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***Transfer Pricing in the 21st Century:
A Proposal for both Developed and Developing Countries***

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Abstract

The conventional wisdom maintains that the emergence of the International Tax Regime since the 1920's is a miracle. This is so, the argument goes, because taxes are the last topic on which a Hobbesian observer would have predicted sovereign nations to reach a consensus given the zero-sum nature of the game: one's country gain in revenue is another's loss. Conversely, this Article predicates that the International Tax Regime is not a miracle, but rather an intelligible (sometimes failed) attempt to solve problems in the strategic interaction among nations in the allocation of international tax bases.

The purpose of this Article is three-fold. First, it elaborates a hypothesis of the pattern of evolution of international tax law since 1913 onwards using game theory as the theoretical framework. Second, it focuses on a structural element of the International Tax Regime which has failed to solve the strategic problem of apportionment of cross-border business income: the arm's length standard. It shows, using the rule/standard distinction as the theoretical framework, why the arm's length standard has been unsuccessful in both the developed and developing worlds in solving the said apportionment problem (normally named the Transfer Pricing Problem). Finally, the Article suggests how the arm's length standard should evolve for increasing the likelihood of solving the Transfer Pricing Problem in both developed and developing countries. The proposal has been written in such a way as to facilitate its addition to Article 9 of the OECD or UN Model Tax Conventions on Income and on Capital.

¹ Professor of Law and director of the Law and Economics Program, Universidad Torcuato Di Tella, Buenos Aires. I have benefited tremendously from comments on previous drafts of this Article by Reuven Avi-Yonah, Richard Bird, David Duff, Emiliano Marambio Catán, Leandro Arozamena, Thomas Ulen, participants of the University of Toronto Law School Tax Policy Workshop, and Universidad Torcuato Di Tella Seminar on Tax Policy. All errors are my own responsibility.

The world has experienced two globalization booms and one bust over the past two centuries. The first boom started about 1820, lasting until the start of World War I. The second boom began at the end of World War II, and the years in between were ones of antiglobalization backlash.²

One major consequence of those globalization booms was the emergence in the late 19th century of a novel strategic problem among nations: how international tax bases should be allocated given the lack of a higher authority³. Since the inter-war period, developed countries reached a fundamental consensus on how to solve this problem.⁴ That consensus is currently embodied in the OECD Model Tax Convention on Income and on Capital (OECD model), which is the foundation of a network of bilateral tax treaties called the international tax regime.⁵

² Jeffrey G. Williamson, *Winners and Losers over Two Centuries of Globalization*, National Bureau of Economic Research, Working Paper 9161 (1992) available at <http://post.economics.harvard.edu/faculty/jwilliam/papers/w9161.pdf> (last visited December 14, 2003).

³An early example of this strategic problem is the following. The U.S. and the U.K. international tax regimes were in conflict during the inter-war period. U.K. multinational enterprises faced a comparative disadvantage vis-à-vis U.S. MNEs in the beef industry due to that conflict. The U.S.-based Chicago Beef Trust (U.S. Trust) and the U.K.-based Vestey Group (U.K. Group) were major competitors in the beef market. The U.S. Trust was able to minimize its global tax liability by implementing the tax-planning strategy of establishing a subsidiary in Argentina to defer U.S. taxation until repatriation of income and consigning its Buenos Aires shipping Free on Board to independent U.K. importers, so its sales were not considered to take place in the United Kingdom, thus avoiding U.K. taxation. The U.K. Group was unable to implement similar international tax planning. In effect the U.K. Group could not minimize U.K. taxation given that, at that time, the United Kingdom taxed the profits of business carried out abroad, whether through a branch or a foreign subsidiary, on a current basis. That is, U.K. foreign-source income could be directly liable to U.K. income tax even if not repatriated. That situation led Lord Vestey, the controlling shareholder of the Vestey Group, to request that the House of Lords modify the U.K. international tax regulation to make it consistent with that of the United States. *See* Sol Piccioto, "International Business Taxation. A Study in the Internationalization of Business Regulation" at 15-17, *Law in Context*, Weidenfeld and Nicolson, 1992. The literature of international taxation and game theory produced by international lawyers is small. The seminal papers in this area are the following: Charles Kingson, "The Coherence of International Taxation," 81 *Columbia Law Review* 1151 (arguing that tax systems do interact and the implications of this; he maintains that the main players of the international tax game are countries and that countries compete for revenues, investments, markets, and jobs); Tsilly Dagan, "National Interests in the International Tax Game," 18 *Virginia Tax Review* 363 (1998) (arguing that countries play as self-interested players in the international tax game; footnote 40 of Dagan's paper maintains that the international tax game is a repeated game played infinitely).

⁴This consensus was suggested in the seminal *Report on Double Taxation*, League of Nations Doc. E.F.S. 73 F. 19 (1923).

⁵The literature on international taxation is immense and can only be highlighted here. Excellent recent surveys of the entire international tax regime area follows. Yariv Brauner, "An International Tax Regime in Crystallisation — realities, experiences and opportunities," 56 *Tax Law Review* 259 (2003). Brauner outlines a general conceptual framework for achieving a world tax regime via a multilateral tax treaty that might be implemented in stages. The effect of the current globalization boom on developing countries' international taxation is focused on in Ian Roxan, *Limits to globalisation — Some implications for taxation in the developing world* (2003). This unpublished paper does not share the negative view of the effects of globalization on taxation in the developing world. Brian J. Arnold, Jacques Sasseville, and Eric Zolt, "Summary of the Proceedings of an Invitational Seminar on Tax Treaties in the 21st Century," *Canadian Tax Journal*, Volume 50, Issue No. 1, 2002. "Symposium: Summary of the Proceedings of an Invitational Seminar on the Taxation of Business Profits Under Tax Treaties," *Canadian Tax Journal*, Volume 56, No. 6, 2002.

The OECD model is largely based on a web of standards (rather than rules) whose precise meaning is determined *ex post* on a case-by case basis.⁶ In effect, key norms of the OECD model do not have precise meaning before the taxpayer acts (rules); rather, their precise meaning is provided after the taxpayer acts (standards) via adjudication.⁷ The central role of the OECD model web of standards is to enforce some structural fictions.⁸

The international taxation of multinational enterprises (MNEs) is a case in point. In 1933 developed countries created the fiction of the separate entity approach according to which the different units of a given MNE should be deemed independent enterprises.⁹ Developed countries also agreed that the separate entity approach should be enforced via the arm's-

Michael Graetz, "Taxing international income: inadequate principles, outdated concepts, and unsatisfactory policies," 54 *Tax Law Review*, 2001, which argues that the current international income tax regime lacks a satisfactory normative basis. Richard Vann, *International Aspects of Income Tax, Tax Law Design and Drafting*, Volume 2, International Monetary Fund, 1998. Reuven S. Avi-Yonah, "The Structure of International Taxation: a proposal for simplification," 74 *Texas Law Review* 1301 (1996), which, as its title indicates, identifies the structure of international taxation and its normative underpinnings. Sol Piccioto, *International Business Taxation, A study in the internationalisation of business regulation* (1992), which is an historical account of the evolution of corporate income taxation. Adrian Ogle, *The Principles of International Tax: a multinational perspective* (1993), which provides a brief and illuminating general overview. The 1945 U.K.-U.S. double taxation convention (DTC) is among the first DTC concluded by developed countries. See Philip Baker, *Double Taxation Conventions. A manual on the OECD Model Tax Convention of Income and on Capital*, Table of Treaties, Conventions and Agreements, Sweet and Maxwell Tax Library, October 2003.

⁶ Ronald Dworkin seems to have been the first author to distinguish between rules and standards. Dworkin made this distinction in the context of his critique of the H.L.A. Hart's book *The Concept of Law*. See Ronald Dworkin, *Taking Rights Seriously*, Chapter 2, Harvard University Press, 1978. On the difference between rules and standards from a legal and economic perspective, see the following materials: Kaplow Louis, "Rules versus Standards: An Economic Analysis," *Duke Law Journal*, Vol 42:557 (1992); Kaplow, Louis, "The Value of Accuracy in Adjudication: An Economic Analysis," 23 *Journal of Legal Studies* 307, 1994; Posner, Richard, *Economic Analysis of Law*, Sixth Edition, Aspen Publishers, 555-561, 2003; Schafer, Hans-Bernd, *Precise Legal Norms as Substitutes for Human Capital in Low-Income Countries*, Universitat Hamburg, Institut für Recht und Ökonomik.

⁷ Two examples of standard-based norms in the international tax regime are the following: "associated enterprises" codified in article 9 of the OECD model (to be explored below) and "beneficial ownership" (codified in articles 10, 11, and 12 of the OECD model). Those concepts are standard-based norms because their precise meaning can only be determined *ex post*, via adjudication. The OECD model is largely based on a web of standards rather than rules because it implicitly assumes that a decentralized network of national legal systems with relatively high human capital endowments, such as those typical in developed countries, is responsible for its case-by-case enforcement. Unfortunately, developing countries typically have relatively low human capital endowments in their legal systems. That implies, *inter alia*, that developing countries face severe difficulties in enforcing standards (rather than rules). It has been argued that the optimal legal system for a developing country is rule-based, rather than standard-based. See Schafer, Hans-Bernd, *Precise Legal Norms as Substitute for Human Capital in Low-Income Countries*, Universitat Hamburg, Institut für Recht und Ökonomik. An open question, to be explored below, is to what extent central standard-based norms of the ITR can be transformed into rule-based norms to facilitate their enforcement by the developing world.

⁸ Fiction normally refers to a nonrebuttable presumption. See F.H.M. Grapperhaus, *The Trade-off Between Accuracy and Administrability, Presumptive Income Taxation*, proceedings of a seminar held in New Delhi in 1997 during the 51st Congress of the International Fiscal Association, Vol. 22d. Chair Reuven Avi-Yonah, Kluwer Law International, The Hague-London-Boston.

⁹ Carroll, Mitchell B., *Taxation of Foreign and National Enterprises* (Volume IV), *Methods of Allocating Taxable Income* by Mitchell B. Carroll, League of Nations, Geneva, 1933, at 47, hereinafter the Carroll Report.

length standard.¹⁰ The arm's-length standard predicates that tax jurisdiction over international income produced by associated enterprises is allocated among countries on the basis of how comparable nonassociated enterprises would allocate their income in comparable scenarios. If the arm's-length standard is not met in a given case, tax authorities are granted the power to adjust the transfer pricing of associated enterprises to make it consistent with the arm's-length standard.

The concept of associated enterprises, a structural element of the arm's-length standard, is standard-based because its meaning is uncertain *ex ante*.¹¹ Prominent tax academics and practitioners have devoted considerable energy to determining the precise meaning of associated enterprises.¹² Predictably, that effort has been futile due to the lack of case law with public good features in this area.¹³ In sum, the precise meaning of the arm's-length standard, as with all standards, can only be provided by case law (or by something functionally equivalent to case law).

For certain strategic reasons, developing countries of all legal traditions have been massively importing the international tax regime, as envisaged by the OECD model, since

¹⁰ See *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration* (OECD guidelines), paragraph 6 *in fine* of the preface.

¹¹ The concept of associated enterprise is codified by article 9 of the OECD model. Article 9 states the following:

Associated Enterprises

1. Where

- a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
- b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case 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.

2. Where a Contracting State includes in the profits of an enterprise of that State — and taxes accordingly — profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other.

¹² See, e.g., *Article 9 OECD Model Convention: What is an Associated Enterprise?* 57th Congress of the International Fiscal Association, Sydney, Australia, September 2003, Seminar G. It is available at <http://www.ifa.nl>.

¹³ Case law is a public good (rather than a private good) if it allows a representative person to predict the probable outcome of a future court's decision. See W. Landes and R. Posner, "Legal Precedent: A Theoretical and Empirical Analysis," 19 *Journal of Law and Economics* (1976).

the early 1960s.¹⁴ That massive importation of the international tax regime has been problematic in areas like enforcement, as the experience of Argentina shows in the transfer pricing arena. That is due to many factors. Developing countries' case law has less relevance in predicting courts' decisions than is usually the case in the developed world. Weak rule of law and political instability are the main reasons for this.¹⁵ For example, the members of the Argentine Supreme Court have been removed *en masse* eight times between 1946 and 2004, leading to sudden changes in the Argentine transfer pricing case law.¹⁶ Hence, the lack of relatively stable case law implies that the precise meaning of the international tax regime's standard-based norms, such as the arm's-length approach, remains largely uncertain in the developing world.¹⁷

Since the late 1970s, developed countries have also faced severe problems with the enforcement of the arm's-length standard. This is because the emergence of confidential advance pricing agreements (APAs) has made litigation a rare element in transfer pricing.¹⁸

¹⁴ The massive importation of the international tax regime (ITR) by developing countries of all legal traditions has few parallels in history. The ITR has even been imported by developing countries from the Islamic world (*see, e.g.*, the Austria-Iran DTC concluded on March 11, 2002), and the communist world (*see, e.g.*, the Austria-Cuba DTC concluded on June 26, 2003). Iraq and the Democratic People's Republic of Korea are among the few countries that remain outside the tax treaty network. Dagan challenges the common conviction that only tax treaties can prevent double taxation and argues that developing countries pay a high and perhaps unnecessary price in tax revenues when they join the tax treaty network. *See* Tsilly Dagan, "The Tax Treaties Myth," 32 *N.Y.U. J. Int'l L. & Pol.* 939 (2000), also available at <http://www.nyu.edu/pubs/jilp/main/issues/32/pdf/32q.pdf> (last visited Aug. 14, 2003).

¹⁵ Another reason is that many developing countries, such as those in Latin America, follow the French civil law tradition in which case law plays a minor role as a source of law.

¹⁶ William C. Banks and Alejandro Carrió, "Presidential Systems in Stress: Emergency Powers in Argentina and the United States," *Michigan Journal of International Law*, Vol. 15.1, Fall 1993, 1-43 at 25.

¹⁷ This scenario increases the cost that a representative taxpayer has to face to know how he is expected to behave in the transfer pricing area. This increased cost includes the legal advice the taxpayer is induced to seek to determine the content of the arm's-length standard.

¹⁸ Diane M. Ring describes the APA system as follows: "In a bold move in the early 1990s, the United States led its trading partners toward a new model of advance dispute resolution for transfer pricing, the APA program, which relies on a backbone of familiar mechanism complemented by some novel features. The APA process is an alternative to the standard taxpayer path of doing the transactions, filing a return, facing audit (some level of audit is more likely with larger taxpayers), and, finally, possible appeal with settlement or litigation. The taxpayer initiates the APA process by approaching the Service (and typically the corresponding tax authority in the other relevant jurisdiction) before engaging in the related party transactions potentially at issue. At this point the taxpayer voluntarily provides detailed information to the government regarding its business activities, plans, competitors, market conditions, and prior tax circumstances. The critical piece of this presentation is the taxpayer's explanation of its planned pricing methods. Following discussion and negotiation, the parties hopefully reach agreement on how the taxpayer should handle the pricing of these anticipated related transactions. This understanding is embodied in the [confidential] APA agreement which typically runs for three years." Diane M. Ring, "On the Frontier of Procedural Innovation: Advance Pricing Agreements and the Struggle to Allocate Income for Cross Border Taxation," 21 *Michigan Journal of International Law*, 2000. In this article, Ring makes a comprehensive description and evaluation of the U.S. APA procedure using, *inter alia*, public choice as a theoretical framework. The U.S. APA model has been followed by many countries including Australia, Belgium, Canada, Germany, Japan, the Netherlands, and Spain. For a global analysis of the APA process, *see* Jose Manuel Calderon, *Advance Pricing Agreements. A Global Analysis*, Kluwer Law International, 1998.

Moreover, the limited available case law is not a public good; the holdings are typically too fact-specific to allow a representative taxpayer to predict the probable outcome of a future court's decisions—especially when no comparables are available.¹⁹ In sum, for a number of reasons, both the developed and developing worlds are facing the same problem; the meaning of the arm's-length standard is largely uncertain because of the absence of case law with public good features in this area. Therefore, the arm's-length standard is unable to provide taxpayers with a clear sense of how they are expected to behave in the legal system in which they operate. This scenario explains the worldwide arm's-length standard crisis.²⁰

As an unfortunate product of the arm's-length standard crisis, a wave of massive transfer pricing litigation has emerged in both the developed and developing worlds since the beginning of the 21st century. For example, GlaxoSmithKline, a British pharmaceutical giant, filed suit against the U.S. Internal Revenue Service early in 2004. With US \$5 billion at stake, the largest transfer pricing litigation in world history began.²¹ The outcome of that

¹⁹ Reuven Avi-Yonah argues that the evolution of the U.S. transfer pricing case law can be summarized as follows. “The development of the case law under [IRC] Section 482 can generally be divided into three periods. The first period, from the earliest cases in the 1930s until about 1962, was characterized by a wide variety of interpretations of the statute, as the courts attempted to define the limits of the Commissioner's authority under the very broad language of Section 482 and its predecessors. The salient characteristic of this period was the very gradual acceptance by the courts that the arm's length standard, which was first included in the regulations promulgated in 1935, was the proper method of determining what constituted a ‘clear reflection of income’ of the related parties under the statutory language. The second period, from about 1962 until about 1972, was characterized by the dominance of the arm's length standard, as interpreted in the 1968 Section 482 regulations, and of the three methods for defining comparables defined under those regulations (that is, the comparable uncontrolled price, cost plus, and resale price methods). The third period, which lasted from approximately 1972 until the issuance of the temporary regulations in 1993, was characterized by the increasing difficulties encountered by the courts in finding comparables under the 1968 regulations, and by their increasing reliance on ‘fourth methods’ incorporating some type of profit split or similar methods.” Avi-Yonah summarizes the increasing problem of identifying comparables in U.S. case law as follows: “The problem of finding comparables can be seen if one examines the major international cases under [IRC] Section 482. If one takes only the cases surveyed in the White Paper (1988), plus the major cases decided since 1988, one finds that up to 1973, the arm's length standard based on comparable transactions was employed in nine out of 14 cases (64%) cited in the White Paper. From 1974 onward, comparables were found only in four of 16 major cases Section 482 cases (25%); in all of these four cases (Eli Lilly, Paccar, U.S. Steel and Bausch & Lomb) the Service argued that the comparable was inappropriate, and with respect to U.S. Steel and Bausch & Lomb, attempted to reverse the result in the final regulation.” See Reuven Avi-Yonah, *Analysis of Judicial Decisions Interpreting Section 482*, Tax Management, Foreign Income Portfolios, *Transfer Pricing: Judicial Strategy and Outcomes*, July 2003, emphasis added, pages A-101 and A-109, respectively. Footnotes omitted.

²⁰ The worldwide crisis of the arm's-length standard has been the focus of many papers. A prominent example of those papers is Walter Hellerstein, *Income Allocation in the 21st Century: The Case for Formulary Apportionment*. As the title of that unpublished paper denotes, it suggests that: “If our tax rules are to reflect the underlying economic reality to which they apply, the arm's-length's-separate-geographic accounting standard will ultimately yield to formulary apportionment as the preferred method of income allocation in the twenty-first century.” (Walter Hellerstein, at 19).

²¹ Martin Sullivan, “With Billions at Stake, Glaxo Puts U.S. APA Program on Trial,” *Tax Notes Int'l*, May 3, 2004, p. 456. Transfer pricing litigation is unfortunate in the following sense: because courts are normally unable to produce case law with public good features in this area, transfer pricing litigation does not normally illuminate the meaning of the arm's-length standard.

case is unpredictable because, for the reasons stated above, the precise meaning of the arm's-length standard is unknown.

The purpose of this article is twofold. First, it seeks to provide an analysis of the problem faced by the arm's-length standard when the legal system in which it operates is unable to produce case law capable of providing a precise meaning to the arm's-length standard (the problem). The U.S. and Argentine experiences in transfer pricing are focused on as case studies for identifying normative lessons. The second purpose of this article is to suggest a procedural method for inducing a legal system — be it from the developed or developing world — to produce a proxy of case law in transfer pricing to provide a precise meaning to the arm's-length standard (the proposal). The proposal is the product of six normative lessons that have been inferred from the U.S. and Argentine experiences in the enforcement of the arm's-length standard. The proposal has been written to facilitate its addition to article 9 of the OECD model or the U.N. Model Tax Conventions on Income and on Capital.

Prominent tax academics and practitioners have pointed out the structural problem of the arm's-length standard, but unfortunately, they have not suggested how to solve it. Conversely, this article offers a structural solution to the arm's-length standard problem. For the reasons stated below, the proposal can be instrumental in solving the current major transfer pricing enforcement problems, such as those that emerge when no comparables are available or when developing countries' political instability destroys the public good feature of case law. Moreover, as is demonstrated below, the proposal can deter the emergence of avoidable transfer pricing litigation, such as the GlaxoSmithKline case.

This article is divided into three chapters. Chapter I identifies six central normative lessons of the U.S. and Argentine experiences in transfer pricing that are relevant for both the developed and developing worlds. Chapter II offers a procedural method for inducing a legal system — be it from the developed or developing world — to produce a proxy of case law in transfer pricing capable of providing a precise meaning for the arm's-length standard. The conclusion is offered in chapter III.

I-Normative Lessons of the Argentine and U.S. Experiences in Transfer Pricing

This chapter identifies six central normative lessons of the U.S. and Argentine experiences in transfer pricing. Those lessons, which have been inferred from two recent articles, are the following.²²

²² These articles are the following: Reuven S. Avi-Yonah — “The Rise and Fall of the Arm's Length: A Study in the Evolution of U.S. International Taxation,” University of Virginia School of Law, *Virginia Tax Review*, Summer 1995, and 15 *Va. Tax Rev.* 89. Eduardo Baistrocchi, “The Transfer Pricing Problem: The Argentine Experience (1932-1998),” *Revista Argentina de Teoria Juridica*, Volume 2, Number 1, November 2000. It is available at <http://www.utdt.edu/departamentos/derecho/publicaciones/rtj1/df/baistrocchi.pdf>.

(1) One recurring question on how legal commands should be formulated in a legal system involves whether commands should take the form of rules or standards. The policy option that is central to this question is if the content of the law should be determined and announced in advance in a rule or left to an adjudicator in a standard. This distinction is relevant in transfer pricing because the arm's-length approach is a standard; its precise meaning can only be determined via adjudication. Thus, the arm's-length standard is unworkable unless the legal system in which it operates is prepared to produce case law (or something functionally equivalent to case law) to show taxpayers how they are expected to behave.

(2) The arm's-length standard faces a fatal problem when the legal system in which it works is unable to produce case law capable of guiding taxpayers on how they are expected to behave in transfer pricing (the problem). The problem is common to both developed and developing countries. On the one hand, developed countries face the problem because, for many reasons, case law is an infrequent element. Moreover, the limited case law available is not a public good; the holdings typically are too fact-specific to allow for predicting the probable outcome of future court decisions. This scenario makes the meaning of the arm's-length standard difficult to determine — especially when no comparables are available. On the other hand, developing countries also face the problem, but for an additional reason — their weak rule of law and political instability produce frequent violations of *stare decisis*, making case law a negligible source for predicting court decisions. In sum, the meaning of the arm's-length standard is largely unknown throughout the world.

(3) Because the meaning of the arm's-length standard is largely unknown, an average taxpayer typically faces nonoptimal costs to learn how he or she is expected to behave in the area of transfer pricing. An example of a nonoptimal cost can be found in the *Glaxo* case. That is so because, for the reasons stated below, the precise meaning of the arm's-length standard in *Glaxo* could have been identified in a more efficient way than litigation.²³

(4) Each time the transfer pricing problem was high on the Argentine agenda, the Congress or the Supreme Court implicitly transformed the arm's-length standard into a set of rule-based norms. This implicit transformation was probably geared toward minimizing the enforcement cost of the arm's-length approach.

(5) In a politically unstable context, rule-based norms have been less volatile than standard-based norms in transfer pricing. That is probably because rule-based norms (especially those that have a procedural feature) tend to be perceived as ideologically neutral by the actors in the political process. For example, a procedural rule-based norm introduced in 1942 into the Argentine income tax system to deter transfer pricing abuses in the import and export of agricultural products lasted 61 years without major changes. The stability of that procedural rule-based norm is remarkable because of the unstable political context in which it operated: Argentina faced five revolutions from 1942 to 2003.²⁴

²³ If the proposal had been effective in the United States, the *Glaxo* Case would probably never have emerged. The reasons for that statement are elaborated in chapter II below.

²⁴ For an excellent book on the history of Argentina, see Luis Alberto Romero and James Brennan, *A*

(6) The legal system of a representative developing country typically faces a low human capital endowment. That implies that legal drafters are not normally well-equipped for drafting workable standards like the arm's-length approach.²⁵ For example, the arm's-length approach was nominally introduced into Argentine income tax law in 1946. However, some of its crucial elements, such as the definition of comparable, were passed 52 years later.²⁶

II. Making the Arm's-Length Standard Workable: A Proposal for Both Developed and Developing Countries

A. The Proposal

This chapter makes a proposal for solving the structural problems faced by the arm's-length standard in both the developed and developing world based on the six normative lessons of the U.S. and Argentine experiences. In the first part of this chapter, the proposal is stated. The proposal has been written to facilitate its addition to article 9 of the OECD model or U.N. Model Tax Conventions on Income and on Capital. In the second part of this chapter, there is a detailed analysis of the rationale and working of each paragraph of the proposal.

The proposal is the following:

Contracting states can implement the arm's-length standard via a system of rule-based presumptions (the principal legal regime). The principal legal regime shall be so that the result shall be in accordance with the principles contained in this article.

A person shall have the option of using the OECD transfer pricing guidelines as a default legal regime enforceable via bilateral or multilateral advance pricing agreements (APAs)

History of Argentina in the Twentieth Century, Penn State University Press.

²⁵ The OECD acknowledges that the arm's-length principle presupposes highly trained personnel who are not available in many countries. The OECD says that "during the 1980s, much of the developed world opposed the use of worldwide unitary combination by some of the American states, and in 1992 the Ruding Committee summarily dismissed global formulary apportionment. It could be argued that, in the interim, globalization has increased the pressure on the use of separate entity and arm's-length principles to the point that many countries (*especially those that lack the highly trained personnel required to implement the current rule*) might be willing to consider an alternative, such as formulary apportionment. It seems clear that, at a minimum, the increased economic integration of Europe has caused the European Commission and some EU Member States to rethink their stand against formulary apportionment within the EU." (Emphasis added.) See paragraph 315 of the OECD report, "Are the current treaty rules for taxing business profits appropriate for e-commerce?" OECD public discussion draft, November 26, 2003, available at <http://www.oecd.org/dataoecd/2/38/20655083.pdf>.

²⁶ See Eduardo Baistrocchi, "The Transfer Pricing Problem: The Argentine Experience (1932-1998)," *op. cit.*

only. The APA procedure shall be governed by article 25. If the person accepts the APA concluded by the competent authorities, the APA will be final and not subject to further administrative or judicial review.

Every APA shall be transformed by the competent authorities into a rule-based presumption (the new norm) without revealing any confidential data. The new norm shall be added to the principal legal regime three years after the APA is concluded. The person is entitled to veto the addition of the new norm to the principal legal regime if he considers that his confidential data has not been properly deleted from the new norm. If he exercises this veto power, he will be unable to request an APA for a period of 10 years from the date the veto was exercised. The new norm shall have retroactive effect to open fiscal years to provide other qualified persons the option of being governed by the new norm.

B. Preliminary Remarks

1. The Proposal's Structure of Incentives

The main goal of the proposal is twofold. First, it seeks to induce the legal systems in which the arm's-length standard operates to produce a proxy of case law in the area of transfer pricing. That proxy of case law is expected to provide the arm's-length standard a precise meaning in the diverse factual scenarios in which it is applied. Second, the proposal seeks to be instrumental in minimizing the enforcement cost of the arm's-length standard in both the developed and developing worlds.

The proposal aims to encourage contracting states and taxpayers to experiment in a procedural framework, the APA, which for the reasons stated below is the best available for solving transfer pricing disputes.²⁷ Moreover, the proposal seeks to encourage the product of this experimentation to be transformed into rule-based norms of the relevant domestic legal system.

Finally, the proposal should create a close link between tax treaty and domestic laws in the transfer pricing arena.²⁸ The close link between treaty law and domestic law seeks to deter the developing countries' current status quo in which only the local elite is able to use the tax treaty network because, *inter alia*, the average taxpayer is unaware of how it works.²⁹ Hence, the close link has been designed to minimize this vertical equality problem, which was the focus of a recent paper.³⁰

2. Definition and Working of Bilateral or Multilateral APA

²⁷ See chapter II.C below.

²⁸ The close link is implemented via the following mechanism. Each APA decision produced by contracting states under treaty law is expected to be incorporated as a new norm into the domestic-law-based principal legal regime.

²⁹ *E.g.*, there is only one comprehensive course on tax treaty law in South America.

³⁰ See Tsilly Dagan, "The Tax Treaties Myth," 32 *N.Y.U. J. Int'l L. & Pol.* 939 (2000), also available at <http://www.nyu.edu/pubs/jilp/main/issues/32/pdf/32q.pdf> (last visited Aug. 14, 2003).

The OECD defines APA as follows: “An advance pricing agreement (‘APA’) is an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparables and appropriate adjustments thereto, and critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time. An APA is formally initiated by a taxpayer and requires negotiations between the taxpayer, one or more associated enterprises, and one or more tax administrations.”³¹

The central difference between bilateral and multilateral APAs is the number of players involved (in addition to the taxpayer) in the transfer pricing dispute. In bilateral APAs, two competent authorities are involved, whereas in multilateral APAs that figure rises to three or more competent authorities.

The APA process is an alternative to the standard taxpayer path of doing the transaction, filing a return, facing an audit (some level of audit is more likely with larger taxpayers), and, finally, a possible appeal with either settlement or litigation. The taxpayer normally initiates the APA process by approaching the tax authority (and typically the corresponding tax authority in the other relevant jurisdiction) before engaging in the related-party transactions potentially at issue. At this point, the taxpayer voluntarily provides detailed information to the governments on its business activities, plans, competitors, market conditions, and prior tax circumstances. The critical piece of this presentation is the taxpayer’s explanation of its planned pricing method. Following discussion and negotiation, the parties hopefully reach an agreement on how the taxpayer should handle the pricing of those anticipated related-party transactions. That understanding is embodied in the APA agreement, which, in the United States, typically lasts for three years.³²

The APA was first designed and applied in the United States in 1991. It was then imported by countries of different legal traditions and development. They include Australia, Canada, Germany, India, Japan, Spain, Mexico, the Netherlands, New Zealand, and the United Kingdom.³³

3. Why Does Bilateral or Multilateral APA Play a Central Role in the Proposal?

³¹ See OECD guidelines, 4.124. By the same token, an APA has been defined by the United States as an agreement between the tax authority and the taxpayer on the transfer pricing method. The APA can be applied to any apportionment or allocation of income, deductions, credits, or allowances between two or more organizations, trades, or businesses owned or controlled (directly or indirectly) by the same interests. See section 1 of the U.S. Rev. Proc. 96-53, IRB CB 96-49, December 2, 1996. Similar definitions of APAs have been established in some other countries, such as Australia (section 10 of the ATO Taxation Ruling 95/23, on APAs) and Canada (sections 3 and 4 Revenue Canada Information Circular Number 94-4). See Jose Manuel Calderon, *Advance Pricing Agreements. A Global Analysis*, Kluwer Law International, 1998.

³² See Diane Ring, “On the frontier of procedural innovation: advance pricing agreements and the struggle to allocate income from cross border taxation,” *Michigan Journal of International Law*, Winter 2000.

³³ See Jose Manuel Calderon, *Advance Pricing Agreements. A Global Analysis*, Kluwer Law International, 1998, *op. cit.* at 9-11. The current features of APA procedures of OECD countries are outlined at the OECD Web site. See http://www.oecd.org/doc-ument/31/0,2340,en_2649_37427_29601439_1_1_1_37427,00.html (last visited July 1, 2004).

The bilateral or multilateral APA procedure is central in the proposal for the following reason. The APA, unlike standard litigation, might create an iterated prisoner's dilemma³⁴ among contracting states that might foster cooperation among them for solving transfer pricing disputes. The reason for that proposition is elaborated in the subsequent paragraphs. Domestic courts have complained about the lack of cooperation of both tax authorities and taxpayers in transfer pricing litigation.³⁵ This is because the parties lack the incentive to provide the courts with all the available information critical for producing transfer pricing case law with public good features. Hence, most current transfer pricing precedents are private goods: they typically are able to solve one case, that in which each precedent is

³⁴ The classic example of the prisoner's dilemma is the following. Two people have been accused of committing a crime and are being questioned in separate rooms. If neither of them confesses, both would receive a minor penalty of, say, two months in prison. If both confess and incriminate each other, they will be condemned to a larger penalty of, say, three months in prison. Finally, if only one of them confesses, incriminating the other, he or she will receive the lightest penalty (one month) and the other person, the largest one (four months). The accused are unable to communicate with each other and they respect no moral principle whatsoever. Each one seeks only to follow the strategy that would benefit him or her the most, no matter what the other player does.

The prisoner's dilemma strategic interaction gives both players incentives not to cooperate with each other, i.e., to confess to the crime and to implicate the other player. This is so because if one player decides to cooperate with the other party by denying that he or she had participated in the crime, he or she will run the risk of being sent to jail the largest available period if the other party confesses. The counterintuitive consequence of the prisoner's dilemma game is that the collective result of mutual defection, which is the rational choice for each person considered individually, is Pareto-inferior to mutual cooperation. That is, each is better off if both deny than if both confess. But, because denying exposes each to exploitation by the other, the dominant strategy is to confess. A prisoner's dilemma problem may be solved by a contract entered into by the players that threatens to apply sanctions for defection strategies. See Russell Hardin, *Liberalism, Constitutionalism, and Democracy*, Oxford, Oxford University Press, 1999, chapter 3.

³⁵ E.g., in *Sundstrand*, 96 T.C. at 374-75, Judge Hamblen said on behalf of the court: "[W]e must say that our attempt to determine an appropriate arm's length price...to a large extent has been stymied by the poor state of the record in this case. We found the record to be one more of obfuscation than enlightenment. The complexity of our task was exacerbated by the contentiousness of the parties. They at times seemed antagonist rather than adversaries. ...It is obvious to us that we were too tolerant with the parties during the pretrial proceedings. However, we must determine the appropriate arm's length consideration ...on the record before us. Our task was not easy but we have shouldered the yoke, and the parties now must reap what they have sowed." See Michael C. Durst and Robert E. Culbertson, "Clearing Away the Sand: Retrospective Methods and Prospective Documentation in Transfer Pricing Today," *Tax Law Review*, Volume 57, Number 1, 2003, footnote 78.

produced.³⁶ Most transfer pricing case law is too fact-specific and lacks a relatively predictable rationale for grounding the courts' decisions.³⁷

At the core of every transfer pricing litigation there is a prisoner's dilemma. And the courts are normally unable to solve that dilemma because they lack information necessary to identify and punish the defecting behavior—that of the tax authority³⁸ or the taxpayer.³⁹ The remainder of this chapter will explain why the bilateral or multilateral APA, unlike standard litigation, might induce the parties to spontaneously solve this prisoners' dilemma.

Robert Axelrod has argued in his book, *The Evolution of Co-operation*, that under some conditions, a prisoner's dilemma problem can be spontaneously solved if it is played an indefinite number of times ("iterated prisoner's dilemma").⁴⁰ The iterated prisoner's dilemma leads players to develop cooperative behavior under the tit-for-tat rule, which means that players tend to start the game with cooperative behavior, defecting only if the other player has defected on the previous move.

A classic example of the tit-for-tat rule is the live-and-let-live system in trench warfare during World War I. German and British soldiers deployed in trench warfare were able to spontaneously reach cooperation among themselves according to which no British soldier would shoot to kill a German one unless the other had done it first (and vice versa).

Tit-for-tat emerges if some conditions are met. They include the following: the relationship among the players is perceived as durable; cooperation is based on reciprocity; and the players have the ability to recognize defection when it occurs.⁴¹ That is, there is clarity of behavior so that the other player can adapt to the first player's pattern of action (that is, the player must have the ability to retaliate to the other party's uncooperative move).⁴² The

³⁶ The following has been said on the pattern of reasoning developed in substantial U.S. transfer pricing case law. "The *French*, *U.S. Steel* and *Bausch & Lomb* decisions illustrate a major problem facing the courts in applying the 1968 regulations: If inexact comparables are used because the market has changed (*French*, *B & L*), or because the relationship between the parties makes for a different nature of transaction (*U.S. Steel*, *B&L*), the application of regulations leads to results that are unrealistic as an economic matter.... Why, then, were the courts in these cases so eager to find that those 'comparables' were controlling?...The main reason was, as the courts themselves state, their awareness of the morass they would be getting into in the absence of comparables, which resulted in other cases in decisions that cover hundred of pages only to reach unpredictable and arbitrary results." Reuven Avi-Yonah, Analysis of Judicial Decisions Interpreting Section 482, Tax Management, Foreign Income Portfolios, *Transfer Pricing: Judicial Strategy and Outcomes*, A-113, 2003.

³⁷ "The main problem with the profit split method as developed in [certain] cases is the lack of rationale for the court's decisions. While the courts are careful to lay out the facts extensively, and the opinions are typically over a hundred pages long, in the end the actual profit split is not justified by an extended functional analysis of the roles performed by each of the parties." *Id.*, at A-123.

³⁸ An example of a tax administration's defection strategy is when it makes an improper transfer pricing adjustment.

³⁹ An example of a taxpayer's defection strategy is when it manipulates its transfer pricing structure to minimize its global tax liability.

⁴⁰ Robert Axelrod, *The Evolution of Co-operation* (1984).

⁴¹ See Axelrod, *supra* note 39, at 140.

⁴² *Id.* at 29-182.

basic idea here is that a player must not be able to get away with defecting without the other individual being able to retaliate effectively. It is important for one player to know what the other player actually did on the previous move because a tit-for-tat player always defects exactly once after each defection by the other player.⁴³ If those requirements are met, the prisoner's dilemma may be solved spontaneously without exogenous intervention.

The bilateral or multilateral APA is a procedural framework that can facilitate the emergence of an iterated prisoner's dilemma in transfer pricing disputes if some elements are met. First, the APA should allow at least two main players of the transfer pricing game (that is, countries of residence and countries of source) to interact in real time in a given dispute. Second, the relationship among those players should be perceived as durable. This element can be met if the proposal is included in the relevant tax treaty network. In fact, if the proposal is effective law, competent authorities should perceive that future interaction among them is likely. Third, cooperation among competent authorities should tend to be based on reciprocity. That is, each competent authority should be willing to provide all the information that is under its control and to make concessions to the other party if the other party reciprocates. That reciprocity will probably emerge if the turnover of public officials involved in the APA process is relatively low. Therefore, several of the same persons should meet periodically. Fourth, the APA framework should make the behavior of the competent authorities visible to each other. Thus, the competent authorities will have the ability to recognize defection when it occurs, triggering the tit-for-tat pattern of behavior referred to above. In sum, the bilateral or multilateral APA seems to be more capable than standard litigation for generating spontaneous cooperation among the participants of transfer pricing disputes. And that cooperation should create the best available environment for experimentation with the arm's-length standard.

4. Why Is Treaty Law the Best Available Legal Framework for Implementing the Proposal?

The proposal has been written to facilitate its addition to article 9 of the OECD or U.N. model (rather than to domestic law) for two reasons. First, tax treaty law is typically less volatile than domestic tax law in both developed and developing countries. That proposition is normally correct in the developing world, even in those developing countries with populist governments. For example, the Chávez administration has not abrogated any of Venezuela's tax treaties so far.

Second, the OECD model has been an effective legal device for signaling countries as to how they are expected to behave in the international tax arena. That signaling power of the OECD model could be used to accelerate the importation of the proposal by both developed and developing countries if the proposal is perceived as useful for minimizing the transfer pricing problem.

5. How Does the Proposal Work in Practice?

⁴³ *Id.* at 132.

A system similar to paragraph 2 of the proposal has been used within a real-world scenario (the case).⁴⁴ In the context of an APA, the IRS agreed with some tax treaty partners to develop a profit-split formula for the allocation of income derived from the global trading of derivatives and commodities.⁴⁵ The contracting states considered that the agreed profit-split formula was consistent with the arm's-length standard codified in article 9 of the relevant OECD-based tax treaties. (In a draft report, the OECD accepts that, under some circumstances, a multifactor formula reflects the arm's-length principle.)⁴⁶

If paragraphs 1 and 3 of the proposal had also been applied to the case, the system would have worked as follows. The APA would have been transformed into a rule-based norm (the new norm) by the competent authorities. Three years after the APA was produced, the new norm would have been incorporated into the domestic law principal legal regimes of all the contracting states involved in the APA, as long as the taxpayer had not decided to veto the new norm on some grounds (that is, his or her confidential data had not been properly deleted from the new norm).⁴⁷

Finally, the new norm could have been applied retroactively to open fiscal years to grant other qualified taxpayers the option of being governed by the new norm.⁴⁸ Hence, the issue of the proposal's potential inconsistencies with liberal democratic principles would have been minimized.

6. Can the proposal Deter the Emergence of Avoidable Litigation (Such as the Glaxo Case)?

Since 2003 a new wave of major transfer pricing litigation has emerged in both the developed and developing world.⁴⁹ *GlaxoSmithKline (Glaxo)* is a case in point in the developed world.

⁴⁴ Paragraph 2 of the proposal states: "A person shall have the option of using the OECD Transfer Pricing Guidelines as a default legal regime enforceable via bilateral or multilateral advance pricing agreements ('APA') only. The APA procedure shall be governed by Article 25. If the person accepts the APA concluded by the competent authorities, the APA will be final and not subject to further administrative or judicial review."

⁴⁵ Libin, Jerome B., "Formulary Apportionment for Global Trading in the Manufacturing Industry: Can It Work?" *Tax Notes Int'l*, Nov. 20, 1995, p. 1375.

⁴⁶ See OECD, Discussion Draft of the Attribution to Permanent Establishments (PES: Part III (Enterprises Carrying on Global Trading of Financial Instruments), March 4, 2003), paragraphs 157-160, available at www.oecd.org. That report provides, inter alia, "guidance on how to apply the profit split method in accordance with the arm's length principle, with particular reference to the multi-factor formula approach." (See paragraph 160.)

⁴⁷ There is no problem, as far as I can see, in having the same rule-based norm being incorporated in the domestic law of the contracting states.

⁴⁸ Because the principal legal regime is domestic-law-based, the option to be governed by the new norm includes those taxpayers who are not within the scope of tax treaty law.

⁴⁹ Since 2003 the Argentine IRS has adjusted the transfer prices of some of the largest MNEs based in Argentina. That decision caused the emergence of the largest transfer pricing cases in Argentine history. Unfortunately, the information available on those cases is less comprehensive than that available in the United States regarding the *Glaxo* case.

The facts of the *Glaxo* case are as follows. After nearly a decade of effort to resolve its transfer pricing dispute with the IRS without going to court, the British pharmaceutical giant Glaxo decided it was time to litigate. The case was filed in April 2004 at the U.S. Tax Court. Before the dispute started, Glaxo attempted to conclude an APA with the IRS (as Glaxo's main competitor had done). However, the IRS rejected the Glaxo APA petition without providing any reasons. The IRS decided to adjust the transfer prices concluded by Glaxo's U.K. parent corporation and its wholly owned U.S. subsidiary, and the litigation started.

According to Martin Sullivan, the *Glaxo* case involved three central issues.⁵⁰ The first issue was the inherent difficulty of determining transfer pricing in the presence of high-profit intangibles. As manufacturing and the importance of national borders shrink, cross-border transfer of valuable intellectual property within a single multinational is becoming increasingly common. Unfortunately, that is the type of transfer pricing issue that poses the greatest challenge to the arm's-length method codified in section 482 of the U.S. Internal Revenue Code. The reason is that intangibles by definition are unique; so it is always difficult — and frequently impossible — to identify transactions between unrelated parties involving the transfer of comparable intangible assets. Left with no other option, the IRS (as indicated in its deficiency notice) was forced in the *Glaxo* case to use an inferior and often arbitrary profit-split method.⁵¹

The second issue was the efficacy and fairness of the APA program. What legal obligation does the IRS have to provide APAs to taxpayers? Does the program provide equal treatment to different taxpayers? How much equality should it provide? Is the APA program legally required to be fair? Has the APA program been overly generous to some taxpayers? The APA program has been primarily an insiders' game. APAs are confidential. Until recently, only current and former IRS officials or practitioners specializing in transfer pricing (often former IRS officials) were privy to the critical details of how the program operated.⁵²

The third issue was the potential political fallout. Recently there have been many reports implying that U.S. corporations do not pay "their fair share" of taxes. For example, a recent Government Accountability Office (GAO) report⁵³ prompted an April 3 story in *The Washington Post*, "GAO Says U.S., Foreign Firms Escaped Income Tax." The GAO cited "improper pricing of inter-company transactions" among the causes. Recent research

⁵⁰ Martin Sullivan, "Economic Analysis: With Billions at Stake, Glaxo Puts U.S. APA Program on Trial," *Tax Notes Int'l*, May 3, 2004, p. 456.

⁵¹ *Id.*

⁵² *Id.*

⁵³ Tax Administration: Comparison of the Reported Tax Liabilities of Foreign-and U.S.-Controlled Corporations, 1996-2000, GAO-04-358, Feb. 27, 2004.

appearing in the pages indicates⁵⁴ that the IRS has allowed U.S. multinationals to shift an inordinate amount of profit to tax havens.⁵⁵

It is likely that cases like *Glaxo* could have been avoided if the proposal had been included in article 9 of the relevant tax treaty for the following reasons. (The example assumes the situation under which Glaxo is unable to request an APA based on the U.K.-U.S. tax treaty.)

In year one, SmithKline (then Glaxo's main competitor) would probably have requested a bilateral APA under article 25 of the U.S.-U.K. tax treaty (rather than a unilateral APA under U.S. domestic law). That is because the bilateral APA would have provided SmithKline legal certainty on how its cross-border income should be allocated in both jurisdictions, according to the view of both the IRS and the U.K. Inland Revenue under article 9 of the said tax treaty. Three years after the issuance of the APA, the competent authorities would have transformed the APA into the new norm. The new norm would have been incorporated into both U.S. and U.K. domestic law (the principal legal regime) without revealing SmithKline's confidential data. SmithKline would have been provided an opportunity to veto the addition of the new norm to the principal legal regime if it had considered that confidential data had not been properly deleted from the new norm. Then Glaxo could have requested that the U.S. IRS and the U.K. Inland Revenue to be governed by the new norm retroactively to open fiscal years.

The proposal could have contributed to avoiding the emergence of the three issues that triggered the *Glaxo* case. First, the proposal would have provided both contracting states and the taxpayer room for experimentation on how to allocate the income derived from the particular intangibles involved in that case. The legal framework would have been articles 9 and 25 of the U.K.-U.S. tax treaty. (As stated above, that kind of experimentation had already been successful in global trading and might be consistent with the arm's-length standard codified by article 9 of the OECD model). Thus, the risk of emergence of the first issue could have been minimized. Second, because the core content of the APA granted to SmithKline would have been made public three years after its issuance, if some confidentiality concerns had been met, the second issue would probably have been avoided. Finally, the bilateral APA concluded by the IRS and the Inland Revenue would have provided a proper forum for discussing what should have been SmithKline's "fair share of [U.S.] taxes." The third issue could have also been minimized. Moreover, the case could probably have been solved in less than 4 years without litigation (instead of the 10 years, plus litigation time, that the *Glaxo* case is now facing).

7. The Transitional Phase

The suggested proposal can be implemented in three phases. In phase I, MNEs should be granted the option of being governed by the OECD guidelines applied via bilateral or

⁵⁴ "Economic Analysis: U.S. Multinationals Move More Profits to Tax Havens," *Tax Notes Int'l*, Feb. 16, 2004, p. 589.

⁵⁵ *Id.*

multilateral APAs or to continue using the older transfer pricing regime. Phase II should be implemented three years after starting phase I. The period that runs between phase I and phase II should provide the contracting states with the time necessary to add the new rule-based norms created during phase I to the principal legal regime. The implementation of the proposal in stages allows for fine-tuning the principal legal regime to each country's particular circumstances. In phase III, an organization, like the American Law Institute, may spontaneously emerge with the goal of inferring predictable general rules from the set of fact-specific rule-based norms of the principal legal regime. If phase III emerges at some point in time, the character of the arm's-length approach would effectively mutate from a standard-based norm into a rule-based norm.

The principal legal regime can coexist with the old transfer pricing regime. For example, IRC section 482, its regulations, and case law can coexist with the set of rule-based norms that the APA will gradually produce. The taxpayer should have the option of using the old regime or the principal legal regime. Over time, the older transfer pricing regime may be implicitly abrogated because of a lack of use.

8. Frequency of Reforms of the Principal Legal Regime

The frequency with which the principal legal regime is updated will mainly be under the control of taxpayers, rather than governments, because they are better informed than governments in identifying the scenarios in which a given transfer pricing regime produces international double taxation. However, the content of the new norms of the principal legal regime will be basically under governments' control. The existence of an appeals system of APA decisions does not seem critical within the proposal's framework because the competing interests of the contracting states in the APA procedure are expected to produce balanced decisions.

9. How Should the Performance of the Proposal Be Evaluated?

The criteria for evaluating the performance of the suggested proposal should be based on two elements. The first element is the effectiveness of the APA process in producing self-enforcing, rule-based norms functionally equivalent to transfer pricing case law. The benchmark of that evaluation system could be the ability of those countries that have not accepted the proposal to provide a precise meaning of the arm's-length standard. The second element is the extent to which rule-based norms provide a precise meaning of the concept of the arm's-length standard.

10. Expected Effect of the Proposal on Both Developed and Developing Countries

The proposal seems to benefit the interests of both developed and developing countries for many reasons. First, the proposal offers a procedural framework that produces self-enforcing rules aimed at providing a precise meaning of the arm's-length standard. Second, the proposal minimizes the enforcement cost of the arm's-length standard via, for example, deterring the emergence of avoidable litigation.

Moreover, the proposal may contribute to advancing three compelling interests of developing countries. First, the protection of the corporate income tax base, which is more

relevant, in tax revenue terms, than the personal income tax base.⁵⁶ That element may help introduce elements of progressivity into the largely regressive developing countries' tax systems. Second, the rule-based character of the principal legal regime may make it more understandable to intelligent lay taxpayers, thus minimizing problems of legitimacy and accountability normally attached to the transfer pricing regime. Third, the rule-based character of the principal legal regime should also contribute to creating a perception of transparency and accountability in the administration of the transfer pricing legal framework. That is because, *inter alia*, violations of rules usually are more visible to public opinion than violations of standards.⁵⁷

Lastly, the proposal allows developing countries to use their tax administrations' human capital endowments more efficiently. In effect, the proposal's structure of incentives encourages contracting states to concentrate their best human capital endowment at the APA process stage, because it is the setting in which the future self-enforcing new norms are effectively created. Because the new norms will have a rule-based feature, they will be largely self-enforcing. The self-enforcing character of the new norms arguably substitutes for human capital endowment.⁵⁸

C. Commentary of the Provisions of the Suggested Proposal

The purpose of this subchapter is to explain the working and justify the rationale of each paragraph of the proposal.

Paragraph 1

Paragraph 1 reads as follows:

Contracting states can implement the arm's-length standard via a system of rule-based presumptions (the principal legal regime). The principle legal regime shall be so that the result shall be in accordance with the principles contained in this article.

The interaction of paragraphs 1 and 2 of the proposal offers taxpayers two alternative legal regimes in transfer pricing: a rule-based regime, known as the principal legal regime (regulated by paragraph 1), and a standard-based regime, known as the default legal regime (regulated by paragraph 2).

⁵⁶ That statement is based on a controversial assumption: The incidence of the corporate income taxation does not fall on labor. *See Taxation and Inequality: Some Evidence from the Americas*, Kenneth L. Sokoloff and Eric M. Zolt, University of California, Los Angeles, unpublished manuscript.

⁵⁷ It has been argued that decisions of governmental agencies on the basis of precise rules are easier to monitor by controllers than standard-based decisions; e.g., high levels of discretion in tax laws are seen as a major source of corruption in developing countries. *See A. Goudie and D. Stage, 1997, Corruption: The Issues: Research Programme on Political Economy and Development in Africa*, Technical Paper No. 577-604.

⁵⁸ See Schafer, Hans-Bernd, *Precise Legal Norms as Substitute for Human Capital in Low-Income Countries*, Universitat Hamburg, Institut fur Recht und Okonomik.

The principal legal regime should be implemented by contracting states via domestic law.⁵⁹ Examples of norms that might be in the principal legal regime are norms inferred from bilateral or multilateral APAs regulated by paragraph 2 of the proposal and the prices listed in the commodity markets to apply the comparable uncontrolled price method to the agricultural industry⁶⁰. Examples of the standard-based regime are detailed below.

1. Justification of the Structure of the Proposal

The dual transfer pricing regime implemented by paragraphs 1 and 2 of the proposal has been inspired by certain case law of the Indian Supreme Court, which held that an assessed taxpayer could claim assessment on the presumptive basis or the regular basis, whichever is more beneficial for the assessed person's point of view.⁶¹

The dual transfer pricing regime has two major purposes. First, as stated above, the lack of case law in transfer pricing makes the precise meaning of the arm's-length standard uncertain. The role of the principal legal regime is to solve that problem because each rule-based norm of the principal legal regime, which should be inferred from APAs, is expected to provide a precise meaning to the arm's-length standard. That is the reason the principal legal regime is functionally equivalent to case law. Second, if a given taxpayer is not happy with the norms of the principal legal regime, he or she can request to be governed by a standard-based norm, the OECD guidelines, via a bilateral or multilateral APA. This second option is called the default legal regime.

The interaction of the principal and the default legal regimes is expected to produce a virtuous circle. It should contribute to periodically updating the precise meaning of the domestic arm's-length standard to the changing circumstances of the countries in which it operates.

Finally, the proposal assumes that, over time, most taxpayers will prefer the principal legal regime (rather than the default legal regime) because the principal legal regime will have already produced the transfer pricing norms more frequently used by most taxpayers in a given jurisdiction. This effect is usually seen in any standard-based area of the law with extensive case law: This area of the legal system is largely self-enforcing because case law has effectively transformed a given standard-based norm into a rule-based norm.

2. The Interaction of the Proposal With the International Tax Regime

⁵⁹ This proposition is justified below.

⁶⁰ This presumption is accepted by the OECD. *See* OECD guidelines.

⁶¹ *See* Union of India and Another v. Sanyasi Rao and others (219 ITR 330) and CIT v. Visakhapatnam Port Trust (144 ITR 146). *See also* Presumptive Income Taxation — The Indian Methodology at 51, paragraph 28. It is published in the proceedings of a seminar held in New Delhi, India, in 1997 during the 51st Congress of the International Fiscal Association, Vol 22d. Chair Reuven Avi-Yonah, Kluwer Law International, The Hague-London-Boston. The principal legal regime plays a role of a safe harbor, meaning that the tax authority will not attempt to make a transfer pricing adjustment if all of the requisites of the principal legal regime are met in a given case.

The principal legal regime should be consistent with the international tax regime as embodied by the network of OECD-based bilateral tax treaties because the principal legal regime will be a set of norms whose content had been agreed on by two or more countries within the bilateral or multilateral APA framework. So, for example, the likelihood of international double taxation should be nil because the taxpayer governed by the principal legal regime will be able to use the foreign tax credit system offered by, at least, the foreign jurisdictions that have participated in the relevant APA.

3. How Should the Proposal Be Implemented?

The principal legal regime should be implemented basically via administrative regulation (rather than laws) to make the principal legal regime more responsive to the new norms periodically produced by the APA procedure. Current examples of that method of implementing the transfer pricing regime are IRC section 482 and article 14 of the Argentine income tax. In both examples, the core of the transfer pricing regime is implemented via regulations (rather than through statutory provisions).

Paragraph 2

Paragraph 2 of the proposal states the following:

A person shall have the option of using the OECD transfer pricing guidelines as default legal regime enforceable via bilateral or multilateral advance pricing agreement (APA) only. The APA procedure shall be governed by Article 25. If the person accepts the APA concluded by the competent authorities, the APA will be final and not subject to further administrative or judicial review.

As stated above, the interaction between paragraphs 1 and 2 of the proposal offers taxpayers two alternative legal regimes in transfer pricing, a rule-based regime (regulated by paragraph 1) and a standard-based regime (regulated by paragraph 2). The standard-based regime is grounded in the OECD guidelines, and its rationale is justified in the following paragraphs.

1. Why Are the OECD Guidelines Used in the Proposal?

The rationale for granting taxpayers the option of using the OECD transfer pricing regime is based on the following reason. The OECD guidelines are the most detailed set of recommendations currently available on how to enforce the arm's-length standard as codified in article 9.1 of the OECD model. Because most countries reproduce the language of article 9.1 of the OECD model in their tax treaty network, it seems reasonable to incorporate the OECD guidelines in the suggested proposal as a way of making the meaning of the arm's-length standard as precise as possible. Austria, for example, has transformed the OECD guidelines into domestic regulation.

2. Why Should APAs Only Be Bilateral or Multilateral?

The suggestion of making the OECD guidelines applicable via bilateral or multilateral APAs only has three purposes. First, the bilateral or multilateral APA is a procedural method more effective than a unilateral APA for preventing international double taxation because the positions of all tax jurisdictions involved in a given case are represented in the same procedural setting. Second, APAs could create the best available environment for experimentation in transfer pricing because the information asymmetries faced by APA players are relatively lower in the APA than in any other procedural context regulated by the OECD model. That relatively low level of informational asymmetry is due to the argument based on the iterated prisoner's dilemma referred to above. Third, because an APA is bilateral or multilateral (rather than unilateral) should minimize agency costs like the corruption of public officials. Moreover, because every APA should be transformed into a public rule-based norm, the chances of providing powerful taxpayers an unjustified favorable regime should be significantly reduced.

In sum, the bilateral or multilateral APA should be instrumental in bringing the fiction of the separate entity approach suggested in the 1933 Carroll Report — which is at the core of the arm's-length standard — as close as possible to business reality.

3. What Are the Legal Grounds for Bilateral and Multilateral APAs?

Because most effective tax treaties include the mutual agreement procedure, with wording similar to that of article 25 of the OECD model, it seems reasonable to refer to article 25 as the legal ground for implementing the bilateral or multilateral APA.⁶² Moreover, there is international consensus, backed by the OECD, that bilateral and multilateral APAs are governed by article 25 of the OECD model.⁶³

It is important that the public officials involved in the APA procedure should be the competent authorities of the contracting states within the meaning of article 25 of the

⁶² Article 25 of the OECD model states the following: “Mutual Agreement Procedure: 1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the Contracting State of which he is a resident or, if his case comes under paragraph 1 of Article 24, to that of the Contracting State of which he is a national. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention. 2. The competent authority shall endeavor, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting state, with a view to the avoidance of taxation which is not in accordance with the Convention. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States. 3. The competent authorities of the Contracting States shall endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention. 4. The competent authorities of the Contracting States may communicate with each other directly, including through a joint commission consisting of themselves or their representatives, for the purpose of reaching an agreement in the sense of the preceding paragraphs.”

⁶³ See OECD guidelines and Jose Manuel Calderon, *Advance Pricing Agreements. A Global Analysis*, Kluwer Law International, 1998.

OECD model. That role will allow them, for example, to produce APA decisions inconsistent with domestic law if this is necessary to be in line with the arm's-length standard.⁶⁴

4. *OECD Guidelines and Statutes Period of Limitations*

For legal certainty reasons, taxpayers should be granted a relatively short period for choosing the OECD guidelines (rather than the principal legal regime). Thus, taxpayers might be granted 15 working days from the date the relevant transaction is legally binding under domestic law to choose to be governed by the OECD guidelines. If no decision is made within this period, it shall be presumed *jure et de jure* that the taxpayer wishes to be governed by the principal legal regime.

5. *How Should OECD Guidelines Be Construed? Static Versus Ambulatory Approaches*⁶⁵

The method of interpretation of the OECD guidelines should be a function of the character of the contracting states involved in each particular APA. If only developed countries take part in a given APA, the ambulatory interpretation seems to be the better available option because their views are normally represented in the periodic updating of the OECD guidelines.

Because developing countries do not normally participate in the updating of the OECD guidelines, it seems reasonable that the OECD guidelines should, in principle, be construed on the basis of the static method of interpretation (rather than an ambulatory one).⁶⁶ To hold otherwise would imply that developing countries' contracting states would lose control of the content of their own international obligations. That proposition seems to be unfair.

6. *Default Regulation of APAs*

Those issues of the APA procedure regulated by neither the relevant tax treaty law nor domestic legislation should be regulated by the OECD guidelines in the section concerning an APA.⁶⁷

7. *The Proposal and the Learning Curve*

If countries accept the proposal, they will be experimenting with the same set of substantive rules (that is, OECD guidelines) in a similar procedural setting (a bilateral or multilateral APA). Thus, the probabilities of cross-country reciprocal learning are higher than they are

⁶⁴ This proposition assumes that tax treaty law preempts domestic law under the legal system of a given country.

⁶⁵ For the definition of dynamic and static interpretation of tax treaties, see Philip Baker, *Double Taxation Conventions. A manual on the OECD Model Tax Convention of Income and on Capital, Table of Treaties, Conventions and Agreements*, from E-15 to E-18, Sweet and Maxwell Tax Library, October 2003.

⁶⁶ Thus, *e.g.*, additions to the OECD guidelines made after a given tax treaty is concluded, in principle, should be ignored for identifying the precise meaning of the arm's-length standard.

⁶⁷ See OECD guidelines, IV-41 to IV-53.

now. Consequently, one country may learn from the mistakes made by another country in that area, and that may accelerate the learning curve of both policymakers and taxpayers in the understanding of the arm's-length standard's precise meaning in the different factual scenarios.⁶⁸

8. APA and Judicial Review

The last sentence of paragraph 2 states that “if the person accepts the APA concluded by the competent authorities, the APA will be final and not subject to further administrative or judicial review.”

Because article 25 of the OECD model grants taxpayers a narrow role in the production of the APA, it cannot be automatically considered binding as an APA. That binding effect may emerge only if the taxpayer accepts the APA. The wording of that sentence of the proposal has been borrowed from section 12.05 of the

U.S. Rev. Proc. 96-13. Judicial and administrative review should not be available on the APA for legal certainty reasons.⁶⁹

Paragraph 3

Paragraph 3 reads as follows:

Every APA shall be transformed by the competent authorities into a rule-based presumption (the new norm) without revealing any confidential data. The new norm shall be added to the principal legal regime three years after the APA is concluded. The person is entitled to veto the addition of the new norm to the principal legal regime if he considers that his confidential data has not been properly deleted from the new norm. If he exercises this veto-power, he will be unable to request an APA during a period of ten years from the date the veto was exercised. The new norm shall have retroactive effect to open fiscal years to provide other qualified persons the option of being governed by the new norm.

1. Balancing Public With Private Interests

Paragraph 3 has been designed to balance three competing interests: the interest of the government to transform an APA (private good) into a rule-based norm (public good); the interest of the taxpayer involved in the APA procedure in preventing confidential information concerning his business from reaching the public domain (secrecy concern interest); and the contracting states' duty to respect the principle of horizontal equity under which all taxpayers located in similar circumstances should be treated alike (horizontal equity interest).

⁶⁸E.g., the increasingly frequent cross-country citation of case law concerning the proper construction of OECD model-based tax treaty provisions.

⁶⁹ Administrative or judicial review should only be available for procedural issues of a given APA.

The transformation of the private good into a public good should be done to use the new norm as a vehicle for communicating to the taxpayer community the precise meaning of the arm's-length standard in the particular set of facts involved in each APA procedure.

2. *Balancing Accountability and Discretion*

The secrecy concern interest is protected through a three-pronged mechanism: the three-year delay in transforming the private good into public good;⁷⁰ the governments' duty to make this transformation without revealing private information of the involved taxpayer;⁷¹ and if the previous two mechanisms fail, the taxpayer's right to veto the publication of the new norm. However, the exercise of that veto has a cost for the taxpayer: He will be unable to request a new APA for a considerable period. Thus, it is assumed that the taxpayer will decide to veto the new norm only after having made a cost-benefit analysis. That analysis is facilitated by paragraph 3 because it provides the precise cost that the veto decision would imply for the taxpayer.⁷²

Finally, the horizontal equity interest is protected via the retroactive application of the new norm. Each qualified taxpayer may request, if some conditions are met, to be governed by the new norm during open fiscal years only to avoid, *inter alia*, administrative problems in enforcing that norm retroactively (particularly by developing countries' tax administrations).

In sum, paragraph 3 of the proposal offers a method for balancing three conflicting interests in transfer pricing — confidentiality, horizontal equity, and discretion for experimentation within the limits of the arm's-length standard.

III. Conclusion

One recurring question on how legal commands should be formulated in a legal system involves whether commands should take the form of rules or standards. The policy option that is at the core of this issue is whether the content of the law should be determined and announced in advance in a rule or left to an adjudicator in a standard. This distinction is relevant in the transfer pricing area because the arm's-length approach is a standard; its precise meaning can only be determined via adjudication. Thus, the arm's-length standard is unworkable unless the legal system in which it operates is prepared to produce case law (or something functionally equivalent to case law) to give guidance to taxpayers on how they are expected to behave.

The purpose of this article is twofold. First, it attempts to provide an analysis of the dramatic problem faced by the arm's-length standard when the legal system in which it

⁷⁰ This time gap seeks to protect the privacy of information by manipulating the timing of the new norm's publication. It is expected that the time gap may provide enough protection to, e.g., intangibles subject to rapid depreciation like software.

⁷¹ The new norm should not be precise enough to make the identity of the corporate taxpayer involved in the APA process and its confidential data evident to an intelligent layperson.

⁷² The taxpayer is not expected to explain why he or she has decided to veto the new norm. That will keep the enforcement cost of the proposal as low as possible.

works is unable to produce case law capable of showing taxpayers how they are expected to behave in the transfer pricing area.

The second purpose of this article is to suggest a procedural method for inducing a legal system — be it from the developed or developing world — to produce a proxy of case law capable of determining the precise meaning of the arm's-length standard. The suggested procedure has been written to facilitate its addition to article 9 of the OECD or U.N. Model Tax Conventions on Income and on Capital.