pricing Guidelines (TPGs)</p>	<p>US Tax Reform, 1986: adds 'commensurate with income' test to s.482.</p> <p>US Treasury White Paper, 1988: proposes a new profit attribution method, creating conflict at the OECD, resulting in a compromise to add both the transactional net margin method (TNMM) and the profit split method.</p>	<p>OECD adopts TPGs, 1995: adds the two new approved methods, but rejects formula apportionment and emphasises case-by-case analysis.</p>
<p>1995-2015</p> <p>Entrenchment of the TPGs and the independent entity principle.</p> <p>Regulations based on TPGs adopted worldwide, first by OECD countries, then emerging economies, and finally developing countries.</p>	<p>OECD countries adopt regulations, mostly based on the TPGs, though some (e.g. France, US) retain broad statutory power. Only Brazil (1998) opts for a simplified method applying fixed margins. India's adoption of the TPGs (2001) creates a litigation explosion.</p> <p>Growth of 'cognitive community' of transfer pricing specialists.</p> <p>BEPS Action Plan includes work on transfer pricing, perhaps going beyond the arm's length principle, though rejecting formulary apportionment.</p>	<p>OECD reviews, 2008-10: further entrench ad hoc approach and focus on transaction pricing and comparables, neglecting profit split.</p> <p>Continual increase of international conflicts and the time taken to resolve them.</p> <p>BEPS reports, 2015: still emphasise starting from transactions, though with strengthened powers to recharacterise them, adding further uncertainty and complexity.</p>

Sources: Avi-Yonah 1995; Durst and Culbertson 2003; Picciotto 1992, 2018.

However, national tax authorities were already aware of the special problem of allocating the business profits from foreign direct investment (FDI) by TNCs, which had begun to emerge since the 1880s. The problem was put succinctly to the UK Royal Commission on Income

Taxation in 1920 by Sir William Vestey, co-founder of a global food firm with cattle ranches in Argentina and worldwide beef sales:

In a business of this nature you cannot say how much is made in one country and how much is made in another. You kill an animal and the product of that animal is sold in 50 different countries. You cannot say how much is made in England and how much is made abroad.

(UK Royal Commission on Income Tax 1920, Minutes of Evidence and Final Report, CMD 615: 452, Question 9460)

Having identified the weaknesses of international tax coordination, the Vestey family became pioneers of international tax avoidance. Attempts to defeat the structures they established to avoid tax resulted in long-running legal battles in the UK in the 1930s (Picciotto 1992: 100-102; Knightley 1993), and challenges in the Congress in Argentina in 1934 (Grondona and Knobel 2017: 10).

In the world market, TNCs do business as unitary firms, as Vestey pointed out. However, at the national level they operate through branches or subsidiaries, while the corporate group remains under common ownership and central control. It was natural for states to claim the right to tax the business profits of a locally incorporated company even if it were foreign-owned. States also claimed the right to tax foreign entities doing business in a country through an agent, office or branch. To set a limit to the extent to which foreign entities could be taxed, the 1928 convention defined a threshold for taxable presence, the concept of a 'permanent establishment' (PE). Hence, the convention allowed a host state to tax the business profits attributable to a PE, as well as those of separately incorporated affiliates of a TNC resident there.

This left the question of how to allocate the business profits of a TNC among its various PEs and affiliates. To resolve this, a study was carried out for the Fiscal Committee of the League, coordinated by Mitchell D. Carroll (the US representative on the committee), based on national reports from 27 countries (League of Nations 1933).

The Carroll report found that tax authorities usually started from the accounts of the local affiliate, and those of the PE if it had separate accounts. However, the tax official had to scrutinise the accounts 'to ascertain whether or not they reflect the true profit attributable to that establishment'. The report continued:

Obviously, his [sic] task is easy if the local establishment is virtually self-contained or is an autonomous unit which is treated as such by the foreign enterprise, or if the foreign enterprise has dealt with each establishment at arm's length as if it were an independent enterprise. This entails, in some cases, allotting to it the capital normally required to carry on its activities, and, in every case, billing to it or making charges at the same rates as it would to an outsider. Unfortunately, however, the local establishment is not so treated by the great majority of enterprises, and the tax inspector finds it necessary to adjust the accounts after securing whatever additional information is available or to make an assessment on an empirical or fractional basis. (League of Nations 1933: p.12, para. 6)

The 'empirical' method generally meant applying a benchmark profit margin, based on that of other companies engaged in similar business activities, usually to turnover. The 'fractional' method allocated a suitable proportion of the overall profits of the TNC to the local entity.

It was easier to apply the 'fractional' method to a PE, since it was not a separate legal entity, and might not have separate accounts. This approach was used notably by Spain, whose national report argued that it was easier to administer and less intrusive for the taxpayer.

Carroll also discussed the system used by US states to tax an in-state affiliate of a corporate group, which he described as fractional apportionment based on consolidated accounts.

Where there was a separately incorporated affiliate, Carroll found that three broad approaches were applied to adjust the accounts:

(1) readjustment on basis of independent persons — i.e., the legal fiction is respected, but the relations between the two are examined in order to divide the joint profit between them in the measure that each would have earned had the two been dealing with each other as independent persons; (2) assessment of the parent in the name of the subsidiary as agent; (3) assessment on basis of economic unity — i.e., merging the subsidiary with the parent on the theory that they both constitute a single economic unit, or that the subsidiary is merely an organ of the parent.
(League of Nations 1933: p.109, para. 386)

Carroll's report concluded that the method of separate accounting was preferred by a majority of governments, and by business, represented by the International Chamber of Commerce (League of Nations 1933: para. 671).

Although this entailed respecting the 'legal fiction' of separate corporate entities, when they were part of a group, a power to adjust their accounts was essential. Hence, some countries had enacted specific provisions for the adjustment of accounts of related entities, while others applied a general anti-avoidance rule. A specific but broad power had been enacted by the US in the Revenue Act 1928 (s.45), which remains in almost identical wording to this day in s.482 of the Revenue Code. This specifies that the income of related entities can be reallocated if necessary 'in order to prevent evasion of taxes or clearly to reflect the income' of the company concerned.⁵ Another example is France, which enacted a provision in 1933, empowering the adjustment of accounts of entities under common control to restore profits which have been 'indirectly transferred'. This became s.57 of the Tax Code and remains in force with little change to this day.⁶ UK legislation of 1915 gave power to the revenue authority to assess a non-resident person doing business with a related resident based on a percentage of the turnover.⁷ This was replaced in 1951 with a general power to adjust the prices of transactions between related entities, which continued until 1998.⁸

Such provisions were not limited to developed countries. Laws based on the French provision were enacted in francophone countries in Africa, and in treaties between them following independence.⁹ Today all these countries have a provision in their tax codes modelled on the French law. Most other African countries also have a general power to adjust the accounts of related entities (see Appendix).

In some cases, simplified rules were used to determine attribution of profits. Thus, Trinidad enacted a provision in 1922 specifying a minimum profit margin of 10 per cent of the selling

⁵ The US corporate tax of 1917 gave the tax authorities power to require consolidation of the accounts of related companies to prevent avoidance, but since it was considered difficult to consolidate the income of a foreign corporation, the 1928 legislation substituted this for a power to adjust (*Asiatic Petroleum* 1935; for a more detailed account of the history see Picciotto 1992: 173-5; Avi-Yonah 1995: 95-98).

⁶ A report of the Inspectorate General for Finances (France, Ministry of Finance 2013) recommended amendment of this section to better reflect the ALP, but no change has been enacted.

⁷ Finance (No. 2) Act 1915, s.31, amending the Income Tax Act 1842, to make non-residents chargeable through a local branch. The amount of the percentage was to be determined according to the nature of the business, with a right of appeal, ultimately to a 'board of referees' (s.31(5)). A similar measure was enacted in Australia in 1922, which applied until 1982, although active enforcement only started in the 1990s (Vann 2012).

⁸ UK Treasury 1997; it was redrafted as part of a tax 'simplification' drive, in the Taxation (International and Other Provisions) Act 2010 (TIOPA).

⁹ See Article 11 of the 1971 Tax Convention of OCAM (Organisation Commune Africaine, Malgache et Mauricienne), signed by 15 francophone states. It continued to be applied after the dissolution of OCAM by the Congo, Gabon, Ivory Coast, and Senegal; it was replaced in 2008 by a similar instrument for UEMOA (the Economic and Monetary Community of West Africa).

price on imported goods. However, this rule was criticised as too blunt in a British government report that put forward a model income tax ordinance for UK colonies. The report recommended instead the UK approach adopted in 1915, giving the tax authority a power to fix 'such a fair and reasonable percentage as the facts of the particular case may justify' (UK Government 1922: 12). This was included, for example, in Kenya's law of 1937 (Waris 2017: 15). This is an early example of the dilemma between the crude but simple and easy-to-administer provision adopted in Trinidad, and a more flexible one which requires ad hoc evaluation and subjective judgement, which the UK then implemented in its colonies.

A simple approach was also favoured in Argentina, following publicity given to the Vestey case. A law enacted in 1943 provided for calculation of the income on exports and imports based on the final wholesale price less transportation costs. This was the forerunner of the 'sixth method' in transfer pricing (see section 1.4 below). Where a wholesale price was not available, a comparison with the profits of independent entities could be used (Grondona and Knobel 2017: 10-11).

1.1.2 Formulation of the international standard

The Carroll report resulted in the inclusion of provisions allowing adjustment of the accounts of related entities in the model conventions (now Articles 7 and 9).¹⁰ They provided for a power to attribute to a PE 'the net business income which it might be expected to derive if it were an independent enterprise engaged in the same or similar activities under the same or similar conditions'. Nevertheless, the fractional method was specifically permitted in the model convention for attribution of profits to a PE (Article 7.4), and a majority of tax treaties still include this provision (Avi-Yonah and Pouga Tinhaga 2014).¹¹

A power was also given to adjust the accounts of enterprises under common control (i.e. affiliates).¹² This provision was adopted, with minor amendments, in the first post-war model convention, issued by the OECD in 1963. Article 9 specified that for entities under common control, where

...conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

It has remained unchanged, and the same wording was adopted in the UN model convention, first issued in 1980. Most national legislation is based on similar wording, so this created a basic principle of global tax law.

Unfortunately, it has provided an insecure foundation, because it is contradictory. It is based on the understanding that the relationships between associated entities are *unlike those of independent enterprises*, so that their accounts may require adjustment for tax purposes to ensure a proper allocation of income. Yet it has been interpreted to mean that they should be treated *as if they were independent*. It is now referred to as the arm's length principle (ALP). The ALP was mentioned in the Carroll report, and was defined in US regulations in 1935 as that of 'an uncontrolled taxpayer dealing at arm's length with another uncontrolled

¹⁰ Based on the report, the League's Fiscal Committee drafted a convention of 1935 on the allocation of business income (League of Nations 1935), the principles of which were later incorporated into the model conventions.

¹¹ The fractional method was provided in some countries' domestic law, for example in Ghana (Income Tax Act 2000, section 7(2), but it was omitted in the revised version of 2015).

¹² The draft convention is in Annex 1 of League of Nations 1935. Article 3.1 dealt with a PE. Article 6 specified that for enterprises under common control, where this meant 'conditions different from those which would have been made between independent enterprises', adjustments could be made to 'any item of profit or loss which should normally have appeared in the accounts of one enterprise, but which has been, in this manner, diverted'.

taxpayer'.¹³ However, the ALP has never been mentioned in tax treaties. It is important to note that neither the treaty Article nor the ALP as used in this period concerned the pricing of transactions: the focus of both is on the allocation of profits. Article 9 still provides the basis for the domestic statutes of most states, notably France and the USA, and most African countries (see Appendix). They provide a broad power to adjust the accounts of affiliates *because they are not independent*. Only much more recently have these broad statutory powers to adjust profits been supplemented by regulations specifying that this should be done by comparing the pricing of transactions between related parties to those of comparable independent entities.

The independent entity concept was adopted because the aim was understood to be to prevent 'diversion' of profits between separate legal entities that are under common control. However, transfer pricing within a TNC is a very different problem from that of mispricing of transactions between unrelated entities, which are actual market transactions. If the price agreed between truly independent parties is misrepresented (for example to reduce the customs duty payable on import) it constitutes fraud.

In contrast, transfers between related entities within a TNC are not decided by bargaining between them, but in accordance with the overall strategy of the TNC determined centrally. Prices only need to be attributed for these transfers to produce accounts for the different entities. Since these entities normally have no outside shareholders (except in the case of joint ventures), such accounts are needed only for internal management and external regulatory purposes, including tax. Indeed, many intra-firm transfers do not necessarily involve transactions, but exploitation of joint assets, such as capital, or intangibles. So, the aim of transfer pricing rules in international tax is to ensure an appropriate allocation of the profits of a TNC. Exploitation of those rules by a TNC to reduce its overall tax liability is better referred to as abusive transfer pricing, to distinguish it from deliberate mispricing which may occur between unrelated parties. This does not mean that abusive transfer pricing is legal, as is sometimes claimed, since the prices attributed may be found unlawful if they are successfully challenged by tax authorities (Picciotto 2018a).

Both the independent entity concept and the ALP are legal fictions. When they were first devised, there was no internationally agreed guidance on how they should be applied. None of the methods used emphasised comparing the prices charged between related entities with comparable transactions between independent parties. In the USA, court decisions interpreted the ALP as meaning that allocation of profits should be 'fair' or 'reasonable' and did not require any comparison with actual or hypothetical transactions between independent entities.¹⁴ The focus was on the appropriate level of profits: the adjustment of accounts was a means to that end and did not necessarily involve transaction prices.

1.2 The emergence of the transactional approach

1.2.1 Post-war growth of TNCs and the responses

The 1950s saw a renewal of FDI, since TNCs could avoid the post-war exchange controls, as restrictions on capital flows affected portfolio investment, but foreign affiliates could expand by reinvesting retained earnings or by borrowing locally. Since capital controls did not apply to current account payments for sales of goods, TNCs could also use their internal

¹³ League of Nations 1933: paras. 6, 384, 385, 694, 713. The US regulations in 1935 expressed the power to adjust in broad terms, while adding that 'the standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer' (cited in *Essex Broadcasters* 1935). The term in French is '*principe de pleine concurrence*' (similar in other languages), indicating that prices should reflect those set in competitive markets. This more is even more starkly inapt, since the reason for corporate concentration is the suppression of competition.

¹⁴ These decisions have been carefully analysed by Reuven Avi-Yonah. Note especially: 'Whether any such business agreement would have been entered into by petitioner with total strangers is wholly problematical.' (*Seminole Flavor v. Commissioner* 4 T.C. 1215 (1945), cited in Avi-Yonah 1995: 98).

transfer pricing policies to help finance such investments, so avoiding tax as well as exchange controls. US-based TNCs, notably pharmaceutical companies, took the lead in taking advantage of the independent entity principle, by transferring assets such as intellectual property rights to affiliates in convenient intermediary jurisdictions or tax havens, and using them as finance hubs. Royalties and other payments to such entities reduced tax for their operating affiliates, and the revenues could be kept offshore, deferring their liability to US tax while remaining available for reinvestment. This expedient both avoided exchange controls, and also minimised their tax liabilities in both home and host countries.¹⁵ As the US Internal Revenue Service (IRS) increased enforcement of s.482 to combat these strategies, the subjective nature of the 'fair' allocation standard became increasingly evident (Bischel 1973: 492).

In 1961 the Kennedy administration responded with proposed legislation to end 'deferral', by applying US tax directly to the profits of US-owned foreign corporations, but with a credit for foreign taxes. This would have sidestepped the transfer pricing problem completely, by starting from the global consolidated profits of US-based TNCs, eliminating internal transfers. It would treat TNCs as unitary firms, but instead of apportioning their profits, the US would retain the ultimate right to tax them, allowing a credit for legitimate foreign taxes actually paid. However, the proposal was watered down due to strong business pressures, and the measures on 'controlled foreign corporations' (CFCs) enacted in 1962 applied US tax only on affiliates with 'passive' income and located in low-tax jurisdictions.¹⁶ This put renewed pressure on the transfer pricing rules. Hence, Congress urged the Treasury to strengthen them, by exploring the possibility of developing regulations under s.482 to apply the fractional apportionment approach (Langbein 1986: 643-5; Avi-Yonah 1995: 101-3).

The US authorities shrank from this suggestion and adopted the opposite approach. Although still based on the ALP, and on the test in s.482 that accounts should 'clearly reflect' income, they devised more specific and prescriptive rules. Instead of aiming at criteria for the apportionment of profits, they focused on the pricing of transactions between the associated enterprises. This introduced the concept of 'transfer pricing' into international tax rules, which until then had discussed the issue as concerning the allocation of income (Picciotto 2018b). Being keenly aware of the international implications of adopting a more specific standard, the US referred the issue to the OECD, where the proposals received a critical response (see Box 1). Despite this, the regulations on transfer pricing were finally enacted in 1968.

¹⁵ Tillinghast 1979: 257. The Netherlands Antilles, which had the advantage of tax treaties extended to it by its colonial mother country, announced low tax rates specifically designed to attract holding companies in January 1953 (Picciotto 1992: 118).

¹⁶ Similar rules were later adopted by some OECD countries, but became weakened especially with the US adoption of 'check the box' regulations in 1997, and of a 'look-through' rule, initially as a temporary measure, in 2006. Strengthening CFC rules was one of the points in the BEPS Action Plan of 2013, and strong measures could have radically transformed international tax, but the outcome again was similar limited rules.

Box 1 OECD rejects the transactional approach, 1967

Stanley S. Surrey, then Assistant US Treasury Secretary, wrote to the OECD Fiscal Affairs Committee in May 1963 urging it to develop agreed principles on the allocation of income, and the issue was referred to a working party consisting of the UK and the Netherlands. The resulting report spelled out the difficulties of trying to develop rules to apply the ALP by focusing on transactions. It pointed out that such rules would need to apply in the absence of ‘transactions which are identical in every material respect... made by the same enterprise with third enterprises which are admitted to be at arm’s length’ (OECD 1967: 4; emphasis in the original). Taking the examples of transactions involving interest, royalties and goods, it showed that deciding on whether a transaction is truly comparable would always depend on a wide range of factors specific to each case. It concluded that it would not be possible to propose ‘rules of general application for determining an arm’s length price’ (OECD 1967: 7).

1.2.2 Fundamental flaws of the transactional approach

The transactional approach entailed a significant shift in two main respects. First, it introduced a new focus on analysing all the relationships between corporate group members in terms of specific transactions. Crucially, this meant treating joint factors of production (money capital, intangibles, central services) not as costs to be charged, but as transactions between group members for which payments are made. As Langbein acutely pointed out, this meant treating internal allocations of shared resources as transactions for which a price must be attributed (Langbein 1986: 345). The most highly centralised and core functions of a TNC are research and development (R&D), the allocation of capital, and risk management. These are also key sources of the profits derived from the synergy of the firm as a whole. Also, they involve non-physical activities, which can easily be notionally attributed to an entity located anywhere. These issues are at the heart of transfer pricing and applying the transactional approach to them has posed insuperable problems, which remain unresolved (Andrus and Collier 2017: ch. 6).

The new emphasis provided an enormous incentive to devise tax-driven restructuring of TNCs, based on making notional transfers to low-tax jurisdictions of key functions related to these ‘moveable activities’, such as group financing, ownership and management of intellectual property rights, and funding R&D, to which substantial income could be attributed. Conversely, the income of operating affiliates in high-tax countries could be greatly reduced by payments for these assets or functions, and these entities could be characterised as engaging in low-risk activities. These techniques have been further encouraged by some countries, mainly in the OECD, which began to offer preferential regimes for affiliates responsible for mobile activities, notably Ireland, Luxembourg, the Netherlands and Switzerland. The transactional focus of transfer pricing rules, which such countries continue staunchly to defend, has made it very difficult to counter these strategies.

Secondly, the regulations required such transactions to be priced by reference to comparable transactions between unrelated parties. For each of the five categories of transactions specified in the US regulations of 1968, the primary test was to be the ‘comparable uncontrolled price’ (CUP) method, the price paid in a comparable transaction between unrelated parties. Alternatives were provided if a CUP could not be found, including ‘safe harbours’ for three types of transaction: loans, services and leasing. For intangibles, the regulations listed a dozen factors to consider in determining the arm’s length price. For tangibles, the alternatives to the CUP were: first, the final sale price to third parties minus the cost (resale minus); and next, the cost plus a profit margin based on comparable transactions (cost plus).

None of these methods took any account of the TNC's own actual profits. So, by reinforcing the myopic focus on the local affiliates, they further encouraged TNCs to find ways to shift high-value activities to entities in low-tax jurisdictions. Finally, however, they allowed use of 'other' methods. Although unspecified, these might include the standard of 'fair' or 'reasonable' profit previously applied by the courts.

Other countries did not follow this US initiative. Following its 1967 report, no further work was done by the OECD to elaborate the ALP. Even the commentary to the new version of the model convention issued in 1977 did not expand on the single paragraph explanation of Article 9(1). As we have seen above, many countries have long had a general power to adjust accounts, and others introduced or revised them in the 1970s,¹⁷ but there was little or no interest at this stage in following the US in adopting detailed regulations spelling out the ALP.

However, the 1977 version of the OECD model convention did include a new Article 9(2). This created an obligation that if one state has made a transfer pricing adjustment in accordance with the arm's length principle of Article 9(1), the other state shall make an appropriate 'corresponding adjustment'. This arose from US concerns that adjustments resulting from heightened enforcement under the 1968 regulations might create double taxation, unless other tax authorities were willing to accept the adjustment.¹⁸ The effect of this provision, over time, would be to create pressure for tax authorities to align their transfer price adjustment methodologies, likely towards those of the US which were first in the field.

The US experience in the 1970s quickly showed the defects of the transactional approach. Application of the regulations resulted in a spate of court cases, which revealed that the requirement to find comparable transaction prices did not work or produced inappropriate results (Avi-Yonah 1995: 112). These were not just a few hard cases: a US Treasury analysis in 1973 also revealed that of a total of 174 adjustments to the pricing of tangibles, only 20 per cent were based on the CUP.¹⁹ The unsuitability of this approach is due to the very nature of TNCs. The competitive advantage of TNCs generally lies in their control of unique technologies, economies of scale and scope, and the advantages of synergy. It is for these reasons that truly comparable products or transactions between independent entities can rarely be found. It is now well understood by experienced practitioners that such corporate groups are 'not simply an amalgam of separate legal entities, each of which necessarily has a stand-alone and independent counterpart operating in the market, nor are all [their] transactions and arrangements necessarily mirrored in the market'.²⁰ Since true comparables do not exist, in practice applying the transactional approach involves deciding how much leeway to allow the taxpayer.

Criticism in the US reached a peak when the General Accounting Office (GAO) published a report to Congress in 1981, which concluded:

Because of the structure of the modern business world, IRS can seldom find an arm's length price on which to base adjustments but must instead construct a price. As a result, corporate taxpayers cannot be certain how income on inter-corporate transactions that cross national borders will be adjusted and the enforcement process is difficult and time-consuming for both IRS and taxpayers. ... We recommend that the Secretary of the Treasury initiate a study to identify and evaluate the feasibility of ways to allocate income under s.482, including

¹⁷ For example, Canada and Germany in 1972.

¹⁸ In 1970 the US adopted the first procedures to operationalise the 'mutual agreement procedure' (MAP) in tax treaties for resolving disputes, and in 1976 it introduced regulations denying a foreign tax credit unless all practicable remedies had been pursued with a treaty partner. These measures sparked the first growth of MAP cases (Picciotto 2016: 13).

¹⁹ US Treasury 1973. It found that 40 per cent of cases used 'other' methods. This was broadly confirmed by studies done for Congress in 1981 and the IRS in 1984; for a summary of this data see Picciotto 1992: 198.

²⁰ Andrus and Collier 2017: para. 2.26; see also Wittendorff 2010: 10-11.

formula apportionment, which would lessen the present uncertainty and administrative burden created by the existing regulations.
(US GAO 1981: 52-54)

Consequently, in the 1980s the US shifted away from transaction pricing and back towards profit-based methods.

1.2.3 Adoption of the transactional approach as the international standard

Despite the negative experience in the US of applying the transactional approach in practice, it became accepted internationally. This resulted from political pressures to formulate an agreed approach to transfer pricing. The need to articulate agreement on more specific standards was due mainly to the spotlight thrown on the issue of transfer pricing during the 1970s, as part of the growing political concern about the power of TNCs. At the same time, the application by some US states (notably California) of their formulary apportionment system on a worldwide basis created conflicts with European and Japanese TNCs expanding into those states. Their concerns were taken up by governments at the highest level, resulting in an entrenched antipathy to formulary apportionment of profits (Picciotto 1992: ch. 9). This reinforced the view of international tax specialists that a more global approach to the question of allocation of TNC profits would be difficult due to political constraints. Hence, the technical experts at the OECD preferred to adopt a pragmatic approach, by recommending a range of methods. This allowed national authorities flexibility to decide how to determine their preferred level of profits.

The political concerns about the power of TNCs, and evidence of abusive transfer pricing,²¹ led to a request from the Council of the OECD to its Fiscal Affairs Committee, resulting in the first OECD report on transfer pricing (OECD 1979). This report recommended the adoption of rules largely based on the US regulations of 1968. It acknowledged that the CUP and the other two methods would often be impracticable due to 'the complexities of real life business situations', so that other methods may have to be used to 'produce a figure which is acceptable for practical purposes' (OECD 1979: para. 13). Nevertheless, it rejected 'so-called "global" methods', as 'tending to disregard market conditions as well as the particular circumstances of the individual enterprises and tending to ignore the management's own allocation of resources' (ibid.: para. 14).

In the 1980s, caught between the difficulties and limitations experienced in practice with the 1968 rules and the hostility of its partners to a fractional approach, which it had been urged by Congress to explore, the US Treasury aimed for the middle ground. It formulated two new methods, focusing on attribution of profits, based on analysing the functions performed by the relevant affiliates.²² The 'comparable profits' method aimed to identify an appropriate level of profit by comparison with similar businesses, building on microeconomic techniques that the IRS had been developing and testing in litigation (Andrus and Collier 2017: chapter 2D). The second was the 'profit split' method (PSM), which in effect adopted a fractional approach (Avi-Yonah 1995: 93). Unsurprisingly, this US shift in direction caused considerable debate and conflict in the OECD in 1992-4. The issues were resolved by a compromise, adding two new profit-based methods broadly similar to those finally formulated by the US Treasury (Durst and Culbertson 2003).

²¹ Notably the highly-publicised case of Hoffmann-La Roche (UK Monopolies Commission 1973). The United Nations set up a Group of Eminent Persons to produce a report on TNCs, which included recommendations on taxes: to enforce the ALP and to elaborate rules on transfer pricing, preferably by international agreement (UN 1974).

²² Avi-Yonah 1995: 133. For a more detailed account, by specialists involved at that time and since, see Durst and Culbertson 2003 section III (describing how the 'camel' of the TPGs evolved) and Silva 1999 (comparing transfer pricing practice to a descent into limbo, and discussing the economic techniques which he suggests can provide a guide comparable to Dante's for avoiding the hell of tax conflicts).

This set of uneasy compromises was embodied in the OECD's Transfer Pricing Guidelines of 1995 (TPGs). Chapter I gave a strong defence of the ALP as 'sound in theory since it provides the closest approximation of the workings of the open market', asserting that a move away from it 'would threaten the international consensus' (OECD 1995: para. I-14). Chapter II outlined the traditional transaction methods (the CUP, resale minus and cost plus), and chapter III discussed other methods, including two new profit-based methods. These were formulated and described as 'transactional' methods to satisfy the opponents of a fractional apportionment approach. In a complete reversal of the view taken in 1967, the 1995 guidelines firmly adopted a transactional approach, although with five approved methods (Box 2).

The use of the term 'transactional' introduced distortion and confusion. Only the CUP is truly a transactional method. The resale price, cost plus and TNMM focus on the profit margin of the entity, compared to those of similar independent businesses, while profit split is a version of the fractional approach. However, by terming it transactional, it limits the profits to be aggregated and split to those from direct transactional relationships. In principle, these were a return to the methods identified by Carroll in the 1930s, applying either a comparable profit margin, or apportionment. However, reconceptualising them as transactional methods, and emphasising the need to analyse the functions performed by each entity, entailed a further major extension of the independent entity principle.

Box 2 OECD-approved transfer pricing methods

Traditional transaction methods

Comparable uncontrolled price (CUP): the price charged between unrelated firms in transactions which are similar in all respects which could affect open market pricing, or which can be determined by reasonably accurate adjustments to take account of any such differences.

Resale price: the price at which a product bought from a related party was sold to an unrelated party minus a gross profit margin to cover costs and an appropriate profit.

Cost plus: the costs incurred in the production of goods or services by a supplier to a related party, plus an appropriate mark-up, based preferably on that charged by the same supplier in comparable transactions with unrelated parties.

Transactional profit methods

Transactional net margin method (TNMM): the net profit realised from an appropriate base (e.g. costs, sales, assets) in a transaction (or series of transactions that can appropriately be aggregated), ideally by comparison with similar transactions by the same person with unrelated parties, or if not possible, the net margin earned in comparable transactions by independent enterprises, based on a functional analysis to determine comparability.

Profit split: the combined profits earned from a transaction or transactions apportioned according to one or more 'allocation keys' (e.g. assets or capital employed, costs, headcount, sales). This method applies to highly integrated operations, and may apply to the total profits, or as a two-stage process in which each party is assigned a routine return (using one of the other methods) for non-unique contributions, and only the residual profit is apportioned.

Chapter II of the TPGs also included a section discussing 'global formulary apportionment', which it rejected as incompatible with the ALP. It distinguished this approach from the 'transactional profit' methods, on the grounds that 'it would use a formula that is predetermined for all taxpayers to allocate profits whereas transactional profit methods compare, on a case-by-case basis, the profits of one or more associated enterprises with the

profit experience that comparable independent enterprises would have sought to achieve in comparable circumstances'. However, it also distinguished it from 'application of a formula developed by both tax administrations in cooperation with a specific taxpayer or MNE [multinational enterprise] group after careful analysis of the particular facts and circumstances' and applied bilaterally or multilaterally in a MAP, advance pricing arrangement (APA) or similar determination.²³ This distinction emphasises the need for a determination based on the 'particular facts and circumstances of the taxpayer', rather than a 'globally pre-determined and mechanistic' one.

The 1995 TPGs also stated (para. 3.55) that due to lack of experience with these methods in many countries, and concerns about them, the Committee on Fiscal Affairs would 'undertake an intensive period of monitoring' of both the traditional transaction methods and the profit methods. In fact, although work was done on other issues, the profit-based methods were not revisited until 2007-8, and only cursorily. It was merely noted that these methods were being used far more frequently than expected, and recommended that they should no longer be considered a last resort.²⁴ No effort was made to develop these profit-based methods. Instead, further work was done on refining the procedures for analysing comparability (Andrus and Collier 2017: para. 3.21 *et seq.*). In fact, the revised version of the TPGs issued in 2010 increased the emphasis on the transactional approach, while accepting the 'best method' rule the US had adopted, abandoning the hierarchy of methods in the 1968 regulations which gave priority to the CUP.²⁵ Instead of trying to remedy the confusions introduced by the compromises leading to the adoption of the TPGs in 1995, they were encouraged to fester.

1.3 The effects of the transfer pricing guidelines

1.3.1 Legal status

The status of the TPGs is unclear. In formal legal terms they are at most aids to interpretation of Article 9(1), and therefore relevant only to transactions between entities to which a treaty containing this Article applies. The commentary to the OECD model itself has made no attempt to provide any guidance on interpretation of the Article, and instead refers to the TPGs as a report that 'represents internationally agreed principles and provides guidelines for the application of the arm's length principle of which the Article is the authoritative statement' (OECD 2017c: 226). This cautious wording suggests that countries are ambivalent about the legal status, and they have interpreted this ambiguity in different ways. Some, such as France and the USA, make no reference to the TPGs in their domestic law, while claiming that their own regulations are compatible with them. Others, notably the UK, have included a specific reference to the TPGs, as updated from time to time, as an aid to interpretation of tax treaties.²⁶ Interestingly, they are called the *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, so they seem intended to be a kind of global 'soft law', aimed directly at both private and public sector practitioners, rather than rules or recommendations for governments.

It is hard to see why non-members of the OECD should have any obligation to follow the TPGs, and they clearly do not unless there is an applicable treaty containing Article 9(1). Developing countries generally have few treaties, and they cannot be assumed to follow the OECD model for those they have agreed, since the UN model treaty (which is designed for developing countries) has an identical version of Article 9(1). The UN Ad Hoc Group of

²³ OECD 1995: para. 3.60; now para. 1.18 in the TPGs 2017 (OECD 2017a).

²⁴ *Transactional Profit Methods. Discussion Draft for Public Comments* (January 2008).

²⁵ The revisions brought all five approved methods together in chapter II, moving the discussion of global formulary apportionment to chapter I, and devoting chapter III to a more extended discussion of comparability. See OECD 2010.

²⁶ Taxation (International and Other Provisions) Act 2010 s.164, which covers all the documents published with the TPGs, as updated from time to time, if laid before Parliament.

Experts on Tax Treaties included in the commentary to the 2001 UN model a recommendation that the TPGs 'should be followed for the application of the arm's length principle which underlies the Article' (UN 2001: 138). This recommendation was dropped in 2011, and the commentary now states that the TPGs 'contain valuable guidance' (UN 2017b: 255). Instead, the UN Committee of Experts on International Cooperation in Tax Matters produced the UN Practical Manual on Transfer Pricing for Developing Countries in 2013, with a revised edition in 2017.

The UN manual opens with an introduction that is very different from the OECD TPGs, explaining how TNCs are 'able to exploit integration opportunities in the cross-border production of goods and provision of services' (UN 2017a: 1). Nevertheless, the manual's main chapters outline an approach broadly similar to that of the TPGs, emphasising the need to analyse transactions based on comparability, although with occasional comments accepting the difficulties in practice. It discusses the OECD's five approved methods, in similar terms to the TPGs, though adding a discussion of the sixth method for commodities. Its discussion of simplified methods and safe harbours (to be examined in section 2.1 below) is similar to that of the TPGs, for example in stating that a safe harbour must be elective for the taxpayer (UN 2017a: para. B8.8.1). However, it also includes a chapter outlining country practices, some of which diverge from the TPGs, notably Brazil's (see section 2.2 below). All this suggests that non-OECD states consider that they have some leeway in how to apply the ALP, and that they need not closely follow the TPGs.

Nevertheless, although far from legally binding, the TPGs have attained a canonical status. Their publication in 1995 led to an increasingly widespread adoption by countries of transfer pricing measures, becoming a veritable torrent from 2010, so that now such rules are in place in almost every country worldwide. (See Appendix for a list of the relevant laws in African countries). Generally, primary legislation provides a broad power to adjust the accounts of affiliates of TNCs, while more detailed regulations or administrative practice notes specify the methods to be applied.²⁷ The general powers are worded broadly, in line with Article 9 of tax treaties based on the model conventions. The more detailed regulations, where they exist, are almost always based on the TPGs, although often adding the possibility of another authorised method. Surprisingly, such regulations are usually worded to apply to all related party transactions, regardless of whether a treaty including a provision based on Article 9(1) is applicable.

The ripple effect is understandable. Countries want to be seen to defend their tax base, but not in ways which might significantly deter foreign investment. Given the high priority given by most developing country governments to attracting investment, adoption of a global standard seems politically sensible. The announcement of new rules, and especially increased enforcement by any state, will lead TNCs to take steps to ensure that their accounts would stand up to this scrutiny, which is likely to result in a short-term increase in tax revenues for that state (World Bank 2016: 7-8, 11-12). Other countries naturally fear this would be at their expense, so they follow suit. Nevertheless, while it is understandable that OECD countries in the early years after 1995 should have followed the consensus expressed in the TPGs, it is more difficult to explain the continuing adherence to them, and the policy advice which continues to be given to developing countries that they should follow the OECD approach, despite its evident limitations.

From one perspective, the soft law status of the TPGs offers the flexibility for new approaches to be adopted and implemented, even unilaterally. This is especially the case for

²⁷ The suggested approach to draft legislation published by the African Tax Administration Forum (ATAF) provides in the primary legislation that the income of an affiliate shall be consistent with the ALP as defined in the regulations, and its draft regulations spell out a methodology based on the TPGs in more detail than has been usual in regulations adopted by African countries until now (ATAF 2017). ATAF's transfer pricing specialist is a former official of the UK tax authority, who has been actively training officials, especially in anglophone Africa.

developing countries, which are only bound to apply the standard formally stated in Article 9, and only in relation to countries with which they have treaties. In practice, the concern to placate TNCs as foreign investors, and the iron grip of orthodox opinion, make it very difficult to formulate, let alone make real progress, on reforms.

1.3.2 The cognitive community and its institutionalisation

The widespread influence of the TPGs is perhaps attributable to two main factors. First is the power generated in a policy community by the formulation of techniques for professional practice.²⁸ Especially where a market exists or can be created for such professional practices, enormous investments pour into their refinement and dissemination. Certainly, the field of transfer pricing quickly became an important field of specialisation from the 1980s, with an increasing proliferation of specialist courses and publications, and the creation of practice groups in the large global legal and corporate advice firms, as well as the forming of smaller boutiques offering more specialist techniques such as microeconomic analysis. The ideologies created in such a field of private practice tend to pervade the public sector also, due to the intermingling of personnel in professional interactions, and career paths crossing between the sectors. The path dependence of policy formation created by these investments in intellectual capital makes it very hard to reform such a field, unless it is disrupted by an exogenous shock. Yet specialists are strongly protected from such shocks due to the increasingly wide gap between the simplistic slogans that dominate public discussion and the technician terms in which specific policy prescriptions are discussed.

Secondly, the professional practices and perspectives of such relatively closed social groups can become institutionalised in ways which make it hard for external political pressures to change them. Again, transfer pricing is a good example, since its practice became embedded in the OECD, which is the main global organisation for formation and diffusion of business and corporate regulatory practices. The OECD has special power in such fields because, although an intergovernmental organisation, its work is considered non-political. It operates by formulating a consensus around such techniques of professional practice, which provide the underpinning for formal international norms, some of which it also formulates. Thus, once the OECD's Committee on Fiscal Affairs became the driver for developing the formal tax treaty framework in 1956, it became the main institutional focus for managing the tensions it generated. The central concern of governmental transfer pricing specialists, even going back to the 1930s, has been to attempt to prevent the public outbreak of conflicts over the allocation of profits of TNCs, by maintaining some consensus on the apparently non-political techniques for dealing with the issue. Whenever political concerns have been awakened about taxation of TNCs, the technical specialists at the OECD have been asked to develop solutions. This occurred in 1976, 1990 and 2012, and each time they responded with further refinements of the ALP, and an expansion in the length of the TPGs.

These factors perhaps help to explain the central paradox of transfer pricing: the almost universal acceptance of the transactional approach to the ALP, despite its known and often admitted defects, together with the continuing elaboration of diverse and imprecise methods for its application in practice. The TPGs are far from providing a clear and practical basis for transfer pricing. They result from discussions among the government transfer pricing delegates to Working Party 6 (WP6) of the OECD, and their style is discursive, that of a report rather than rules for application. Nevertheless, they specify the approach that must be adopted, although leaving considerable leeway for choosing among the five approved

²⁸ This analysis draws on a variety of social science research on the shaping of markets through professional practices: some based on social studies of science emphasising 'performativity' (e.g. MacKenzie 2006), and others in international political economy on the role of epistemic communities or cognitive capitalism (e.g. Adler and Haas 1992; Adler and Bernstein 2005; Dezalay and Garth 2001), as well as work on the interpretive practices of lawyers (see Picciotto 2015). The role of 'cognitive capture' in the development of the ALP in transfer pricing has also been pointed out by Langbein (Langbein 2010).

methods and how they should be applied. In practice, however, enforcement has been restrained by two factors: the enormous resources needed, and the concern not to damage inward investment (which weighs more heavily on poorer countries).²⁹ Consequently, the reality of transfer pricing enforcement is that in practice outcomes result from ad hoc negotiation or bargaining, in which technical arguments provide only the firepower.

Despite their evident failings, the international diffusion of the TPGs as the internationally agreed standards has occurred, through various channels. Even the larger developing countries have found it hard to develop an alternative, mainly due to the institutional power of the OECD. Little attempt has been made at a concerted effort to formulate such an alternative, for example through the BRICS grouping, or even the UN committee.³⁰ Countries which aspire to OECD membership are subjected to a 'peer review' of their transfer pricing legislation and practices, as occurred with Mexico in 2003. Brazil, which until now has maintained a distinctive system (see below, section 2.2), has become an OECD candidate and in February 2018 agreed a 15-month work programme with the OECD to 'assess the potential for Brazil to move closer to the OECD's transfer pricing rules, which are a critical benchmark for OECD member countries'.³¹ Pressure also occurs more informally,³² and indirectly, due to the assumed authoritative nature of the TPGs. For example, in the *Unilever* case in 2005, a Kenyan court rejected transfer price adjustments made by the Kenya Revenue Authority, on the grounds that the taxpayer had applied a method approved under the OECD Guidelines, which the judge accepted established a global standard, even though the Kenyan legislation at that time made no reference to them.³³ Consequently, in 2006 Kenya enacted regulations adopting the five OECD methods, although adding the power to prescribe another method if they prove ineffective (Waris 2017: 19).

The cognitive and institutional resistance to any reconsideration of the transactional approach has resulted in identifying the problems experienced in practice as due to lack of adequate data on comparables. It is certainly true that the databases used in performing a

²⁹ There is some evidence that increased transfer pricing enforcement, unless internationally coordinated, affects the levels of FDI (de Mooij and Liu 2018), although this seems due to the uncertainty of the transfer pricing rules.

³⁰ Although UN committee members are appointed in their personal capacity as experts, they are almost always government officials, and represent governmental positions. Those from developing countries have been much less cohesive in their views than those from OECD countries (this derives from personal participant observation of the UN Committee meetings 2007-9 and 2013-17 and could be verified from analysis of the meeting records). The OECD experts interact with each other in the OECD working parties, and since much of the work of the UN committee consists of revisiting issues already covered by the OECD (as with transfer pricing), a substantial consensus has usually been formed among OECD members, some of whom are developing countries (Chile, Mexico). While the OECD has worked on international tax since 1956, the first BRICS summit was in 2009, and most of the ministerial and other lower-level meetings focus on attempting to coordinate their positions ahead of G20 meetings. High-level declarations on BRICS cooperation in tax matters have been issued after meetings of heads of revenue administrations in New Delhi in 2013, and Hangzhou in 2017, but there is no evidence of joint technical work on specific issues such as transfer pricing. This may change with the increasingly close interactions through regional groups, notably ATAF and the Centro Interamericano de Administraciones Tributarias (CIAT).

³¹ OECD Press Release, 28 February 2018, www.oecd.org/tax/oecd-and-brazil-launch-project-to-examine-differences-in-cross-border-tax-rules.htm

³² OECD aspirant states can send observers to meetings, including those of the key Working Party 6 which deals with transfer pricing. One government representative has reported that, after questioning the effectiveness of the ALP in such a meeting, the country was contacted at a high level and advised that it was inappropriate to challenge the OECD approach (personal communication).

³³ Waris 2017: 17-18. The adjustment was made under a general power to adjust accounts (a successor to the provision enacted under British rule, mentioned above), and applying a CUP. Unilever's advisers argued, based on the OECD TPGs, that a CUP was not appropriate in the circumstances, and justified use of the cost plus method. The judge ruled that since the method used complied with the OECD TPGs, it could not be said that the 'course of the business [had been] so arranged' to produce 'less than ordinary profits' as required by the statute's power of adjustment (*Unilever* 2005: 13). In contrast, in a more recent case, the Malawi High Court quashed an adjustment on the grounds (inter alia) that the reasons given for it by the revenue authority were based on the TPGs, which are not part of Malawi law (*Eastern Produce* 2018). On the other hand, the Zimbabwe High Court in 2017 emphatically confirmed an adjustment, holding that the statutory provision (which refers to the arm's length principle, in a section on tax avoidance) confers a wide discretion on the Commissioner, and the adjustment was justified since 'the appellant and its tax advisers deliberately implemented an opaque system of tax avoidance and reduction with the intention of evading the payment of the correct tax due' (*C F (PVT) Ltd* 2017: 28). Not surprisingly, litigation on transfer pricing seems to be rising in Africa, and court decisions seem based more on judges' impressions of the behaviour of the parties than evaluation of the technical complexities.

comparability analysis generally do not include data from less developed countries, since they rely on company filings in national registries. Consequently, transfer pricing specialists have developed statistical techniques for adjusting data from other regions for use as comparators (e.g. Gonnet, Starkov, Pletz and Maitra 2014). Although sophisticated and apparently objective, such methods produce a wide range of putative comparables (Platform for Collaboration on Tax 2016: 59), which leaves considerable scope for discretion. The response during the BEPS project to developing country concerns about the difficulties of the transactional approach was a joint report by the OECD and the other main intergovernmental organisations, the terms of which indeed defined the problem as the lack of data (Platform for Collaboration on Tax 2017). After fifty pages explaining and discussing comparability analysis, it acknowledged that: 'It is often necessary to recognise that a comparability analysis provides only an approximate answer and that some flexibility is needed to determine a principled answer in many cases' (ibid.: 66). It therefore recommended negotiation with taxpayers to achieve a 'sensible, arm's length result' (ibid.: 67). However, a short section was also included on 'safe harbours, fixed margins, and other prescriptive approaches', and a footnote conceded that these might be used not only when data is unavailable, but also as simplification or anti-avoidance measures.

The OECD has now in effect become a global tax body, by opening up to all states membership of the Inclusive Framework for BEPS. This may further consolidate the cognitive consensus around the TPGs. On the other hand, alternative perspectives might emerge from this broader forum. This might be facilitated if regional organisations can help formulate joint positions, and there is some evidence that this role could be played by both the African Tax Administration Forum (ATAF) and the Centro Interamericano de Administraciones Tributarias (CIAT).³⁴

1.3.3 Reconciling global regulation and national sovereignty

Key to the maintenance and diffusion of the TPGs has been the ad hoc methodology they establish. This preserves a nominal sovereignty for each national administration to decide how to apply the ALP, while avoiding overt public debate over criteria for allocation of the profits of TNCs, which technical specialists have always regarded as too contentious to be resolved by politicians. The transactional approach adopted in the TPGs requires an analysis of the 'facts and circumstances' of each case,³⁵ to identify the functions performed, assets deployed and risks assumed by each entity. This is referred to as a 'functional analysis' (Andrus and Collier 2017: para. 3.26 *et seq.*). Hence, they require the transfer pricing methodology selected to be tailored to each individual taxpayer. Indeed, as mentioned above, this is the main reason given for rejecting formulary apportionment. This 'depoliticises' the issue by converting it from one to be addressed directly in terms of broad principle, to a 'technical' one to be dealt with pragmatically, on a case-by-case basis.

This pragmatic approach creates enormous administrative problems for both taxpayers and administrations. These generally fall more heavily on tax authorities, due to the disadvantages of information asymmetry. Although the formal legal burden is usually on the taxpayer to justify its accounts, in practice the reverse is the case, at least for large TNCs. If the taxpayer prepares and documents a transfer pricing structure, the tax authority cannot challenge it without carrying out a detailed analysis, as was seen in Kenya in the *Unilever* case. The introduction of the best method rule in 2010 made it more difficult to make such a challenge, since it must now in effect show that the taxpayer's methodology is wrong. This reinforced the use of 'one-sided' methods (cost plus, retail minus and especially the TNMM). These are preferred for TNC tax planning, since independent companies generally have

³⁴ ATAF has reported that interventions by African delegates resulted in significant modifications to reports on allocation of profits in 2018 which are part of the continuing BEPS work (ATAF 2018). CIAT began work in the same year on a report concerning alternative transfer pricing methods (personal communication).

³⁵ This phrase occurs 119 times in the 600 pages of the 2017 edition of the TPGs.

lower profit rates than large TNCs. The one-sided methods encouraged a wave of tax-driven corporate restructurings since the late 1990s, based on characterising operating affiliates as ‘stripped risk’ producers, distributors, and even contract R&D providers, while ‘high value’ functions are attributed to design or control centres in jurisdictions where their income would be low-taxed.³⁶

To apply functional analysis, tax authorities need staff with a range of skills, who not only are familiar with the legal and economic techniques needed to interpret and apply the TPGs, but also understand the taxpayer’s business model and industry segment well enough to analyse the documented transfer pricing model, choice of method and selection of comparables. Large TNCs always assemble a team of transfer pricing specialists to design structures aimed at tax minimisation, and to produce the necessary documentation.³⁷ Matching the resources available to TNCs is impossible for tax authorities even from developed countries (which are often under-resourced), let alone poor developing countries.³⁸

The approach also creates a burden for taxpayers, who must ensure that their transfer pricing policies are properly justified and documented. This has created a boom for professional advice, so that transfer pricing has become the main area of international tax practice, growing ever larger as more countries adopted transfer pricing regulations and began enforcing them. The two processes operated in symbiosis, creating a kind of arm’s race in expertise. This in turn has strengthened the role of the professional community which has maintained a grip on its techniques of practice.

The main justification given for continued adhesion to the TPGs is that they express an international consensus, without which there would be an increase in double taxation conflicts and disputes.³⁹ However, the ad hoc and subjective nature of the approach specified in the TPGs is itself a major cause of conflicts and disputes, as experience has confirmed. In the two decades since the adoption of the TPGs there has been a continued and steady rise in the number of international tax conflicts, mostly concerning transfer pricing, and the time taken to resolve them has also increased.⁴⁰ However, instead of an

³⁶ See for example Caterpillar, the US-based machinery and construction TNC, which adopted a structure devised by PwC in 1999, creating a Swiss affiliate to manage its global parts business (covering even parts sourced from the US), shifting substantial profits to Switzerland, where they were taxed at an effective rate of 4-6 per cent (US Senate 2014).

³⁷ A leader in adopting an aggressive tax planning strategy since the 1990s was General Electric (GE), which recruited John Samuels from the US Treasury in 1988. He built an exceptionally large international tax department of close to 1,000 specialists, including many former government officials (Gerth and Sloan 2011; Kocieniewski 2011). However, it also called on outside teams, and in 2017 GE outsourced its tax planning functions by transferring some two-thirds of its tax team to PwC (Schwanke 2017), joining one of the world’s largest corporate tax networks of 41,000 specialists in 157 countries. A firm such as PwC clearly outmatches government tax expertise, in both quantity and degree of global coordination, and it is not alone.

³⁸ In 2014 the US IRS hired a specialist consultant at a cost of \$2m to assist its audit team in the examination of the transfer pricing arrangements of Microsoft (Gupta 2014). In the UK, HMRC expanded its transfer pricing specialists from 65 to 81 between 2012 and 2016. Its six-year investigation of Google involved between 10 and 30 specialists at any one time, eventually resulting in a settlement agreeing payment of an additional £130m covering a 10-year period (Public Accounts Committee 2016: paras. 4-6). Some African countries have now, with support from OECD countries for capacity building, begun to build up their international tax departments. Notably, Kenya created a special unit to audit TNCs after 2011, with a dozen staff in two teams. This has had some success in increasing tax revenues, although short of targets and resulting in some conflicts (Platform for Collaboration on Tax 2016: 31; Waris 2017). The unit has now expanded to 36 staff (personal communication), and its head was recruited to lead Tax Inspectors Without Borders, a joint OECD-UNDP initiative. More typical is Madagascar, which enacted transfer pricing regulations in 2014 based on the TPGs, but has had difficulty in developing an enforcement strategy and has made several requests for external assistance to do so. An IMF exploratory mission in 2015 recommended the establishment of a specialist transfer pricing unit, while also reporting that the Large Business unit had 21 inspectors, covering 576 firms, of which 93 were known affiliates of TNCs (IMF 2015). It found that the available data indicated that TNC affiliates were generally as or more profitable compared to domestic firms, and hence paid a relatively higher level of tax, although this probably also reflected under-declaration by domestic firms. By 2017, the Large Business unit had some 627 dossiers, and the entire staff of the revenue authority was 93, of whom 31 were inspectors, six specialising in international tax, although none with in-depth skills in transfer pricing (personal communication). It still had not decided on a transfer pricing enforcement strategy.

³⁹ See for example the views of Joseph Andrus, then head of transfer pricing at the OECD, and Stig Sollund, member of the UN tax committee and chair of the subcommittee which wrote the UN manual, in Andrus 2012.

⁴⁰ In addition to the usual procedures available under national law, tax treaties provide an essentially administrative procedure for taxpayers to complain to the ‘competent authority’ of taxation contrary to the treaty, which includes the

overt and more public debate about criteria for the allocation of TNC profits, this has been done on an ad hoc basis in private, indeed in conditions of high secrecy, enforced by both confidentiality obligations and arcane professional practices.

1.4 The BEPS project and beyond

A review of the transfer pricing rules was included in the recent major effort to reform international tax rules, the G20/OECD project on base erosion and profit shifting (BEPS). The mandate from the G20 world leaders for this project was to ensure that TNCs could be taxed 'where economic activities occur and value is created' (G20 2013: 4). However, the BEPS Action Plan (OECD 2013) defined a narrow scope for the work on transfer pricing. Not only did it exclude any examination of alternatives to the ALP, particularly formulary apportionment, it affirmed that the existing rules operate 'effectively and efficiently' (OECD 2013: 19) in many cases and specified that work should focus on their misuse.

The narrow scope of the attempt to make the TPGs more effective paradoxically resulted in extensive revision and expansion of the TPGs, which has made them more complex, obscure and difficult to apply.⁴¹ This is the inevitable consequence of attempting to refine a basically ad hoc approach. The starting point for transfer pricing audits is still the fictitious agreements between associated enterprises, even if such transactions are not seen between unrelated parties.⁴² This continues to allow TNCs to make formal transfers of capital, ownership of intangibles and the responsibility for managing risk, to different group entities. Although the revised TPGs now give tax authorities powers to disregard those transactions, to do so they must conduct a factual analysis to determine if the actual conduct of the parties diverged from the formal contractual arrangements and show that they were commercially irrational. The most authoritative account yet published, written by the former OECD official responsible for transfer pricing during most of the BEPS project and an experienced private practitioner, shows how, due to disagreements among participants in the BEPS project, the TPGs have become even more uncertain and obscure. They conclude that the result has been to make the transfer pricing process 'far more complex', mostly due to the 'level of factual detail' now required for the functional analysis.⁴³

Work was also done on two issues concerning simplification of transfer pricing. One was the so-called sixth method, which (as mentioned above) originated in Argentina, and has been adopted in other countries in Latin America. This applies to exports of commodities, and it uses as a benchmark the prices quoted on a relevant exchange. The aim of the method was to provide a clear and transparent standard, which would be easy to apply. However, the BEPS project report (OECD 2015) found that these published prices might not be appropriate, due for example to variations in the quality of the commodity, and to fluctuations in the traded prices that make it possible for the taxpayer to choose dates for shipment to select a favourable price. Consequently, the final report assimilated the sixth method to the CUP method, requiring a detailed comparability analysis between the 'economically relevant

transfer pricing rules. Such complaints may be resolved at the national level or may require recourse to the international mutual agreement procedure. This procedure is totally confidential, but the available data shows a continual rise in such complaints, a high proportion of which seem to relate to transfer pricing (Picciotto 2016: 16).

⁴¹ The report on BEPS Actions 8-10 (OECD 2015) included revisions to chapters I, II, VI, VII and VIII of the TPGs, which were incorporated into the version issued in 2017, which is now over 600 pages.

⁴² 'Importantly, the mere fact that the transaction may not be seen between independent parties does not mean that it should not be recognised' (OECD 2017a: para. 1.122; see the criticisms by Andrus and Collier 2017: paras. 6.14, 7.43).

⁴³ Andrus and Collier 2017: paras. 7.70-71. They trace in detail how, due to these disagreements, the TPGs have been made more complex and unclear on the key points. These include: (i) the notion of control of risk ('very complex', para. 6.35; 'most confusing', para. 7.32; imposing 'only limited burdens on MNEs desiring to transfer risk to tax advantaged locations', para. 7.13; and leaving 'clear potential for heated disagreement', para. 7.16); (ii) the returns which can be attributed to a cash-box entity ('quite mysterious', para. 6.46; 'most confusing', para. 7.32; will 'give rise to substantial amounts of controversy', para. 7.31; and leaving 'a rather confused muddle, at least for now', para. 7.42); and (iii) how to allocate the difference between projected and actual returns from an intangible ('far from clear', para. 7.56; 'manifestly inadequate', para. 7.58). They conclude that the result has been to make the transfer pricing process 'far more complex' (para. 7.70), mostly due to the 'level of factual detail' now required for the functional analysis (para. 7.71).

characteristics' of the controlled transaction and the specifications of the quoted price (OECD 2015: 53).

This essentially removed whatever merits the sixth method had in ease of administration. Experience in Zambia suggests that using suitable publicly quoted prices, if they are available, can greatly simplify administration; however, there can be abuse if taxpayers are allowed to make adjustments for quality discounts unless the revenue authority has the capacity to verify quality (Readhead 2017b). A more effective approach could be based on the system of administrative prices used for some years for the oil sector in Norway, as well as in Angola and Indonesia. Prices are set (monthly or quarterly) by a government-appointed agency to provide a benchmark, although taxpayers can (at their own cost) object to an independent panel. The main benefit for the government is the first mover advantage, although both sides gain from reduced compliance costs and fewer disputes (Readhead 2018).

A stronger effort was made to adopt a simplified approach to the allocation of central service costs. These are in their nature joint costs for the TNC corporate group as a whole, such as central management services, communications and information technology, and head office costs. Companies themselves favour apportionment of such costs, to ensure that they can be deducted somewhere. The BEPS project report included adoption of a simplified method for pooling and allocating central service costs within a corporate group. However, many tax authorities are understandably reluctant to allow deduction of costs incurred by a parent company against the profits of operating subsidiaries. Hence, the report limited this approach to low-value-adding services, subject to a benefit test, and the definition of a threshold was left for further work (OECD 2015: 141-160). It continued the confusion introduced by the transactional approach, ignoring the business reality that charging for central services is an allocation of joint costs, by suggesting a mark-up of 5 per cent as if it were a contract between independent entities.

Once again, the OECD did not take the opportunity to build on the profit split method and move away from the transactional approach.⁴⁴ Work on the PSM was not completed by 2015, and the eventual report issued in June 2018 contained only some limited suggestions. There seems to be significant disagreement among government representatives about the PSM, making it impossible to reach consensus on whether it should be strengthened, let alone how. This perhaps leaves scope for countries to adopt their own versions of profit split, and this has even been mentioned as a possibility for developing countries (Platform for Collaboration on Tax 2016: 77).

However, one enormous advance resulted from the BEPS project: the formulation of standard templates for country-by-country reports (CbCRs), as well as transfer pricing documentation. These are now included as chapter V of the TPGs. They specify three levels of documentation to be produced by the TNC (see Box 3).

⁴⁴ For suggestions on how this could be done see Avi-Yonah, Clausing and Durst 2008; Durst 2012; Kadet 2015.

Box 3 Documentation requirements	
Type of document	Contents
Local file As appropriate for each country Filed locally	Organisational chart, management structure, key competitors Names and locations of those to whom local managers report Details of each key category of controlled transactions Financial accounts and data
Master file For the TNC as a whole For all TNCs, though countries may specify a threshold Filed in each country where there is a taxable entity	Organisational structure General description of the TNC's business(es) Intangibles list, details of ownership and transfers, R&D strategy Intercompany financial activities Financial and tax positions
Country-by-country report – CbCR For the TNC as a whole For TNCs with worldwide turnover over 750m Euros Filed in the TNC's home country Exchanged with countries which have an affiliate/PE	List of all affiliates and PEs and country of tax residence For each tax jurisdiction: Revenues (split between related and unrelated parties) Profit/loss before income tax Income tax paid (cash) Income tax accrued (current year) Stated capital Accumulated earnings Number of employees Tangible assets (other than cash and equivalents)

Source: OECD 2017a Chapter V and Annexes

This establishes for the first time a global system to provide potentially all tax authorities with comprehensive information about the complete structure of TNCs. The content is defined precisely; the template for country-by-country reports is standard, while the master file and especially the local file allow for some national variations. These standards should simplify documentation requirements, which are often cited as a significant burden for business.

The CbCR, in particular, will provide a key tool for assessing whether and how far the application of the transfer pricing rules succeeds in aligning profits and tax with the location of activities and value creation. Since the reports, at least for the time being, are to be available only to the relevant tax authorities, this assessment would guide only them. It should also be noted that the scheme for exchange of these reports includes strict standards, which include not only confidentiality obligations but conditions on 'appropriate use'.⁴⁵ The peer review standards for this scheme specify that the CbCRs:

- (i) can be used only to assess high-level transfer pricing risks and other BEPS-related risks and, where appropriate, for economic and statistical analysis;

⁴⁵ Hence, countries would be well advised to enact a 'secondary mechanism' to provide for local filing of reports in case they are denied access, although the OECD is closely monitoring implementation of its strict framework for the scheme through the peer review process.

- (ii) cannot be used as a substitute for a detailed transfer pricing analysis of individual transactions and prices based on a full functional analysis and a full comparability analysis;
- (iii) are not used on their own as conclusive evidence that transfer prices are or are not appropriate;
- (iv) are not used to make adjustments of income of any taxpayer on the basis of an allocation formula (including a global formulary apportionment of income). (OECD 2017b: 16).

This effectively precludes the use of CbCRs to provide the only documentation for a simplified transfer pricing scheme. Nevertheless, the information will make it much easier to consider the overall allocation of profits, and not just the income attributed to the local entities. The availability of these reports, which may be extended to a wider range of TNCs and perhaps be made public when the system is reviewed in 2020, may prove transformative in the practice of TNC taxation.

2 Approaches to simplification

The previous section has shown that the transactional approach to the ALP lies at the heart of the problems of increasing complexity, subjectivity and difficulty of administration of the transfer pricing system. A more effective system would clearly require a change in the dominant perspectives on the allocation of profits of TNCs which have become entrenched, especially since 1995. Several approaches are available to move towards a different perspective, which would treat TNCs in accordance with the business reality that they operate as unitary firms, restore the focus on allocation of profits and remove the incentives for avoidance created by the independent entity concept. This raises much wider issues, which have been explored by the ICTD in greater detail elsewhere (Picciotto 2017).

In the meantime, tax administrations are faced with the problem of formulating a policy which suits their circumstances, while complying with their international obligations. The previous section has also shown that, although many countries have long given their tax administrations a legal power to adjust the accounts of affiliates of TNCs, few developed an active enforcement programme until after 1995. Most poor countries began to pay attention to this issue even more recently, and many are still deciding how to formulate an effective and sustainable approach.

Much of the effort in recent years to provide advice and support to developing countries on this issue has focused on administrative aspects of adopting the OECD approach, such as problems of lack of suitable data for comparables.⁴⁶ It would seem at least as important to ensure first that the rules themselves are suitable, and formulating methods capable of cost-effective and sustainable administration should be a high priority, for developing countries in particular. This should include consideration of the possible measures for simplification of profit allocation, based on an evaluation of the experience that other countries have had with such measures.

⁴⁶ See e.g. OECD 2014; Platform for Collaboration on Tax 2017. Others have emphasised risk assessment as a means of ensuring that scarce resources are used effectively: the World Bank handbook points to the need to weigh the costs and benefits of enforcement (though suggesting that in most countries the benefits would exceed costs) and consider the appropriate level of resources to devote, also taking into account the impact on the investment climate (World Bank 2016), while Readhead (2017a) helpfully analyses specific high-risk structures. The World Bank handbook has only a couple of pages on safe harbours (out of nearly 400) and does not discuss the Brazilian approach, mentioning only that it is considered non-standard. The European Commission has sponsored a study on the possibility of introducing safe harbours in west Africa (Charlet, Silberztein and Pointe 2017).

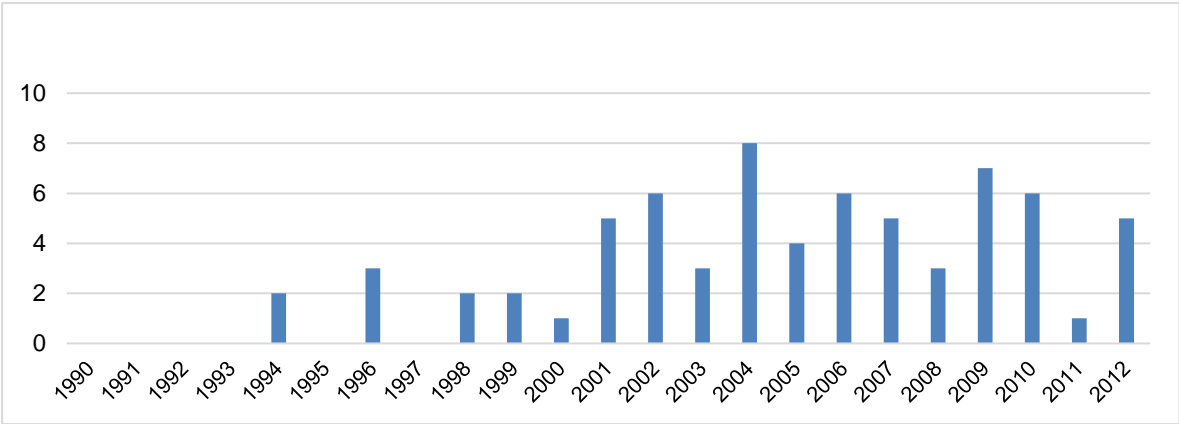
The difficulty, as this section will show, is that devising simplified methods for attribution of profits runs counter to the emphasis in the TPGs on an ad hoc analysis based on the facts and circumstances of each taxpayer. The OECD only reluctantly accepted the possibility of some kinds of ‘safe harbours’ in 2012, and within strict limits. Observance of these limits greatly reduces the effectiveness of safe harbours. The adoption of alternative simplified methods, most notably by Brazil, has been regarded as contrary to the TPGs, although they may be compatible with Article 9. The controversial status of simplified methods no doubt helps to explain why most capacity building has focused on applying the TPGs, and little serious interest has been shown in alternatives, such as the Brazilian methods. Nevertheless, in view of the rapid spread of transfer pricing rules, especially in developing countries, simplified methods are clearly an important policy issue.

2.1 Simplification and the TPGs

Since most countries are committed to complying with the TPGs, a key question is whether simplification is compatible with the approach they adopt towards the ALP. Concern with the practical administration of the transfer pricing rules is evident in many parts of the TPGs, and chapter IV has been devoted to this issue since 1995. The source of the concern is evidently the imprecise nature of the rules to be applied, and the requirement to conduct a specific functional analysis for each taxpayer. The TPGs stress from the outset that ‘the objective [is] to find a reasonable estimate of an arm’s length outcome’, and that ‘transfer pricing is not an exact science but does require the exercise of judgement on the part of both the tax administration and taxpayer’ (OECD 2017a: para. 1.13). This creates a dilemma in devising simplified standards which are compatible with the TPGs. While it is conceded that precision is not possible, the emphasis on the exercise of judgement seems to preclude a simplified method that can be applied automatically.

This was the view taken in the 1995 TPGs, which included a section discussing ‘safe harbours’. The conclusion was that they raise ‘fundamental problems’ and were ‘generally not compatible with the enforcement of transfer prices consistent with the arm’s length standard’ (OECD 1995: para. 4.121). However, as countries introduced regulations based on the TPGs and began to enforce them, many found it necessary to provide simplification measures. A survey conducted by the OECD, as part of a project begun in 2010 on the administration of transfer pricing,⁴⁷ found a sharp growth especially from 2001 (see Table 2).

Table 2 Introduction of simplification measures



Source: OECD 2012: 16. Derived from responses from Argentina, Australia, Austria, Belgium, Canada, Chile, China, Colombia, Czech Republic, Denmark, Estonia, Finland, France, Germany, Hungary, India, Indonesia, Ireland, Israel, Italy, Japan, Korea, Luxembourg, Malaysia, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Russia, Singapore, Slovak Republic, Slovenia, Spain, South Africa, Sweden, Switzerland, Turkey, the United Kingdom and the United States.

⁴⁷ For a discussion by the responsible official at the OECD at that time, see Andrus 2012.

Consequently, a revised version of the section on safe harbours in the TPGs was issued in 2013 (OECD-CFA 2013) and incorporated into the 2017 edition. It now considers such measures acceptable if ‘carefully targeted and prescribed and when efforts are made to avoid the problems that could arise from poorly considered safe harbour regimes’ (OECD 2017a: para. 4.97). In 2018 the OECD initiated a consultation on revisions to chapter IV, which might include the discussion of safe harbours and perhaps other simplified methods.

In the current chapter IV, the TPGs define a safe harbour as:

a provision that applies to a defined category of taxpayers or transactions and that relieves eligible taxpayers from certain obligations otherwise imposed by a country’s general transfer pricing rules. A safe harbour substitutes simpler obligations for those under the general transfer pricing regime. (OECD 2017a: para. 4.102)

This cautious attitude limits the range of simplification measures considered acceptable to the OECD. It stems from the commitment to analysis of the specific facts and circumstances of each taxpayer to verify the appropriate transfer pricing methodology. Hence, it excludes the possibility of a blanket simplified rule generally applicable to all taxpayers. The revised chapter IV-E of the TPGs evaluates the problems which may be caused and identifies solutions to be adopted in the design of substantive safe harbour rules (Box 4).

Box 4 Design of safe harbour rules to comply with the TPGs	
Concern	OECD suggested solution
Divergence from the ALP: not tailored to fit individual taxpayers; may mandate use of particular method, instead of the most appropriate	Make safe harbour elective for the taxpayer
If adopted unilaterally, increased risk of double taxation, possibly also of double non-taxation	Safe harbour parameters should be set to avoid both under- and over-taxation; target low-risk taxpayers or transactions to ensure that administrative costs savings outweigh tax revenue losses; be prepared to reconsider application of safe harbour if a claim is made under the mutual agreement procedure; negotiate bilateral or multilateral safe harbours
May provide taxpayer with tax planning opportunities	Limit application of safe harbours by adopting them on bilateral or multilateral basis, and specify narrow range of acceptable results
Equity and uniformity issues	Define eligibility criteria carefully to ensure that all similar taxpayers are treated alike

Only 15 of the measures found in the OECD survey mentioned above concerned simplification of the pricing method, such as specifying an arm’s length range or rate (including interest rates). These were generally directed at either low-value-adding intra-group services or loans (OECD 2012: para. 20). Thirteen measures in nine countries concerned simplified transfer pricing methods, of which nine refer to the cost plus method, two the CUP, and two the TNMM or profit split (OECD 2012: para. 27).

Five categories of measures were covered in the survey of 2011-12:

- **Procedural measures** (usually for small/medium enterprises, and/or small transactions):
exemptions from transfer pricing rules
exemptions from, or simplified, documentation requirements
exemptions from, or alleviated, penalties
simplified APA procedures, or reduced charges
- **Substantive measures:**
simplified transfer pricing measures, e.g. safe harbour ranges or rates

The survey did not cover thin capitalisation rules, but did include safe harbour interest rates, and low value-adding service charges, among the substantive measures. It showed that 33 of the 41 participating countries had introduced some type of simplification measures, with a total of 69 measures. However, the large majority were procedural, over half were exemptions for small and medium enterprises and small transactions, and from measures related to documentation. The World Bank manual recommends that a 'hard threshold' for exemption from compliance with transfer pricing rules should be based only on the size of the taxpayer; exemptions based on transaction size should be limited to documentation requirements (World Bank 2016: 64).

Clearly, a key condition under the TPGs for a simplified method is that it should not be imposed, hence it should be to the advantage of the taxpayer. Further, if its application may create a risk of double taxation, i.e. if the profit allocation affects a related party in a treaty partner, it should either be agreed bilaterally, or the MAP should be available. For these reasons, it seems that there is greater scope in the TPGs for using APAs than for safe harbours. APAs are usually specific to the taxpayer, and therefore require an individual facts and circumstances and comparability analysis. Since they last for several years there can be some saving on administration costs, but this is not significant, since there is still a need to monitor for compliance with their conditions, and to check that circumstances have not changed. However, chapter IV mentions the possible use of bilateral APAs as a simplification measure (para. 4.120), and an appendix was added describing the US-Mexico agreement on taxation of maquiladoras. This is a sectoral arrangement, which does involve a simplified method, and will be discussed in the next section.

2.2 Country experiences

This section will outline and analyse the attempts by some key countries to establish simpler methods for attributing profits which reduce or eliminate the need for a facts and circumstances analysis of individual taxpayers. It does not examine exemptions based on thresholds for SMEs or small transactions.

Three of the case studies concern large developing countries which introduced transfer pricing regulations or began enforcement programmes in the early years after the introduction of the TPGs. It is not surprising that it should have been such countries that attempted such methods, and a careful evaluation of their experience should be valuable for others also.

2.2.1 Brazil

Brazil introduced its first transfer pricing rules in 1996,⁴⁸ in the context of a fiscal reform programme launched in the Presidency of Fernando Henrique Cardoso. They were based on

⁴⁸ Law no. 9,430 of 27 December 1996; amended in 2000, 2009 and 2012, available in a consolidated version showing revisions (in Portuguese) at www.planalto.gov.br/CCivil_03/leis/L9430.htm (Cap. I, Sec. V).

the three traditional methods accepted by the OECD, and alignment with OECD practice was officially stated as the reason for their introduction (Rocha 2017: 160). However, the formulation of the rules departs significantly from the orthodox interpretation of the ALP by the OECD in the TPGs. The three traditional OECD methods are defined slightly differently in the Brazilian rules in relation to activities involving imports and those involving exports. An additional method was added in 2012 for pricing commodity exports, based on the so-called sixth method for pricing commodities (see Box 5).

The most distinctive feature is that the legislation itself specifies the profit margins to be applied to each type of transaction. This methodology is the opposite of that recommended in the TPGs, which requires evaluation of the specific facts and circumstances of each firm. For these reasons, the rules do not comply with the concept of safe harbours accepted in the TPGs, even after the 2010 revision (OECD 2010). In addition, Brazil does not permit the two OECD profit-based methods (TNMM and profit split), nor does it accept the best method rule (which was included in the TPGs only in the 2010 revision). However, if more than one of the specified methods may be applicable, the taxpayer may choose which to apply, even if it produces a lower tax burden (Calich and Rolim 2016: 529). Also, the taxpayer is not required to make an adjustment if the deviation from the parameter price is less than 5 per cent, or 3 per cent for the commodity price (UN 2017a: para. D 1.8.6). Although the starting point is prices observed in market transactions between unrelated parties, the Brazilian rules require this to be an annual average, rather than a single price, or a range.

Box 5 Brazil's transfer pricing methods		
OECD equivalent method	Imports Law 9430, Article 18	Exports Law 9430, Article 19 para. 3
CUP	Comparable independent price Weighted average of prices observed in transactions in Brazil or elsewhere by the same enterprise or others for identical or similar goods, rights or services, under similar payment conditions	Export sales price Average price for sales abroad obtained by the enterprise from third parties or by another exporter of identical or similar goods, services or rights under similar payment conditions
Resale minus	Resale price minus profit Weighted average price received in Brazil for imported goods, rights or services (excluding discounts, commissions and sales taxes), with a profit margin fixed at 20%, or 60% if the imports are used in a manufacturing process. New margins were introduced in 2012 of 20%, 30% or 40% for different economic sectors	Foreign sales price minus profit Average sales price in the export market of identical goods, rights or services (excluding taxes) with a fixed profit margin of 15% for wholesale or 30% of retail sales prices
Cost plus	Production cost plus profit Average cost in the country of production to produce similar or identical goods, rights or services, with a fixed profit margin of 20%	Purchase/production cost plus profit Average cost of acquisition or production (including Brazilian taxes) of goods, rights or services, with a fixed profit margin of 15%
Sixth method	Import quoted price Daily average price quoted on an internationally recognised commodity or futures exchange, adjusted to take account of the average market premium	Export quoted price Daily average price quoted on an internationally recognised commodity or futures exchange, adjusted to take account of the average market premium

Source: Brazil 1996 (Law 9430 as amended); Calich and Rolim 2012: 527; Gomes and Mansur 2018.

The Brazilian approach clearly has the advantages of simplicity and especially ease of application, and this seems to have been its motivation (Rocha 2017: 162). On the other hand, it is a very broad-brush approach, which takes little account of differences between industry sector or business models, and ignores the actual profitability of the company concerned (either the local affiliate or the TNC as a whole). However, some leeway is allowed for the taxpayer, since it can choose which method to apply and how to do so, although this choice must be supported by documentation. In addition, the law (Article 20) provides for the Minister of State for Finance to authorise application of a different profit rate, in justified circumstances. In practice, this has apparently never occurred, although a couple of requests have been made.

It is important to understand this approach in the overall context of Brazil's international tax rules. Firstly, since the 1960s Brazil has applied strict limitations (set by the Ministry of

Finance) on deductions for royalties at 5 per cent (1 per cent for trademarks) (Calich and Rolim 2012: 531); and this applies to management and service fees, which under Brazilian law (and most of its tax treaties) are classified as royalties (Rocha 2017: 50). Thus, the key issue of intangibles is not dealt with under transfer pricing rules (Valadão and Lopes 2013: 31).

Secondly, in 1995, as part of the same fiscal reform adopting the transfer pricing rules, Brazil also moved from a territorial to a worldwide tax system. It continues to have the strongest rules in the world on controlled foreign corporations, so that all foreign profits of Brazilian resident companies, as well as their subsidiaries, are taxable in Brazil, subject to a foreign tax credit (Rocha 2017). Hence, for Brazilian-based TNCs, the transfer pricing rules affect only what counts as foreign profit, and hence the availability of the tax credits. Finally, Brazil has strong rules to prevent base erosion through transactions with entities in countries with low-tax or preferential tax regimes. These include application of the transfer pricing rules to transactions with any entities in such jurisdictions, even if unrelated. All these rules establish strong defences against erosion of Brazil's tax base by TNCs, taking much of the pressure off the transfer pricing rules.

The evidence suggests that these rules have been effective. Brazil's total tax revenue in relation to its GDP increased after 1994, and since 2001 has been close to the average of OECD countries, at around 35 per cent, while the ratio of corporate profits tax revenue to GDP has also tracked the OECD average (Calich and Rolim 2012: 521-2). This is around double the average tax to GDP ratio of developing countries, although the tax system as a whole seems highly regressive, contributing to Brazil's social inequalities (Fagnani 2018). There is some evidence that Brazil's tax administration has been able to deploy a much lower number of personnel to enforcement, proportionate to taxpayer numbers, than OECD countries (Gomes 2014: 96). The fixed margin method has achieved much greater simplicity of administration, as well as a very low level of tax disputes.

No transfer pricing disputes have reached the courts: all have been resolved administratively, through the administrative procedures provided, which include review by an administrative judge, with the possibility of appeal to the Administrative Taxpayers' Council. A comprehensive review of the decisions relating to transfer pricing by this council has analysed 19 cases, almost all concerning the pharmaceutical, chemicals and auto sectors (Calich and Rolim 2012: 533). Many of the decisions discuss the TPGs, treating them as secondary rules of interpretation, while recognising that Brazil's rules diverge from them. However, the decisions have taken the view that Article 9(1) of tax treaties leaves it to each state to decide on the method of implementation of the ALP, and that Brazil's methods are compatible with that Article (Calich and Rolim 2012: 536-40; Ilarraz 2014). Thus, an early decision by the council denied a taxpayer's claim to use the TNMM, on the grounds that the legislation had laid down simplified methods for reasons of practicality (Ilarraz 2014: 223).

Brazil has 33 tax treaties now in force, many of long standing, and under Brazilian law these treaty provisions override domestic law. Yet the apparent incompatibility of its transfer pricing methodology with the TPGs seems to have caused few problems. However, some significant disagreements with Germany, including over the transfer pricing rules, led to that country cancelling its treaty with Brazil in 2005. There seems to have been only one attempt to use the MAP, in the 1970s, involving a Brazilian bank and its branch in France, but the matter was resolved at national level (Calich and Rolim 2012: 547). This may be partly attributable to Brazil's reluctance to accept an obligation under tax treaties to resolve cases of economic double taxation, and its treaties do not include Article 9(2), providing for 'secondary' or 'corresponding' adjustments.

The view taken in Brazil that its fixed margin methods are compatible with tax treaties, though not with the TPGs, seems sound. As the account in section 1 of this paper has

shown, the adoption of the TPGs in 1995 was a major departure from previous approaches to the application of Article 9. Brazil was not (and still is not) a member of the OECD, and many of its treaties were concluded before 1995. As explained above (section 1.3), although the 2001 version of the commentary to the UN model recommended following the TPGs, ensuing versions have not. The UN practical manual includes a chapter outlining country practices, including Brazil's, although it makes clear that no attempt was made to seek a consensus in the committee on this chapter.

The section on Brazil in the UN manual, written by Marcos Valadão (then the Brazilian member of the committee), includes some suggestions for other countries considering adoption of the fixed margin method. These focus on tailoring the specified margins to the kinds of goods and services dealt with in the country concerned, and setting the margins based on research into the profit margins prevalent in the relevant industry, sector or line of business. Further, it suggests that the regulations could provide a range within which the taxpayer could choose: for example, if the research shows a spread of comparables in an industry going from 28 per cent to 35 per cent (taking account of frequency distribution), the legislation could specify a fixed margin of 30 per cent, and a taxpayer could use the 5 per cent margin to choose a margin between 28.5 per cent and 31.5 per cent (UN 2017a: D.1.9.7). If the comparables search results in too wide a range, it suggests a narrower specification of products or product lines. However, this would create more complexity and could create problems of classification. It should be noted that the Brazilian rules themselves allow a 5 per cent deviation from the fixed margin, and they establish different margins only where there is some domestic manufacturing, for three broad industry groups.

Similar suggestions for modifications to the Brazilian rules which could make them sufficiently compatible with the approach in the TPGs have also been made by Schoueri (2015). These include greater transparency in the formulation of the fixed margins, more differentiation of those margins according to economic sector, and making it easier for the standardised fixed margin to be rebuttable by the taxpayer. Although rebuttal is formally possible under the Brazilian law, no application has been made in practice, which Schoueri attributes to the excessive complexity of the documentation required (*ibid.*: 708). Making such applications procedurally easier could enable exceptions to be made in hardship cases, encourage revision of the standard margins by the administration, or facilitate determination of more appropriate sector-specific margins, perhaps by agreement with representatives of sectors. It may be, however, that the very low level of disputes despite the application of quite rigid profit margins indicates that those margins have been set at generally tolerable levels. Making the fixed margin more easily rebuttable, or introducing lower margins for more specifically defined sectors, might justify increasing the applicable margin, although this might result in more hardship applications. As always, there is a balance to be struck between ease of administration and ensuring appropriate tax levels.

The joint project with OECD now taking place (see section 1.3.2 above) will no doubt scrutinise more closely the compatibility of the Brazilian methods with the TPGs. This clearly goes beyond the more specific question of compatibility with Article 9(1) for which, as already said, there seems a good case. It should also be borne in mind, as mentioned above, that Brazil's fixed margin transfer pricing methods must be understood in the context of its overall international tax rules. In particular, the difficult issue of intangibles is dealt with separately, by limiting royalty deductions (Valadão 2016: 308).

Brazilian authors rightly stress the great advantages of the fixed margin method, in providing both ease of administration and greater predictability for business, and point out that it can meet the aim of Article 9(1) of preventing double taxation at least as well as the OECD approach with its wide range of methods and need for ad hoc subjective judgements (Ilarraz 2016; Schoueri 2015: 710; Valadão 2016). Nevertheless, it is clearly not a panacea. All these

considerations give a much wider global importance to the evaluation of the Brazilian model, which should therefore be conducted in a more transparent and inclusive manner.

2.2.2 India

India's Income Tax Act 1961, replacing the colonial-era legislation dating back to 1922, included a provision that, where a 'close connection' existed between an Indian taxpayer and a foreign entity, income 'reasonably attributable' to the operations in India should be taxed in India. Regulations specified that where this could not be readily ascertained, it should be determined according to: (i) a reasonable percentage of turnover in India, or (ii) a proportion of the worldwide profits applying the ratio of Indian to worldwide revenues, or (iii) another appropriate method (Butani 2012). This reflected the methods used by tax authorities as far back as the 1920s, as found in the Carroll report (discussed in section 1.1).

In 2001 this was replaced with transfer pricing rules based on the OECD TPGs.⁴⁹ Unusually, and in sharp contrast to Brazil, the primary legislation directly enacted the OECD methods specified in the TPGs, although without referring to them directly. Implementation of these methods was taken up enthusiastically by both the tax administration and the cadres of tax advisers who quickly emerged to service TNCs. It has been reported that, by fiscal year 2007-2008, enforcement of these rules had resulted in adjustments of \$9 billion, totalling about \$16 billion in seven rounds of transfer pricing audits (Supekar and Dhadphale 2012). However, applying the rules also created an explosion of tax litigation, resulting in an estimated backlog of 3,000 cases before the tribunals by 2012.⁵⁰ Indian cases were estimated to account for 70 per cent of the world's transfer pricing litigation, by number of cases (*ibid.*); a digest of tax court decisions published by an Indian advocate contained 2,000 cases for the year 2017 alone, 1,200 of which concerned transfer pricing (Lala 2018).

Concern about the volume of disputes led to the enactment of a provision in 2009,⁵¹ empowering the Central Board of Direct Taxes to set 'safe harbours' specifying 'circumstances in which the income tax authorities shall accept the transfer price declared by the assessee'. However, no action was taken until July 2012, when it was announced that a committee had been set up to study the appropriate taxation of TNC subsidiaries in the IT sector. This concerned so-called 'development centres' set up by some 750 TNCs in 1,100 locations in India (India Income Tax Department 2012). Based on the committee's recommendations, proposed safe harbour regulations were issued for comments in August 2013, and finalised in October.

The regulations covered specified industry sectors: (i) software development or IT enabled or knowledge process outsourcing services; (ii) contract R&D for software development; (iii) contract R&D for generic pharmaceutical drugs, and (iv) manufacture and export of auto components, for 90 per cent of which the entity should be the original equipment manufacturer. Companies in these sectors could request to be certified as eligible by the relevant tax official. The official had to approve the sectoral designation and verify that the operation did not involve 'significant risks', the criteria for which were that other related parties performed most of the economically significant functions, supplied the funds, economically significant intangibles and other assets, and could and actually did control the activities. Once certified, the normal audit process did not apply (*Mehsana* 2018), and eligible taxpayers were entitled to acceptance of their declared operating profit margin if it complied

⁴⁹ The new Section 92(1) of the Income Tax Act reads: 'Any income arising from an international transaction shall be computed having regard to the arm's length price. Explanation – For the removal of doubts, it is hereby clarified that the allowance for any expense or interest arising from an international transaction shall also be determined having regard to the arm's length price.' The ALP is spelled out in Section 92C by reference to the five OECD-approved methods, specifying that it should be determined by the most appropriate method, having regard to the nature of the transaction or functions performed, or such other relevant factors as the Central Board of Direct Taxes may prescribe.

⁵⁰ For an account of the procedures prior to appeal to a tribunal see Butani 2012.

⁵¹ Tax Act Section 92CB, inserted by Finance Act 2009 s.42.

with a specified minimum. These were, broadly, 20 per cent for software development, or 22 per cent if aggregate transactions exceeded INR (Indian Rupee) 100 crore (about US\$ 13.6m);⁵² 25 per cent for knowledge process outsourcing; and 12 per cent for core or 8.5 per cent for non-core auto component manufacture. There were also safe harbours for intra-group loans (interest rate 150 basis points above the base rate for small loans, and 300 basis points above for larger loans), and loan guarantees (minimum fee of 2 per cent of the amount guaranteed) (India-CBDT 2013; Chawla 2013).

A taxpayer could opt in for a period of up to five years, but could opt out, or be declared ineligible, during that time. However, by opting for a safe harbour the taxpayer became ineligible to invoke the MAP for resolving conflicts under tax treaties (India-CBDT 2013: Rule 10TG).

In the event, there was very little take-up for this scheme, as taxpayers considered that the margins it provided were too high.⁵³ A revised scheme was enacted with effect from April 2017. This reduced, by a few percentage points, the minimum profit rates, while introducing an aggregate transaction limit of INR 200 crore (about US\$ 27.3m) and amending some of the provisions defining the calculation of operating profit (especially employee costs). Despite the lowering of rates, it seems that take-up for this revised scheme may not be significantly greater.⁵⁴ It also added a new safe harbour, for low-value-added central services costs, implementing the changes recommended in the BEPS project, to a maximum value of INR 10 crore (about US\$ 1.36m).

Unfortunately, the hope that this scheme would reduce the level of conflicts has not been fulfilled, and it has been ineffective, for several interrelated reasons. It was designed as optional for taxpayers, but they have little incentive to opt in to the scheme, because it does not significantly reduce the burden of documentation, and taxpayers consider the fixed margins too high. Hence, they have preferred to submit their own calculations for audit and, if necessary, appeal an adverse adjustment to the tribunals.

The scheme also denies their access to the MAP, which potentially creates a risk of double taxation. This was borne out by the conflict which became public in early 2013 between the Indian and US officials responsible for the MAP, leading to the replacement in July 2013 of the Indian official.⁵⁵ Following the election of a new government with a more favourable policy towards foreign investors, in January 2015 the US and Indian competent authorities signed a framework agreement under the MAP procedure. This agreement had the stated aim of facilitating resolution of some 200 conflicts relating to the information technology sector, and a year later it was reported that about half had been resolved.⁵⁶ This process seems to have contributed to the 2017 revisions of the safe harbour scheme, by helping to identify appropriate margins.

Clearly, India has attempted since 2001 to adhere to the OECD approach, in contrast to Brazil. However, this can hardly be considered to have been effective, either for taxpayers or the administration. The ad hoc transactional approach has generated an enormous flood of conflicts. This has likely been exacerbated by the reluctance of the Indian revenue authority to accept the limitations on taxation at source of operating affiliates due, for example, to the concept of stripped-risk outsourcing (UN 2017a: Section D.3.4). India has also sought to introduce concepts other countries have been reluctant to accept, such as location

⁵² Using an exchange rate of US\$ 1 = INR 73.2 (www.xe.com/currencyconverter/ – 2 Nov 2018). This rate is used for all the conversions in this section on India.

⁵³ No data was collected, but there were an estimated 25-30 cases (personal communications from officials and practitioners, December 2017).

⁵⁴ Personal communications with tax practitioners, December 2017.

⁵⁵ Parillo 2013. For some information about earlier MAP negotiations with the US, see Butani 2012: 613.

⁵⁶ See <http://pib.nic.in/newsite/PrintRelease.aspx?relid=135867>

advantages, to increase the profits attributed to operating companies (UN 2017a: Section D.3.7).

The attempt to introduce safe harbours has also been unsuccessful so far. This seems due to adopting an opt-in model, in strict compliance with the OECD approach, while trying to resist the restriction of source taxation by setting margins at a level acceptable to the tax authority. Unsurprisingly, this has led to a very low level of take-up.

2.2.3 Mexico

Mexico became a member of the OECD in 1994, the same year that the NAFTA (North American Free Trade Agreement) between Canada, Mexico and the USA came into force. It was among the many countries that introduced detailed rules on transfer pricing following publication of the TPGs in 1995. Prior to that, its income tax law included powers for the tax authority to adjust the accounts of a taxpayer which had 'common interests' with another entity, resulting in deviation from 'market prices'. In a tax reform package enacted in December 1996, a new Article, 215, was included in the income tax law based on the ALP, requiring corporate taxpayers in their dealings with foreign related parties to determine their gross income and allowable deductions by using the prices and consideration that they would have used with independent parties in comparable transactions. In 2002 an addition was made specifying that the transfer pricing section in the income tax law should be interpreted in accordance with the TPGs, provided they are consistent with the other provisions of that law and with Mexico's tax treaties (OECD 2003).

In 2003 the OECD published a report of a peer review of Mexico's transfer pricing practices.⁵⁷ It pointed to two issues in particular, both of which it said would be relevant to the general review of transfer pricing methods being conducted by WP6 at the time. The first was the selection by taxpayers of profit-based methods, which could not be countered by the administration, since the law allowed the use of any appropriate method. The second was the lack of local companies which could be used in comparability analysis resulting in reliance on foreign (mostly US) comparables, and the 'development of approaches to such complex comparability issues as determination of location savings' (OECD 2003: 24). Neither of these observations seem to have influenced WP6's thinking: on the contrary, it decided in 2010 to introduce the best method rule into the TPGs,⁵⁸ and only accepted the concept of location savings in the context of restructurings. The problem of lack of suitable comparables is in any case endemic to the ALP, and the observation would not have surprised members of WP6.

A major problem faced by Mexico, as the report also highlighted, is dealing with the maquiladora sector. These are sub-contracting export-processing firms generally owned by foreign TNCs, mostly from the USA. They date back to the 1960s, but received a boost from the NAFTA, with their number climbing from 1,920 in 1990 to 3,630 in 2001, falling back to 2,810 in 2006, and rising again to 5,055 by 2012, by then employing 2m workers (Dorocki and Brzegowy 2014: 102). They became established due to tax incentives, with exemptions from import duties for temporary imports of machinery, equipment, parts and materials, and from VAT if the finished goods are exported. Commonly, maquiladoras use imported machinery, equipment and inventories owned by the foreign parent corporation, which ensured exemption from Mexico's asset tax (now no longer in force), which was levied at 1.8 per cent, in the proportion that the production was exported (OECD 2003: 46).

⁵⁷ Although it stated that this was part of a general system of such peer reviews, no report on the transfer pricing practices of other OECD members seems to have been published.

⁵⁸ Mexico, however, followed the recommendation of the peer review and a 2006 revision gave priority to the CUP (UN 2017a: 608).

Initially, the maquiladoras were taxed under the general law, apparently based on a margin of 2-5 per cent on their operating costs, mainly payroll (OECD 2003: 48). Since the Federal Tax Law of 1981, Mexico had a broad definition of a PE, so a maquiladora could be treated as the PE of its foreign parent, as well as being taxable itself. However, the standard for attribution of profits for such a PE was uncertain, and in view of the dependence of the sector on the US, it was hard for Mexico to determine this unilaterally (Schatan 2002: 920). The tax treaty negotiated with the US in 1992, that came into force in 1994, included a special provision (Article 5(5)), that an entity could be considered a PE if it habitually processes goods for a foreign enterprise using assets furnished, directly or indirectly, by that or an associated enterprise. This was intended by Mexico to dispel any doubts that a maquiladora constitutes a PE of its US parent (Morrison 1993: 316).

Since there was no agreed international methodology for attributing profits to a PE, Mexico might have adopted a fractional apportionment method. Instead, in 1994 Mexico introduced special rules for the maquiladoras. These provided a safe harbour, allowing exemption from the PE provision, subject to a tax at 5 per cent of all assets, including foreign-owned, with the alternative of seeking an individual tax ruling or APA. Regrettably, this proved ineffective, since only labour-intensive entities opted for the safe harbour, which taxed them at a relatively low rate, while capital-intensive firms with significant assets requested an APA (Schatan 2002).

Hence, in 1998 Mexico decided to phase out the safe harbour and negotiated an agreement with the US in 1999 under the MAP provisions of the treaty, to apply for three tax years. This agreed exemption from a PE based on a new safe harbour: taxation at either: (i) 6.9 per cent of the assets used in the activity; or (ii) 6.5 per cent of operating expenses (excluding financing costs), whichever is higher. Again, the alternative was an APA in the form of an advance ruling under Mexican law, which should take into consideration the assets, including inventory, used by the maquiladora entity.⁵⁹ The agreement with the US helped to clarify for US firms the eligibility of Mexican taxes for a US tax credit.

In 2002, with the decline of the maquiladoras due to the US recession and a strong peso, Mexico extended the exemption and safe harbour arrangement, while debating additional regulations (McLees, Bennett and Gonzalez-Bendixsen 2002). The new provisions introduced from 2003 dropped the requirement to seek an APA if the safe harbour was not accepted, and instead specified two alternatives, variations of the cost plus and TNMM methods. Through a Presidential decree, an additional relief was also enacted which would reduce the profits tax by half (OECD 2003: 51). A further boost to the sector in 2006 extended the programme to all companies with export sales of over \$500,000 or 10 per cent of sales. By that time, maquiladoras were also allowed to perform sales functions in Mexico, triggering significant deviations from a tax perspective.

Following the sector's rapid growth, restrictions were reintroduced in 2014, including limitation of the PE exemption to income deriving wholly from export of products resulting from imported inputs, and ending the additional relief (Leon-Santacruz and Lujan 2014). The tax authority also began closer scrutiny of claims to maquiladora status (UN 2017a: 615). The transfer pricing rules were revised to introduce methods based on all five of those in the TPGs, and the only alternative to the safe harbours became applying for an APA, based on these methods. This resulted in a rapid rise in APA applications, producing a backlog of 700 by 2016.

The Mexican tax administration therefore negotiated with the US IRS a framework agreement establishing an agreed APA methodology. This involved three steps: (i) distinguishing between labour-intensive and asset-intensive firms, based on a threshold of an

⁵⁹ McLees, Bennett and Gonzalez-Bendixsen 1999, which provides the text of the agreement.

assets/operating costs ratio of 2.08 per cent; (ii) a detailed methodology for calculating costs, to which a mark-up should be applied (by sector: 3.49 per cent for electrical, 4.84 per cent for auto, and 4.25 per cent for others); (iii) adding, for labour-intensive firms, 1.6 per cent of the net book value of the machinery, equipment and inventory owned by the parent but physically in Mexico; in the case of capital-intensive firms, an adjusted mark-up on total costs would be calculated, based on the sector, and their level of costs, expenses and operating assets, plus 2.4 per cent of net book value of the machinery, the equipment and inventory owned by the parent but physically in Mexico (Mexico-SAT 2016). For both scenarios, the methodology agreed between Mexico and the US contemplates the exclusion of any financial effects that could distort the results of the maquiladora, given that the methodology was agreed on the basis that these entities in Mexico have a low risk profile.

This agreement aims to provide 'fast track' approval for APAs, as an alternative to the safe harbours agreed in 1999, which remain in place. Although the APAs will be issued and monitored by Mexico, the US announcement stated that the outcomes will be accepted by the IRS (US-IRS 2016). That announcement also stated that the agreement would be published, but this does not seem to have taken place.⁶⁰ It seems that the Mexican administration will offer the arrangement to companies that it considers are performing non-high-value manufacturing functions within the maquiladora context.

The Mexico-US agreement seems to adopt a similar approach to the framework agreement negotiated with India by the IRS in 2015, mentioned above. One report suggests that a similar arrangement was attempted between Taiwan and China in 2010, although unsuccessfully (Feinschreiber and Kent 2017).

The experience of Mexico has been like that of India, largely due to their similar relationship to the US as a destination of outsourced manufacturing and service activities by TNCs taking advantage of lower unit labour costs. For both countries, politicians' perceptions of the desirability of supporting this sector has influenced the tax authorities' design of the simplification measure. There was an incentive for maquiladoras to accept the safe harbour because of the uncertainty due to lack of a clear standard for attributing profits to a PE, but making it optional has led to a sharp rise in applications for APAs unless the safe harbour rate is acceptable to taxpayers. The unsuitability of the single margin fixed in 1994 was corrected by the agreement of 1999 with the US, introducing a distinction between labour- and capital-intensive companies, and this was further refined in the 2016 agreement with a more detailed methodology, distinguishing between three major sectors. The bilaterally agreed safe harbour, taking the form of a bilateral APA, ensures a high level of take-up, though no doubt the agreed margins entailed some compromises between the two tax authorities. Some control is exercised over eligibility of firms for the safe harbour, to prevent abuse.

2.2.4 The Dominican Republic

The Dominican Tax Code has, since its inception in 1992, included a provision (Article 281) requiring legal acts between a local foreign-owned company and a related foreign entity to conform to the principle that they are 'done between independent parties when the provisions are consistent with normal market practices between independent entities'. This provision also denied deduction of interest, royalties or fees for technical services unless tax of 30 per cent had been withheld (República Dominicana 1992-). The code also had long-standing provisions (Articles 65-66) allowing the tax administration, in cases where the taxpayer's declaration is false, inaccurate or unreliable, to make necessary adjustments.

⁶⁰ The analysis here is based on a copy of the document, in Spanish, kindly supplied by the Mexican tax authority.

In 2006, provisions were added to Article 281 empowering the tax administration to assess affiliates and PEs of foreign TNCs on the basis of the proportion of their gross revenues to those of the TNC as a whole, or in relation to their assets, and to adjust transfer prices with related entities by applying the independent entity principle. The 2006 changes also made specific provision for the tax administration to negotiate an APA for the all-inclusive (package) hotel sector, to be represented by the National Association of Hotels and Restaurants (ASONAHORES). It specified that such an APA would be published and, once agreed, would be valid for 18 months, renewable for three years, and would continue in force if a renewed version were not agreed (República Dominicana 1992-). In 2011 the tax administration published regulations for the application of Article 281, largely based on the TPGs, specifying transfer pricing methods, procedures for identifying comparables, and documentation requirements (Dominican Republic 2012). At the same time, it established a transfer pricing unit.

However, enforcement of the 2006 provisions had begun in 2009, focusing audits especially on the all-inclusive hotels sector, which accounts for 2 per cent of the country's GDP and 7 per cent of exports (CIAT 2013: 61). The sector was selected because of its use of related marketing companies located in low-tax jurisdictions, while local financial statements and tax returns showed continued losses; the guest per night rate declared was often lower than operating costs, while the rates advertised on marketing sites were over 100 per cent higher than these declared rates. The tax administration requested taxpayers in that sector to submit sworn affidavits, which were then subjected to verification. Where the submitted data seemed unreliable, assessments were issued, based on a methodology developed by the administration. Appropriate rates per night were obtained by an independent market research firm and, with deduction of transportation costs, were broken down by dates and season, and further by hotel categories and zones (obtained from ASONAHORES). Revenues estimated on this basis were subject to a 16 per cent discount for sales taxes, 10 per cent for the compulsory 'tipping' or labour cost levy, and then 20 per cent and 25 per cent for the margin allowed for the marketing and tour operator intermediaries. Through this process, 73 audits, of 33 taxpayers, were carried out in 2009-11, for fiscal years 2005-10, representing half of all the registered all-inclusive hotels, mainly in zones A and B (Dominican Republic 2012: 4-6), and accounting for 83 per cent of the revenues in the sector (CIAT 2013: 62).

Objections to these assessments were rejected on administrative review, and one taxpayer appealed to the Superior Administrative Tribunal (Box 6). The administration's victory in this case enabled it to put pressure on all taxpayers in the sector to fall into line with the APA. Thus, a general framework was agreed in a memorandum of understanding (MOU) signed with ASONOHORES in 2013 for three years, then revised in 2016.⁶¹

⁶¹ This MOU was not published: this information was received from Wanda Montero, a consultant on the project which produced the MOU.

Box 6 The Coconut Investments hotels case

The case concerned an income adjustment equating to some US\$ 15.75m, resulting in tax payable of US\$ 2.8m including interest. The taxpayer argued that the assessment was unconstitutional and unlawful, since the legislation required the APA to be agreed with ASONOHORES, and was arbitrary, being based on average prices rather than the taxpayer's own profitability. It claimed that the estimation methodology showed a lack of knowledge of the package hotel sector, that the tour operators and marketers assumed significant costs and risks, and that the transfer pricing method applied did not comply with the OECD TPGs. The tax administration countered that the law gave it the power to make appropriate adjustments if the taxpayer's data was considered unreliable, and this power could be used since the APA had not been signed. It showed that the local hotel company in question was owned by a holding company in Luxembourg, with a marketing affiliate also in Luxembourg, but with a PE in Cadempino in the Swiss canton of Ticino, a known tax haven. Due to the complex structure, the data submitted could not be verified. The taxpayer's return claimed room rates close to operating costs, resulting in losses or low profits, but checks had shown that the rates charged by marketers were on average 242.9 per cent higher in high season and 176 per cent higher in low season than similar hotels. The tribunal found that the administration had acted within the law and upheld the assessments.

Source: *Inversiones Coconut 2012*

The MOU establishes three methods for pricing the all-inclusive hotel room sales (fixed rate, gross margin on costs, and net margin on costs and expenses), and a minimum effective tax rate of 2 per cent on the income of the taxpayer, as well as reporting obligations. On this basis, each taxpayer must submit a request for an individual APA, to be valid for three years. This should specify the hotel's category (as defined by ASONOHORES), the method selected and the calculation of the room price – resulting from the application of the method – to be applied for the entire length of the agreement. The taxpayer should also provide its financial statements, number of occupancies in previous years and any other relevant information substantiating the intra-group price determination. Taxpayers electing to apply for an APA do not need to provide detailed transfer pricing documentation. However, they must provide an annual report with sufficient information to verify compliance, including the number of rooms per type (e.g. standard, superior, suite), monthly occupancy, discount pricing strategy (e.g. children, or additional persons in a room), and total revenues from related and non-related parties.

The legislation also authorises a similar approach to other sectors with significant foreign ownership, such as insurance, energy and pharmaceuticals (República Dominicana 1992-: Article 281 Para. IV). However, this has not yet been done.

Like India and Mexico, a sectoral approach was adopted, described as a sectoral APA. In this case the negotiation was with an association representing the sector and not a treaty partner (the Dominican Republic has double taxation agreements with only Canada and Spain). However, the tax administration put itself in a strong position by establishing a benchmark for the selected sector, which was well researched and hence survived challenge by the taxpayer in the administrative tribunal. The failure of the challenge may also be attributable to the evidence that the taxpayer had devised a structure which seemed aimed at avoidance. The approach adopted seems to have been successful. Central Bank data shows a continued increase in tourist numbers and hotel rooms, and a growth of some 150 per cent in the value of the sector between 2007 and 2017 (República Dominicana 2017: Table 3.1.1). Government revenues from taxes on income and profits increased between 2010 and 2016

from 2.7 per cent to 4.1 per cent of GDP, and from 22 per cent to 29.9 per cent of total tax revenues (OECD, CIAT and CEPAL-UN 2018: Table 4.5).

2.3 Alternative simplified methods

This section will briefly outline two other approaches which have been advocated that could simplify income allocation.⁶² These could be introduced by countries unilaterally, while taking account of their international obligations under tax treaties (discussed in section 3 below).

2.3.1 An alternative minimum tax⁶³

A significant departure from the independent entity principle is a ‘minimum tax’ scheme. Minimum tax systems have been used, especially in low- and middle-income countries, to prevent the erosion of the corporate tax base (Best, Brockmeyer, Kleven, Spinnewijn and Waseem 2015). They generally target avoidance or evasion of corporate profits tax by either the under-reporting of sales or over-reporting of costs. As we have seen in section 1, the ALP is particularly inappropriate when applied to allocation of joint costs. Hence, it makes sense to tax an alternative base that is harder to evade than profits, and the simplest and most common base for the minimum tax is sales.

In Pakistan, for instance, all corporations are required to calculate their tax liability based on profits (at a tax rate of 35 per cent) and based on sales (at a tax rate of 0.5 per cent). Firms are then required to pay whichever is higher. This puts a limit on how far firms can avoid or evade tax on profits. When the profit rate falls below a certain threshold, the firm must pay tax calculated on the sales basis: this threshold is the ratio of the two tax rates, i.e. 0.5 divided by 35, equalling 1.43 per cent in Pakistan. Indeed, empirical evidence shows a bunching of reported profit rates around 1.43 per cent. The degree of bunching in the distribution of the profit rate can be used to estimate the extent of avoidance or evasion in response to the minimum tax. Using this approach and firm-level tax records from Pakistan, Best *et al.* (2015) show that the minimum tax in Pakistan reduces evasion by about 70 per cent.⁶⁴ In Guatemala and Hungary, the alternative tax base is also sales, and the scheme generates a very similar bunching response to the one observed in Pakistan. Some African countries have operated a minimum tax, for example The Gambia,⁶⁵ although their effectiveness does not seem to have been studied.

Some countries have chosen alternative tax bases other than sales, for instance fixed assets, in the hope of limiting distortions. The alternative tax in Ecuador is particularly sophisticated, being constituted of the sum of 0.4 per cent of assets, 0.2 per cent of wealth, 0.4 per cent of taxable profits and 0.2 per cent of deductible costs. This algorithm seems intended to address both the production efficiency and the secondary concern that a calculation based on sales could still be evaded.

In some countries, including Ecuador, the minimum tax is not an alternative tax but rather an advance payment that is creditable against the corporate tax liability calculated at the end of the fiscal period. If the advance tax payment is higher than the final corporate tax liability, the taxpayer can request a refund of the difference. If requesting a refund generates significant

⁶² It has also been suggested that the OECD could adopt a simplified profit split method applying agreed allocation keys for standard business models (Kadet 2015). Other methods are also available to safeguard source taxation, such as the limitation of deductions of interest and royalties, but these are beyond the scope of this paper. The two methods included here are also only briefly outlined, as they have been discussed in greater detail elsewhere, including in ICTD publications which are cited in the references.

⁶³ This account relies substantially on the section on this topic in Faccio, Picciotto, Brockmeyer, Clausing, Durst, Fleming, Miller and Nerudová 2017, written by Anne Brockmeyer.

⁶⁴ For more details, see also the Microeconomic Insights blog by these authors, at <http://microeconomicinsights.org/designing-tax-policy-high-evasion-economies/>

⁶⁵ The Income and Sales Taxes Act 2004, s.79, specifies 2 per cent of turnover, or 3 per cent for unaudited accounts, and the normal income tax can be credited against the amount so calculated.

inconvenience for the taxpayer, or a perception that it would increase the probability of audit, refund requests might be rare, and the minimum tax can effectively increase tax payments.

The minimum tax relies on an alternative tax base that is easier to verify than profits. It is generally applied to all taxpayers, not just TNCs, and empirical studies of its effectiveness have focused on domestic taxpayers in low-income countries. For these, the major problem is likely to be relatively unsophisticated forms of evasion, such as the fabrication of receipts for non-existent inputs. Nevertheless, it seems to be worth pursuing as a backstop to limit tax losses from tax avoidance by TNCs, in a way that is relatively easy to administer.

2.3.2 The shared net margin method

A different approach has been put forward by Michael Durst (Durst 2016). Although presented as a modified version of the TNMM, it would avoid the need for a detailed audit based on functional analysis and attempting to identify comparable independent firms, by simply establishing a benchmark for the local affiliate's profitability. The proposal would require the local affiliate to earn a profit margin in proportion to that of the corporate group as a whole. The benchmark he suggests is 25 per cent of the group's before-tax net operating margin (Durst 2016), based on experience of attempting to apply the TNMM to a wide range of distributors, manufacturers and service providers. The fraction is chosen to arrive at a profit allocation which could be acceptable to both the revenue authority and the taxpayer. This suggested method, the shared net margin method (SNMM) would require a minimum level of income, consistent with group-wide profitability, disregarding all intra-firm related party payments such as interest, royalties and fees, which are a major cause of base erosion. It would generally prevent the very low requirements of income that under current practice tend to be ascribed to 'risk-stripped' subsidiaries. This is put forward as a pragmatic solution, aimed mainly to provide developing countries with a method which is easy to administer and could adequately protect their tax base.

Durst leaves open the key question of whether such a provision would be applied as a safe harbour, in the form acceptable under the TPGs, i.e. optional for taxpayers. As we have seen from the country experiences discussed above, especially that of India, a purely optional safe harbour is unlikely to be effective. The SNMM is likely to be more suitable if treated as a benchmark, or a backstop, like the alternative minimum tax.

A merit of this method is that it focuses on the actual profits, or indeed losses, of the specific firm concerned. In this respect it is very different from the Brazilian fixed margin method, which applies a single yardstick to all firms, on a broad sectoral basis. The SNMM is therefore based on the ability to pay principle which many consider foundational. However, its focus is on the profitability of the TNC as a whole, and it does not factor in the contribution of the specific local entity. For that reason, as mentioned above, the proposal suggests applying a relatively small fraction of the firm's global profit rate in calculating the local entity's benchmark profit margin (Durst suggests 25 per cent). This is not simply pragmatism but flows from the underlying principle that in an integrated firm, profits derive from the synergy of the activities as a whole. A national tax authority might nevertheless find it difficult in some circumstances to accept this method, for example if the TNC as a whole is experiencing difficulties while the local entity seems to be doing well.

An extension of this approach would be to establish a benchmark on a formulary basis, by allocating a proportion of the TNC's global income to the local entity, based on factors reflecting its presence in the jurisdiction, such as employees, assets and sales. This would revert back to the fractional method which the Carroll report found was in widespread use, and which continues to be permitted for attribution of profits to PEs in most existing tax

treaties.⁶⁶ Such a method of course runs counter to the transactional approach now deeply entrenched in the TPGs, which explicitly reject formulary apportionment. However, this approach could be applied in a way which is compatible with the TPGs, using the framework of an APA, preferably on a sectoral basis to achieve the aim of simplicity. Such an approach has been suggested by Baistrocchi (2006), modelled on the well-known example of global financial trading.

3 Conclusions

Tax authorities around the world have powers under national laws to adjust the accounts of entities which are part of a transnational corporate group, to ensure an appropriate allocation of income. These powers are based on an international standard, agreed in 1935 and embodied in tax treaties, that the profits of such entities should be like those of similar independent enterprises. This is termed the arm's length principle. Unfortunately, the very essence of a corporate group is that the internal relationships between its various affiliates are unlike those of independent enterprises operating through markets. The difficulty of applying this standard has been exacerbated by the adoption by the OECD in 1995 of its transfer pricing guidelines, which aim to apply the ALP by focusing on the pricing of transactions. Although not normally formal law, the TPGs have been applied in practice in OECD countries, and have more recently spread more widely.

The approach in the TPGs involves individual examination of the facts and circumstances of individual taxpayers, and adjustment of the prices of transactions between related entities by comparison with those of independent parties. This is time-consuming and requires specialist expertise, placing an impossible burden on tax administrations, due to information asymmetry and capacity constraints. The TPGs also produce inappropriate results, since they do not allocate the actual profits of the TNC, especially the super-profits these firms generate through economies of scale and scope, and synergy.⁶⁷ Pending more wide-ranging reforms, poorer countries in particular would benefit from simplified methods for allocation of profits.

Following the introduction of the TPGs in 1995, some leading developing countries have aimed to apply the TPGs, while seeking methods of doing so which reduce these administrative burdens. Their experience shows the inherent difficulty of devising simplified methods which are compatible with the TPGs. As explained in section 2.1, although the TPGs now concede that safe harbours have a place, this seems mainly confined to limited exemptions – especially from documentation obligations – for small and medium enterprises and low value transactions. Such safe harbours would not seem very relevant to countries with small economies, in which any entity forming part of a TNC group is likely to be a large taxpayer. As regards substantive safe harbours, the TPGs specify that they should be: (i) voluntary for firms, and (ii) agreed bilaterally or even multilaterally, if they might result in claims of double taxation.

The Brazil case shows that a system which is easy to administer can be devised, which is compatible with tax treaties, but runs counter to the way in which the ALP has been formulated in the TPGs. Although based on methods accepted in the TPGs (cost plus and retail minus), Brazil's fixed margin system is regarded as conflicting with the TPGs in not

⁶⁶ As mentioned in section 1.1 above. For further discussion of formulary apportionment see Picciotto 2017.

⁶⁷ Discussion of the extent of tax revenue losses due to avoidance, or of the impact of profit misallocation between countries, is beyond the scope of this paper. It is now generally accepted that there is sufficient evidence that both have reached significant proportions, as shown by the efforts put into the BEPS project. The concern in this paper is that resulting methods for allocation of profits of TNCs should be both effective and easy to administer, especially for revenue authorities in poorer countries.

allowing firms a choice of methods (although not all OECD countries do this either), or an effective right to rebut the profit margin that is effectively imposed. India's experience shows the converse: designing a safe harbour system which is compatible with the TPGs makes it ineffective, as a voluntary system inevitably means that a profit margin considered safe by the tax administration is unlikely to be acceptable to taxpayers.

Mexico attempted to resolve this dilemma, by agreeing its sectoral safe harbour rules with its main treaty partner, the USA. This was combined with offering as an alternative to the safe harbour the possibility of an APA. Initially this option was apparently open-ended, leading to a sharp rise in applications for APAs, defeating the aims of the safe harbour. Its strengthening as a broad bilateral APA, with a refined methodology, seems to have established a more effective system, since the taxpayer's choice is limited to the margins resulting from the safe harbour or those in the APA. Inevitably, it involves compromise on the attribution of profits, with Mexico at a disadvantage due to its dependence on foreign investment in the sectors concerned. Nevertheless, the arrangements seem to provide a system which enables profit attribution to several thousand foreign-owned entities with a minimal need for individual scrutiny. This frees up staff to deal with other, more high-risk, taxpayers. Such a system might be appropriate for other countries in a similar situation, i.e. having a large number of entities of a similar character owned by foreign enterprises in a treaty partner state.

The Dominican Republic example is of particular interest, as it concerns a small developing country, which seems to have made good use of its scarce human resources in international tax, by targeting a sector of some economic importance, in which there was evidence of tax avoidance. The approach adopted seems to have been successful, by establishing a well-researched benchmark which could effectively be enforced on taxpayers, who seemed unprepared or unable to counter it. This seems to have provided a strong incentive to ensure that taxpayers would accept the transfer pricing methods agreed with the organisation representing the sector, which included a minimum effective tax rate. It had the advantage that it did not need to be agreed bilaterally, as there were no applicable treaties.

It seems clear that for simplified methods to be effective for developing countries needs a relaxation or abandonment of the OECD's two conditions, as expressed in the TPGs: that they should be voluntary for taxpayers, and agreed bilaterally or multilaterally. Analysis of the experience suggests that there may be some freedom of manoeuvre even within current rules. First, a simplified method could be designed on an opt-out basis, rather than opt-in. Clearly, in either case much depends on the acceptability to the taxpayer of the specified allocation of income, compared to the alternative. An opt-out procedure seems more effective, as the taxpayer should bear the burden of proving that the safe harbour profit allocation is unfair or unreasonable. To be sufficiently dissuasive, this burden of proof can be set high.

It is easier to design a rigorous safe harbour if the local entity's related parties are not resident in a treaty partner state. Where this is not the case, the TPGs state that the country must allow the taxpayer access to the MAP to resolve any conflicts, or that the safe harbour should be bilaterally agreed. It seems important that OECD countries should not abuse their dominant positions by demanding bilateral safe harbours that unduly advantage residence taxation. It would also be good practice to publish such bilateral safe harbours so that domestic business and wider public opinion can monitor them.

The two alternative approaches to simplification briefly outlined in section 2.3 demonstrate that there are also other possibilities. These methods essentially establish a benchmark effective tax rate, either as a minimum tax (based e.g. on turnover), or a profit margin set as a proportion of the TNC's global rate of profit (or loss). Used alone, they would have the disadvantage that the rate would have to be set at an acceptable level, in order not to have

an appreciable negative effect on inward investment. However, the Dominican Republic example suggests that perhaps such a benchmark tax rate could be used as a backstop or incentive for a safe harbour, or sectoral APA. Under such an approach, a taxpayer which considers the benchmark unsuitable would be required to apply for an APA in terms which comply with the methods specified in the safe harbour or sectoral APA. These methods could be based on those accepted in the TPGs.

Much depends, however, on the freedom of manoeuvre available to the country concerned. In formal legal terms, as discussed in section 1.3, simplified approaches can be said to be compatible with Article 9 of tax treaties, and even more so with Article 7 (attribution of profits to PEs). This argument is even more valid for developing countries, which are not members of the OECD. However, it is more difficult to make if they have adopted transfer pricing regulations based on the TPGs, and especially if they refer to the TPGs as an aid to interpretation of treaties, as some regulations have. On the other hand, since most developing countries have relatively few tax treaties, there may not be an applicable treaty (as was the case for the Dominican Republic hotel sector).

Aside from this formal legal position, it seems time for the OECD to give further consideration to the issue of safe harbours, and to simplified methods more generally. Two immediate opportunities present themselves for such a reconsideration, at this time of writing. One is the joint review with Brazil of its transfer pricing methods, due to complete by May 2019. The other is the scoping exercise, begun in May 2018, for a new project to revise chapter IV of the TPGs, on administrative approaches to avoiding and resolving transfer pricing disputes. Both these exercises will be a test for the validity of the OECD's claim to be the de facto international tax organisation, despite continued pressure for the creation of one that is UN-based. The UN tax committee can also demonstrate its independence and ability to respond to the needs of developing countries by reviewing its manual on transfer pricing to include alternative methods more suitable for poorer countries.

Appendix

African transfer pricing legislation

Country	Power to adjust	Transfer pricing regulations	Comments
Algeria	Loi des Finances Complementaires 2010 s.4, amending CIDTA v2018, www.mfdgi.gov.dz/images/pdf/codes_fiscaux/code_impots_Directs_taxes_Assimilees_LF2018.pdf 141 bis	2012 reporting	French model extended to all enterprises 2018
Angola	Estatuto dos Grandes Contribuintes, Decreto 147/13, Art. 10, 2013, www.ucm.minfin.gov.ao/cs/groups/public/documents/document/zmlu/mduy/~edisp/minfin052581.pdf Código de Imposto Industrial 2014, Art. 50 (p.19), www.ucm.minfin.gov.ao/cs/groups/public/documents/document/zmlu/mduy/~edisp/minfin052578.pdf		Similar to Mozambique
Benin	CGI (Code Général des Impôts) 2018, Art. 37, www.impots.finances.gouv.bj/code-general-des-impots/		French model
Botswana	Income Tax Act Art. 36 (ALP), www.burs.org.bw/index.php/treaties-and-legislation/legislation/revenue-laws		Regs. under consideration 2017
Burkina Faso	CGI Art. 66		French model
Burundi	CGI Art. 79, https://obr.bi/index.php/lois-et-reglements		French model
Cabo Verde	Código do Imposto sobre o Rendimento das Pessoas Colectivas 2014 Art. 65, www.parlamento.cv/userfiles/image/HIPERLINK/IRPC.pdf		Specifies CUP/Cost+/Resale- + PSM, TNMM
Cameroon	General Tax Code Art. 19, www.impots.cm/index.php?page=textes-reglementaires&hl=fr_FR		French model
Central African Republic	CGI version 2017, Art. 131, www.finances-budget.cf/documents/337-rca-2017-06-code-general-des-impots-2017-pdf/file		French model
Chad	CGI v. 2016 Art. 41, http://finances.gouv.td/index.php/publications/codes-lois-textes/codes?view=simplefilemanager&id=88CGI		French model
Comoros	CGI v. 2011 Art. 31, www.finances.gouv.km/v1/index.php/publications/reglementation-legislation/textes-nationaux		French model
Congo, Rep. of	CGI v. 2011 Art. 34 > CGI 2012 Art. 120, http://impots-gouv.cg/documentation/codegeneral		French model
Côte d'Ivoire	CGI Art. 38, enacted 2008-381, www.dgi.cgici.com/indexs.htm		French model
Democratic Republic of Congo	Law 91 2005, Art. 31 bis, www.droitcongolais.info/files/les_impots_en_rdc.pdf		Enacted 1970
Djibouti	CGI v.2009 Art. 54, www.ministere-finances.dj/publication_text.htm		French model

Egypt	Income Tax Law 2005 Art. 30, www.mof.gov.eg/MOFGallerySource/english/IncomeTaxLaw.pdf	Regulations in Decree 991 2005, Arts. 38-39, www.mof.gov.eg/MOFGallerySource/english/ERsIncomeTax.pdf	Regs. specify CUP/Cost+/Resale- and refer to OECD methods; amended May 2018 (https://drive.google.com/file/d/1zhURzxLI_ekJ6MBfNNv2Krd8drFrTRuU/view – in Arabic) to include TNMM and profit split: https://tax.thomsonreuters.com/blog/egypt-enhances-transfer-pricing-rules/
Equatorial Guinea			
Eritrea			
Ethiopia	Proclamation 286/2002 Income Tax Law, Art. 29, www.erca.gov.et/index.php/proclamation/39-income-tax		ERCA website, www.erca.gov.et/
Gabon	Loi de Finances 2015 added Art. 11 aliéna 2, www.dgi.ga/7-documentation/13-loi-de-finances/1112-lois-des-finances-/		French model
Gambia	Income & Sales Tax Act 2004, s.77, www.wipo.int/wipolex/en/text.jsp?file_id=238435#LinkTarget_4698		Wide power, refers to ALP
Ghana	Income Tax Act 2015, Art. 31, http://gra.gov.gh/index.php/legal-documents/	LI 2188, 2012	Replaced Internal Rev. A. 2000, s.70, http://www.gra.gov.gh/docs/info/irs_act.pdf Income splitting provision retained Annual Return Form, www.gra.gov.gh/docs/forms/trips/direct/DT_22a_22b_transfer_pricing_form.pdf Amos 2013
Guinea	CGI v. 2015 Art. 117, www.dni.gov.gn/index.php/2012-12-14-02-12-59/codes		French model
Guinea Bissau			DGCI http://dgci.gw/
Kenya	Income Tax Act 18(3), http://kenyalaw.org/lex/actview.xql?actid=CAP.%20470	TP Rules 2006	
Lesotho			Income Tax Act 1993, updated to 2012, www.lra.org.ls/sites/default/files/2017-05/Income%20Tax%20Act%201993%20%20Updated%20up%20to%201%20April%202012.pdf
Liberia	Revenue Code 2000, s.211 [retained in 2011 consolidated version], www.lra.gov.lr/Official_Files/revenue_code/LRCamended2011.pdf	Regulations 2016	2017 APA provisions 2009 refer to OECD TPGs, www.lra.gov.lr/Official_Files/administrative_r

			egulations/transfer_pricing_practice_note.pdf
Libya			
Madagascar	CGI 2015 Art. 01.01.13, of Law 2013-12, www.sim.mg/images/documents/textes_lois/fiscalite/CGI_2015.pdf	Decision 04-2014	Law requires <i>principe de pleine concurrence</i> , regs. specify OECD methods
Malawi	Taxation Act 2006 s.127, www.mra.mw/assets/upload/downloads/Taxation_Act.pdf Transfers to defraud, and artificial transactions; 127A added 2009?, revised 2017 (ALP), www.mra.mw/assets/upload/downloads/Customs_VAT_and_Taxation_Amendments_2017.pdf	Regulations 2009 Regulations 2017, www.mra.mw/assets/upload/downloads/Gazette_Notice_No_36_of_2017.pdf	See <i>Eastern Produce</i> case 2018
Mali	CGI Art. 81 (rearranged 2016), www.dgi.gouv.ml/CGI/		French model documentation requirements incl. CbCR introduced into LPF 57 in 2016
Mauritania	CGI Art. 10E, www.impots.gov.mr/fr/Documentation_CGI		French model
Mauritius	Income Tax Act Art. 75 (ALP), www.mra.mu/index.php/legislations		Seem to be no TP regs.
Morocco	CGI 2018 Art. 213 II, https://portail.tax.gov.ma/wps/wcm/connect/30b7372b-68d0-462f-b40b-bd5c9f642a26/CGI_2018_FR.pdf?MOD=AJPERES&CACHEID=30b7372b-68d0-462f-b40b-bd5c9f642a26 Introduced by CGI 2006 Art. 213(7), http://cgem.ma/upload/790547307.pdf		APA provision 2017
Mozambique	Lei n.º 34/2007, www.at.gov.mz/por/Media/Files/Lei-n1-34-2007-de-31-de-dezembro Código do Imposto sobre o Rendimento das Pessoas Colectivas, Art. 49 (ALP)	Decreto nº 70/2017, de 6 de Dezembro	Text in LegisPalop, registration needed
Namibia	Income Tax Act s.95, more specific 95A inserted 2005, https://laws.parliament.na/cms_documents/income-tax-69ded2e914.pdf	Practice Note 2/2006 (see WB Handbook 2016)	ALP. Also power to limit interest deduction 95A(3)
Niger	CGI 2014 s.33, www.impots.gouv.ne/reglementation/code-general-des-impots-a-jour		Amended in Loi des Finance 2014, JO p. 736
Nigeria	Companies Income Tax Act s.22, esp. (2)(b) ALP, https://lawsfnigeria.placng.org/laws/C21.pdf	Transfer Pricing Regulations, www.firs.gov.ng/transfer_pricing.html	
Rwanda	Income Tax Act 2018 s.33 (enacted 2005), www.rra.gov.rw/index.php?id=30	Ministerial Order 2007, www.rra.gov.rw/typo3conf/ext/complete/Resources/Public/download/pdf/Ministerial_Order_No_004-07_Of_09.05.2007_Governing_the_Implementation_of_the_Law_No_16-2005_of_18.08.2005_on_Direct_Taxes_on_Income.pdf	ALP

Sahrawi Republic			
São Tomé and Príncipe	Código do Imposto sobre o Rendimento das Pessoas Colectivas, 2009 Art. 68, https://impostos.financas.gov.st/index.php/legislacao/leg-tributaria		Similar to Mozambique
Senegal	CGI 2013 Art. 17, www.impotsetdomaines.gouv.sn/fr/le-nouveau-cgi2013	Loi n° 2018-10 du 30 mars 2018, www.sec.gouv.sn/lois-et-reglements/lois-et-d%C3%A9crets	French model, see Ba 2011
Seychelles	Business Tax Act 2009 s.54 ALP, www.src.gov.sc/pages/resources/BusinessTaxAct.aspx	Public Ruling 2015-3, www.src.gov.sc/pages/pressreleases/2015/TransferPricing.aspx	General power for Commissioner General to distribute gains/expenses, guided by international standards
Sierra Leone	Income Tax Act s.95 (revised 2013), www.nra.gov.sl/import-and-export/laws-and-regulations		ALP
Somalia			
South Africa	Income Tax Act s.31, www.gov.za/documents/income-tax-act-29-may-1962-0000 as amended in 1995, www.gov.za/sites/default/files/Act21of1995.pdf	Practice Note 7, 1999, www.sars.gov.za/AllDocs/LegalDoclib/Notes/LAPD-IntR-PrN-2012-11%20-%20Income%20Tax%20Practice%20Note%20of%201999.pdf	
South Sudan			
Sudan			
Swaziland	Income Tax Order revised 2013 s.65, www.sra.org.sz/legalandpolicy/tax-legislations.php		ALP
Togo	CGI 2016 Art. 112, www.otr.tg/index.php/fr/documentation/sur-les-impots/54-code-generale-des-impots.html Revised Loi des Finances 2017-14, www.otr.tg/index.php/fr/documentation/sur-les-impots/76-loi-n-2017-014-portant-loi-de-finances-gestion-2018/file.html		<i>Principe de pleine concurrence</i> ; see Adoki 2017
Tunisia	Code de l'Impot sur le Revenu Art. 48 septies (added 2009), www.legislation.tn/sites/default/files/codes/IRPP.pdf		
Uganda	Income Tax Act Laws 2000 s.90, www.ura.go.ug/Resources/webuploads/INLB/DT%20Laws%202014.pdf	Regulations 2011, www.drtp.ca/wp-content/uploads/2015/02/Uganda-Transfer-Pricing-Regulations-2011.pdf	Regs. also cover APAs
United Republic of Tanzania	Income Tax Act rev. 2008 s.33 (ALP); 34 (income splitting), 35 General Anti-Avoidance Rule (GAAR), www.tra.go.tz/tax%20laws/Income%20Tax%20Act%20Revised%20Edition%202008.pdf	Income Tax (Transfer Pricing) Regulations 2014, www.tra.go.tz/tax%20laws/Income%20Tax-	ALP

		Transfer%20Pricing%20Regulation.pdf	
Zambia	Income Tax Act s.97A inserted 1999 (ALP), http://zambialaws.com/principal-legislation/chapter-323income-tax-act	Regulations 2018	Income Tax Act 1997, www.parliament.gov.zm/sites/default/files/documents/acts/Income%20Tax%20Act.pdf ZRA presentation 2016, www.un.org/esa/ffd/wp-content/uploads/2016/11/2106TP_Zambia_CountryPresentation-en.pdf
Zimbabwe	Income Tax Act s.24 (ALP), www.zimra.co.zw/index.php?option=com_phocadownload&view=category&id=23:legislation&Itemid=112	Income Tax Act s.98B and Schedule 35 (added 2016)	No text of 2016 regs. available; see report www.maweresibanda.co.zw/transfer-pricing-in-zimbabwe-the-basics/

Note: these links were all accessed at various times during 2018.

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