The Transfer Pricing Problem: A Proposal for Simplification

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2006.
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Abstract

This Article focuses on the problem of transfer pricing from an international taxation perspective. It elaborates two major points using game theory as a theoretical framework. First, it argues that both developed and developing countries are facing the same fundamental problem in the transfer pricing arena; the meaning of the arm's length standard (ALS) is increasingly unknowable because of the absence of transfer pricing case law with public good features. Second, this Article proposes a solution to the transfer pricing problem within the ALS framework. The proposal consists of a procedural, rather than a substantive, system in which multilateral advance pricing agreements (APAs) are used to produce a proxy for case law with public good features. The proposal is arguably superior to other options (such as formulary apportionment and consolidated base taxation approach elaborated by the European Commission in 2001) because it can be applied by both developed and developing countries and is consistent with the current structure of international taxation. The proposal has been written to facilitate its addition to Article 9 of the OECD Model Tax Convention on Income and on Capital.

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T a b l e o f C o n t e n t s

I- Introduction

The world has experienced two globalization booms and one bust over the past two centuries. The first boom started about 1820, and lasted until the advent of World War I. The second began at the end of World War II and has continued since. The interwar years witnessed a retreat from this otherwise continuous shift towards greater global integration.[2]

One major consequence of the globalization movement was the emergence in the late 19th century of a novel strategic problem among nations: how to divide the international tax base in the absence of a centralized authority. Developed countries eventually reached a fundamental consensus on how to solve this problem.[3] That consensus is currently embodied in the Organisation for Economic Co-operation and Development (OECD) Model Tax Convention on Income and on Capital. The OECD model is the foundation of a network of over 2500 bilateral tax treaties. This network is referred to as the "international tax regime."[4]

The OECD model is largely based on a web of standards (rather than rules) whose precise meaning can be determined with certainty *ex post* via case law.[5] In effect, key norms of the

[2] Jeffrey G. Williamson, Winners and Losers over Two Centuries of Globalization (NBER Working Paper N° 9161, 1992), at http://post.econom-ics.harvard.edu/faculty/jwilliam/papers/w9161.pdf (last visited December 14, 2003).

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

[4] The literature on the international tax regime is broad and deep; only certain elements can be highlighted here. Excellent recent surveys of the entire international tax regime are the following: Yariv Brauner, An International Tax Regime in Crystallization — 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. Ian Roxan, Limits to Globalization — Some implications for taxation in the developing world (2003) (unpublished manuscript on file with author). Roxan does not share the negative view of the effects of globalization on taxation in the developing world. Michael Graetz, Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies, 54 Tax Law Review 261 (2001), which argues that the current international income tax regime lacks a satisfactory normative basis. Richard Vann, International Aspects of Income Tax, in Tax Law Design and Drafting, (International Monetary Fund, Volume 2, 719-810, 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 Picciotto, International Business Taxation, A Study in the Internationalization of Business Regulation (1992), which is an historical account of the evolution of corporate income taxation. Adrian Ogley, The Principles of International Tax: a Multinational Perspective (1993), which provides a brief and illuminating general overview. The literature of international taxation and game theory produced by international lawyers is small. Seminal papers in this area are the following: Charles Kingston, The Coherence of International Taxation, 81 Columbia Law Review 1151 (1981) (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).

[5] See Part II.2. Ronald Dworkin seems to have been the first author to distinguish between rules and standards from a philosophical perspective. 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

OECD model do not have precise meanings before the taxpayer acts; rather, the precise meaning can be determined only after the taxpayer acts on a case-by-case basis.[6] The central role of the OECD model is to minimize international double taxation by establishing some structural legal fictions to guide the division of the international income tax base.[7]

The international taxation of multinational enterprises (MNEs) is a case in point. Since about 1928, developed countries created by consensus the legal fiction of the separate entity approach according to which the different profit units of a given MNE should be deemed independent enterprises. For example, pursuant to the OECD model, IBM (the parent company based in the US) and each of its subsidiaries (based in a number of other countries) should be considered to be separate taxpayers for the purposes of national corporate income taxes, rather than one global taxpayer.

Developed countries also agreed that the fiction of the separate entity approach should be enforced via the arm's length standard (ALS).[8] The ALS provides that national tax jurisdiction over income produced by an MNE should be allocated among countries on the basis of how comparable non-associated enterprises would have realized income in comparable circumstances. For example, the ALS provides that the transfer pricing agreed by IBM and one of its subsidiaries (based, say, in Singapore) of a certain type of hardware must be consistent with the market price of a comparable type of hardware that independent companies would agree to in similar circumstances. If the ALS is not met in a given case, national tax authorities are normally vested with the power to adjust the transfer pricing of associated enterprises to make it consistent with the ALS.

The concept of associated enterprises, a structural element of the ALS, is standard-based because its meaning is uncertain *ex ante*.[9] Scholars have devoted considerable energy to determining the precise meaning of associated enterprises.[10] Predictably, that effort has

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University Press (1978). On the difference between rules and standards from a legal and economic perspective, see the following materials: Louis Kaplow, Rules versus Standards: An Economic Analysis, Duke Law Journal, Vol 42:557 (1992); Louis Kaplow, The Value of Accuracy in Adjudication: An Economic Analysis, 23 Journal of Legal Studies 307 (1994). Richard Posner, Economic Analysis of Law, 555-561 (Aspen Publishers, Sixth Edition) (2003). Hans-Bernd Schafer, Precise Legal Norms as Substitutes for Human Capital in Low-Income Countries, (July, 2003) (unpublished manuscript on file with the author).

[6] See Part II.3.

[7] 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.

[8] Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration, at P-2, paragraph 6 (1995) (OECD guidelines). As Richard Vann argues, the ALS was firstly introduced in the context of permanent establishment, and it was extended latter to subsidiaries. See Richard J. Vann, Reflections on the Business Profits and the Arm's Length Standard, in The Taxation of Business Profits under Tax Treaties, 133-169, at 135 (Brian J. Arnold, et al eds., Canadian Tax Foundation, 2003). See also Taxation of Foreign and National Enterprises (Volume IV), Methods of Allocating Taxable Income by Mitchell B. Carroll, at 47 (League of Nations, Geneva, 1933) (the Carroll Report).

[9] See Part II.3.

[10] See, e.g., Article 9 OECD Model Convention: What is an Associated Enterprise? 57th Congress of the International Fiscal Association, Sydney, Australia, Seminar G. (September 2003) <http://www.ifa.nl>.

been largely unsuccessful due to the lack of case law with public good features in this area.[11]

For certain strategic reasons, developing countries of all legal traditions and cultures have been importing the international tax regime since the early 1960s in a systematic way. The adoption of the international tax regime has not been limited to open economy developing countries. For example, treaties based on the OECD Model have been concluded by developing countries from the Islamic world (such as Iran),[12] and also the communist world (including North Korea).[13]

The massive importation of the international tax regime by developing countries has been problematic in areas like enforcement, as the experience of Argentina shows in the context of transfer pricing.[14] This 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.[15] The main reasons are political instability and relatively weak observance of the rule of law. For instance, the members of the Argentine Supreme Court have been removed *en masse* eight times between 1946 and 2005, leading to sudden changes in the Argentine transfer pricing case law.[16] The unstable case law implies that the precise meaning of the international tax regime's standard-based norms, such as the ALS approach, for the most part remains unknowable in much of the developing world.

Since the late 1970s, developed countries have also faced severe problems with the enforcement of the ALS. This is because the emergence of confidential advance pricing agreements (APAs) has made litigation rare in the context of transfer pricing.[17] Moreover, the case law that is available is not a public good because the holdings are typically too

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[11] 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 James M. Buchanan, The Limits of Liberty: Between Anarchy and Leviathan (1974), chapter 6 (arguing that legal precedent is a form of social capital having public good characteristics). *See also* W. Landes and R. Posner, Legal Precedent: A Theoretical and Empirical Analysis, 19 Journal of Law and Economics 249 (1976) (arguing that the body of legal precedents is a capital stock that yields a flow of information services).

[12] *See, e.g.,* the Austria-Iran Double Taxation Convention concluded on March 11, 2002, available in LEXIS, WTD File.

[13] S*ee, e.g.,* the Austria-Cuba DTC concluded on June 26, 2003, and Czech Republic-North Corea signed on March 2, 2005, available in LEXIS, WTD File.

[14] Eduardo Baistrocchi, The Transfer Pricing Problem: the Argentine Experience, Revista Argentina de Teoría Jurídica, volume 2, number 1, (November 2000). <http://www.utdt.edu/departamentos/derecho/publicaciones/rtj1/pdf/baistrocchi.pdf>

[15] See, for example, Jonathan Miller, Judicial Review and Constitutional Stability: A Sociology of the US Model and its Collapse in Argentina, 21 Hastings International and Comparative Law Review 77 (1997-1998) (arguing that the US Constitutional Model failed in Argentina mainly because the Argentine Supreme Court has been substantially inconsistent with the principle of *stare decisis* since the Thirties onwards).

[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] 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 her Article, Ring makes a comprehensive description and evaluation of the U.S. APA procedure using, *inter alia*, public choice as a theoretical framework. For a global analysis of the APA process, *see* Jose Manuel Calderon, *Advance Pricing Agreements. A Global Analysis,* Kluwer Law International, 1998.

fact-specific to allow a representative taxpayer to predict the probable outcome of a future court's decisions—especially when no comparables are readily available.[18]

In sum, for different reasons, both the developed and developing worlds are facing the same fundamental problem: the meaning of the ALS is largely unknowable because of the absence of case law with public good features in this area. Therefore, the ALS 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 in part accounts for the worldwide ALS crisis.[19]

As an unfortunate product of the ALS crisis, a wave of transfer pricing litigation has emerged in both the developed and developing worlds since the beginning of the 21st century.[20] For example, GlaxoSmithKline, a British pharmaceutical giant, filed suit against the U.S. Internal Revenue Service early in 2004. With USD 5 billion at stake, it is the largest transfer pricing litigation in world history.[21]

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[18] 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.

[19] The worldwide crisis of the ALS 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).

[20] Transfer pricing litigation is unfortunate in the following sense. Because courts are normally unable to produce transfer pricing case law with public good features in this area for the reasons elaborated *infra*, transfer pricing litigation does not illuminate the meaning of the ALS. See Part IV.A.2.a.

[21] Martin Sullivan, With Billions at Stake, Glaxo Puts U.S. APA Program on Trial, *Tax Notes Int'l*, May 3, 2004, p. 456.

The purpose of this Article is twofold. First, it seeks to provide an analysis of the problem faced by the ALS when the legal system in which it operates is unable to produce case law with public good features; that is, case law capable of providing reliable guidance with respect to the precise meaning of the ALS in other cases. The U.S. and Argentine experiences with 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 the legal system of representative developed and developing countries to produce a proxy for case law in transfer pricing with public good features. 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 ALS. The proposal is written to facilitate its addition to Article 9 of the OECD Model Tax Conventions on Income and on Capital.

The suggested proposal is arguably superior to competing ones, such as formulary apportionment and consolidated base taxation elaborated by the European Commission on October 2001. This is largely because, unlike the alternative options, the procedural proposal can be applied readily in both the developed and developing worlds given the relatively minor demands it places on local institutions and human capital endowments.

The Article is divided into five parts. After this introduction, Part II outlines the distinction between rules and standards from a law and economics perspective. It shows that the OECD model is primarily a standard-based (rather than a rule-based) legal framework. A key assumption of the OECD model is that it presupposes a decentralized network of domestic courts capable of producing case law with public good features for providing precise meanings to such a model. Finally, Part II explains how this failure to produce case law with public good features is at the root of the transfer pricing problem.

Part III explores the normative lessons to be drawn from the Argentine and U.S. experiences in transfer pricing. It concludes that, for different reasons, both the developed and developing worlds are facing the same problem: the meaning of the ALS is largely unknowable because of the absence of case law with public good features in this area. Therefore, the key assumption of the OECD model referred to above is violated in the transfer pricing area. The result is that the ALS is unable to provide taxpayers with a clear sense of the law's demands with regard to transfer pricing in the legal systems in which they operate.

Part IV argues that a representative transfer pricing contest is an unsolved, one-shot prisoner's dilemma between the tax authority and a taxpayer. Consequently, the parties to a transfer pricing case lack the incentive to provide the courts with all the available information critical for producing transfer pricing case law with public good features. This strategic scenario results in most current transfer pricing precedents being private goods: they are typically applicable only to the case at hand. Conversely, APAs may trigger an iterated (rather than a one-shot) prisoner's dilemma between contracting states that might be solved spontaneously. Hence, the Article proposes that the bilateral or multilateral APA, provided for in Article 25 of the OECD Model Tax Convention, be applied in such a way as to achieve two fundamental goals: (a) to promote the emergence of tit-for-tat between contracting states in the transfer pricing arena; (b) to produce a proxy for case law with public good features capable of providing meanings to the ALS in the wide array of contexts in which that standard operates, such as e-commerce and derivative financial instruments. Part V concludes.

II- The Transfer Pricing Problem

1- The Root of the Transfer Pricing Problem

The rise of multinational enterprises (MNEs) has been underway since the end of the nineteen-century.[22] The emergence of MNEs is essentially a consequence of the relatively high transaction cost of certain market transactions. In effect, MNEs are a byproduct of the minimization of cross-border transaction costs.[23]

This explanation can be illustrated by the following example. Suppose that a French multinational (*FM*) manufactures cars in France and owns a valuable intangible: know-how in the marketing of its cars. *FM* is willing to expand its business to country *X*, however intellectual property rights are not properly enforced in country *X*. Due to this deficient protection of property rights, *FM* decides that, instead of supplying its intangible to *Indep Co*., (an independent reseller in country *X)*, it will create a wholly-owned subsidiary in country *X* to sell its vehicles (*FM sub*). Thus, this strategy allows *FM* to expand its business to country *X* minimizing the risk of damaging its intangible via the internalization of this transaction cost.[24] This example shows that MNEs may be able to replace an arm's length market in products and services (the external market) with an internal market of inputs.[25] This result applies generally.

The external and internal markets of inputs differ at least in the following significant respect: the pricing mechanism applies in the former but not in the latter.[26] Conversely, in the internal market transfer pricing is used to determine the price at which transactions are notionally conducted; that is, a transfer price is "…the unit price assigned to goods and services between the parent company and subsidiaries or between divisions within the same firm…"[27] This difference between the internal and external markets is relevant because while multinationals in principle do not control market prices, they are relatively free to set

[22] See Picciotto, note 4.
[23] See Ronald H. Coase, The Nature of the Firm, Economica, 1937, reprinted in: The Firm, the Market and the Law, The University of Chicago Press, Chicago and London 40, 33-55 (arguing that the operation of a market cost something and that, by forming an organization and allowing some authority (´an entrepreneur´) to direct the resources, certain marketing costs are saved); See also Christos N. Pielis & Roger Sugden, On the Theory of the Transactional Firm, 9-15 at 9, in The nature of the transnational firm (Christos N. Pielis & Roger Sugden eds., 1996).
[24] Another answer to the question why do MNEs exist is generally labeled the "divide and rule" approach. This states that some multinationals are created in order to divide its workers into country- specific groups and, thus, "employers improve their bargaining position and thereby gain at the expense of the worker" (See Sudgen, note 155, at 187-89).
[25] The *external market* is where interdependent activities are coordinated by the market forces rather by the internal market (where such activities are centrally coordinated by a firm). On the internal-external market distinction, see Sudgen, note 155, at 169.
[26] Robert G. Eccles, The Transfer Pricing Problem. A Theory for Practice, at 19, Lexington Books, Mass. (1986).
[27] André Gabor, Pricing. Concepts and methods for effective marketing, at 113-114, University Press, Cambridge, Great Britain (1988).

the transfer pricing of their intra-firm transactions. Consequently, this power may be used abusively. Consider the following example.[28]

In the example referred to above, *FM* is a manufacturer of cars, and a resident of France. *FM Sub* is its wholly owned subsidiary resident in country *X* and resells the cars to independent customers in that country. The taxable income of the subsidiary is determined by three variables: (i) the reselling price of the cars to independent customers; (ii) the expenses paid for all its inputs (except for the cars); and, (iii) the expenses incurred for purchasing the cars from the manufacturer. The market generally determines the first two variables (price of inputs from independent enterprises and price of output to independent costumers). Conversely, the third variable (the price paid by the subsidiary for buying the cars) is under the manufacturer's control. Therefore, if the tax rate of the manufacturer's jurisdiction is higher than that of its subsidiary, then the manufacturer can charge the lowest possible transfer price to its subsidiary in order to channel the profits of the multinational enterprise to the manufacturer's jurisdiction. On the contrary, if the tax rate applicable to the manufacturer is lower than that of its subsidiary, the manufacturer can charge the highest possible price to its subsidiary. The net effect of this transfer pricing strategy is to increase the global after-tax return of the MNE.[29]

Transfer pricing manipulation produces two major consequences. Firstly, as the last example shows, it puts national tax jurisdictions under stress because it is an income-shifting system that allows MNEs to maximize after-tax profits by channeling taxable income to lower-tax jurisdictions. Secondly, it raises horizontal equity issues on the basis that it provides a substantial advantage to MNEs in comparison with non-MNEs; only the former can use this type of international tax planning strategy.

Since 1915, when the U.K. implemented the first regulations on transfer pricing, tax jurisdictions have been exploring ways to curb transfer pricing abuses in order to minimize the consequences pointed out in the previous paragraph.[30] From this exploration two different anti-avoidance mechanisms have emerged. They are the opposite ends of a continuum.[31] On the one hand, the ALS that enjoys a fairly wide international consensus and is backed by the OECD. On the other hand, there is global formulary apportionment (GFA). Although GFA was initially rejected by the OECD,[32] it has more recently been gaining some guarded support from the OECD.[33] Both anti-avoidance mechanisms can be summarized as follows.

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[28] Transfer pricing is not only a tool for minimizing the tax liability of MNEs. It is also instrumental for MNEs to evaluate the performance of their own profit-centers (see 1995 OECD Report at I-2).

[29] This example has been based upon that developed in Reuven Avi-Yonah, The Rise and the Fall of the Arm's Length: a Study in the evolution of U.S. International Taxation, *15 Va. Tax Rev. 89*-75, at 89 (Summer 1995). A similar example may be found in Peter Muchlinski, Multinational Enterprises and the Law, Blackwell, Oxford U.K. & Cambridge, at 289 (1995).

[30] Herbert Bettinger Barrios, Precios de Transferencia. Sus Efectos Fiscales, Ediciones Fiscales ISEF, S.A. Mexico (1996).

[31] See Avi-Yonah, note 29 (arguing that the profit split method is somewhere between the ALS and the formulary apportionment continuum).

[32] 1995 OECD Guidelines III-19/24.

[33] See note 49.

The ALS attempts to replicate the "… the working of the open market in cases where goods and services are transferred between associated enterprises…".[34] Hence, the ALS requires a multinational to set the transfer prices of its internal transactions as if they were entered by independent parties in similar circumstances. If a given transaction does not pass this standard, tax authorities are generally empowered to adjust the transfer prices in order to achieve consistency.[35]

By contrast, the GFA method allocates the global profit of a MNE on a consolidated basis on the grounds of a predetermined formula.[36] Therefore, GFA disregards both the separate entity approach to MNE and the transactions entered into among their constituent business units. It is used principally by some countries' political subdivision such as the U.S. States and Canadian provinces.[37] The European Commission has recently suggested a GFA method for Europe.[38]

Neither the ALS as currently embodied in the OECD Model, nor the GFA provide satisfactory answers to the central issue of how to divide the international tax base among different tax jurisdictions. Two reasons explain this unsatisfactory scenario. On the one hand, the ALS is unworkable when courts are unable to produce case law with public good features.[39] On the other hand, the GFA has a clear meaning but, unfortunately, it cannot be applied in both the developed and developing worlds because the GFA presupposes elements (such as common accounting standards) that are not met in both worlds.[40] In sum, both the ALS and global formulary apportionment suffer structural problems when applied to developed and developing countries. This is why the transfer pricing problem will most likely remain a contentious international tax issue for the foreseeable future.

2- Standards versus Rules: An Economic Analysis[41]

Legal systems must provide information about the legal norms applicable in a given society. Interestingly, the government can give content to legal norms *ex ante* (via rules) or *ex post* (via standards). Examples of rules and standards can be found in many settings. For instance, a norm demanding "no driving in excess of 55 miles per hour" is a rule because its meaning is precise before an individual drives her vehicle. Conversely, the norm "drive carefully" is a standard because its meaning can be determined *ex post* via case law only (or by something functionally equivalent to case law). Rules and standards differ in at least three important dimensions: (i) cost structure; (ii) distribution of power within a legal system; and (iii) institutional assumptions. Those three dimensions will be addressed independently.

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[34] 1995 OECD Guidelines, at I-6.
[35] OECD Model Tax Convention on Income and on Capital, June 1998, second paragraph of Article 9 (1).
[36] 1995 OECD Report, III.19.
[37] See Part IV.C.2.
[38] *Ibid.*
[39] See Part II. 2 and 3.
[40] See Part IV.C.
[41] This section is closely based on the following Articles: Kaplow Louis, Rules versus Standards: An Economic Analysis, 22 Duke Law Journal 557 (1992); Kaplow, Louis, The Value of Accuracy in Adjudication: An Economic Analysis, 23 Journal of Legal Studies 307 (1994).

First, rules and standards have different costs of promulgation (*i.e.* the expenses incurred in the creation of a norm) and enforcement (*i.e.* the cost arising from applying a norm to a given set of facts). Rules are normally associated with high promulgation costs and low enforcement costs. An example of a rule is a detailed and precise tax norm that clearly specifies *ex ante* the taxpayer's expected behaviour. Hence, rules are expensive to create, but relatively cheap to apply given their largely self-enforcing character. On the other hand, standards are normally associated with low promulgation costs and high enforcement costs. An instance of a standard is the ALS. Its meaning can only be provided *ex post* via case law. Therefore, the enforcement cost of standards is high *vis-à-vis* its promulgation cost.

Second, rules and standards imply differing institutional allocations of power. While rules are usually a centralised creation of the legislative branch of government, standards are a decentralised creation of the law through, paradigmatically, the judiciary.

Finally, standards and rules have different institutional assumptions. Standards (unlike rules) presuppose a legal system capable of producing case law with public good features. Standards therefore require a higher threshold of human capital endowments than rules within the legal system in which they operate (such as competent lawyers and judges).

A main criterion for choosing among rules or standards is the frequency with which a legal norm is applicable in a given society. Louis Kaplow maintains that rules should be preferred in cases of frequent behaviours because the relatively high cost of promulgation is off-set by a relatively low cost of enforcement. Conversely, standards should be preferred for infrequent behaviour in order to defer the main cost to the time of enforcement.

3- The OECD Model: A Standard-Based Regulatory Model

This section identifies the structure of the OECD model using the rule/standard distinction as a theoretical framework. It argues that the central norms of the OECD model are fundamentally standards-based (rather than rules-based). That is, the full meaning of the central norms of the OECD model can be provided *ex post* by case law only. Articles 9.1 and 3.2 are used as examples for grounding this proposition.

a- The Cases of Articles 3.2 and 9.1: A Standard-based Norms

The OECD model regulates the transfer pricing problem through two separate provisions. Article 7 addresses that problem in the context of permanent establishments, whereas Article 9.1 is focused on the transfer pricing problem in the context of associated enterprises. Article 9.1 states the following:

> Associated Enterprises
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> 1. Where
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> 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.

Article 9.1 embodies a norm that has the following logical structure:

1) If associated enterprises conclude a transfer price;
2) And that transfer price is not consistent with the ALS; then
3) The tax authority may adjust that transfer price to make it consistent with the ALS.

Interestingly, the OECD model does not provide an *ex ante* meaning for two fundamental elements of Article 9.1. Indeed, neither "associated enterprise" nor "ALS" is defined by the OECD model. Article 3.2 governs those cases of terms not defined by the OECD model in order to solve the interpretative problem of norms without *ex ante* meaning. Article 3.2 states the following:

> As regards the application of the Convention at any time by a Contracting State, any term not defined there in shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.

The logical structure of Article 3.2 is the following:

1) If a term is not defined in the OECD model;
2) And the context does not otherwise require; then
3) The meaning of that term will be provided by domestic law of Contracting States.

Article 3.2 of the OECD model has a mixed character. It consists of a rule embedded in a standard. In effect, the rule ("undefined terms must be defined by contracting states' domestic law") is subject to the standard ("unless the context otherwise requires"). Article 3.2 has, therefore, a prevailing standard-based nature because only case law can provide a meaning to the standard "unless the context otherwise requires." In sum, both Article 9.1 and Article 3.2 have standard-based (rather than rule-based) structure because they lack a precise *ex ante* meaning.

b- Main Assumption of the OECD Model: a Decentralised Network of Domestic Courts Capable of Producing Case Law with Public Good Features

The previous Section has shown that two of the main norms of the OECD model (i.e. Articles 3.2 and 9.1) have standard-based features. Other prominent examples of OECD norms that have standard-based nature include the following for reasons similar to those identified when analysing Articles 3.2 and 9.1: agent of independent status (Article 5.6), beneficial owner (Articles 10, 11 and 12), and royalties (Article 12).

The standard-based structure of the OECD model is meaningful. It suggests that the OECD model is grounded on a crucial institutional assumption. In effect, the OECD model assumes that the content of its norms will be fundamentally provided by a network of decentralised domestic courts via case law with public good character. Unfortunately, for the reasons stated in Part IV below, this assumption of the OECD model is not met with respect to the ALS.

III-Drawing Normative Lessons from the Argentine and U.S. Experiences in Transfer Pricing

This Part identifies six central normative lessons of the U.S. and Argentine experiences in transfer pricing. The lessons derived from two recent Articles, one American and one Argentinean, are the following.[42]

(1) One recurring question on how legal regulations should be formulated in a legal system involves whether regulations should take the form of rules or standards. The policy option that is central to this question 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 transfer pricing because the ALS is a standard; its precise meaning can only be determined *ex post* via case law with public good features (or by something functionally equivalent to case law).

(2) The ALS faces a problem when the legal system in which it works is unable to produce case law with public good features. In such legal systems there is little or no information capable of guiding taxpayers on how they are expected to behave in transfer pricing. This problem is common to both developed and developing countries. On the one hand, developed countries face the problem because, for certain strategic reasons explored below, reported decisions are infrequent. Moreover, the limited case law available is not a public good; the holdings typically are too fact-specific for predicting the probable outcome of future court decisions. This scenario makes the meaning of the ALS difficult to determine — especially when no comparables are available. On the other hand, developing countries face a similar problem, but for an additional reason — their weak rule of law and political

[42] 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, 15 *Va. Tax Rev.* 89 (1995); Eduardo Baistrocchi, The Transfer Pricing Problem: the Argentine Experience, Revista Argentina de Teoría Jurídica, volume 2, number 1, (November 2000). <http://www.utdt.edu/departamentos/derecho/publicaciones/rtj1/pdf/baistrocchi.pdf>
Baistrocchi´s Article is focused on the Argentine experience on transfer pricing since 1932 (when the federal income tax was introduced) onwards. It explores the evolution of Argentine transfer pricing regulations and their judicial enforcement at both the domestic and tax treaty levels. He offers two main conclusions. First, the evolution of the Argentine version of the ALS is, particularly since the 1990´s, towards an increasing consistency with the ALS as defined by public customary international law (which is, in turn, greatly influenced by the OECD). Second, both the Argentine Supreme Court and Congress (or the body in charge of enacting laws during military regimes) have normally attempted to mutate the standard nature of the ALS into a rule based norm, occasionally with procedural features, in the arena of frequent cross-border transactions (such as exports of commodities). This trend towards providing an *ex ante* meaning to the ALS (via transforming a standard into a rule) can be explained as an attempt of minimizing the enforcement cost of the ALS.

instability produce frequent violations of *stare decisis*, making case law an unreliable source for predicting court decisions.[43] In sum, the meaning of the ALS is largely unknowable throughout the world for the same reason: the lack of transfer pricing case law with public good features.

(3) Because the meaning of the ALS is largely unknowable, an average taxpayer typically incurs avoidable costs to learn how he or she is expected to behave in the area of transfer pricing. An example of an avoidable cost can be found in the *Glaxo* case. The precise meaning of the ALS in *Glaxo* could have been identified in a more efficient way than litigation.[44]

(4) Each time the transfer pricing problem was high on the Argentine agenda, the Congress or the Supreme Court implicitly transformed the ALS into a set of rule-based norms when the transactions involved were frequent. The prohibition of deduction of royalty payments to non-resident associated enterprises is a case in point. This implicit transformation of a standard into a rule was probably geared toward minimizing the enforcement cost of the ALS.

(5) In a politically unstable context, procedural 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 local 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.[45]

(6) The legal system of a representative developing country typically has a relatively low human capital endowment. This suggests that the legal systems of developing countries will frequently encounter difficulties when enforcing standards because standards, unlike rules, presuppose a decentralized network of competent and well educated lawyers and judges.[46]

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[43] See footnote 15.

[44] The facts of the Glaxo case and reasons for that statement are elaborated in Part IV.A.8.

[45] For an excellent book on the history of Argentina, *see* Luis Alberto Romero & James Brennan, A History of Argentina in the Twentieth Century, Penn State University Press (2002). The Argentine revolutions referred to above were mostly implemented by non-elected military governments.

[46] The OECD acknowledges that the ALS presupposes highly trained personnel who are not available in many countries. According to the OECD, "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 ALS to the point that many countries (*especially those that lack the highly trained personnel required to implement the current rules*) 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 entitled 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

Conversely, rules presuppose a relatively smaller number of well-trained policy-makers or government officials—those who have the responsibility of drafting (largely self-enforcing) rules.

The six normative lessons derived from some of the Argentine and U.S. literature in the transfer pricing arena can be encapsulated in the following statement. In the area of frequent cross-border transactions, the ALS should be largely implemented by a procedural rule capable of producing a proxy of transfer pricing case law with public good features.

IV- A Procedural Proposal for Solving the Transfer Pricing Problem

This Part elaborates a proposal for solving the structural problem faced by the transfer pricing legal system in both the developed and developing worlds. The proposal is based on the normative lessons of the U.S. and Argentine experiences as reported above.

The proposal is to harness the multilateral APA (APA) system to produce a proxy for case law with public good features in the transfer pricing area. It works as follows. A private good (*e.g.* a particular APA) is transformed into a proxy of case law via systematically making public each APA without revealing potentially sensitive confidential data.

The confidentiality element is protected via two legal devices. First, the proposal grants the taxpayer the right to veto the transformation of her APA into a public good if she considers that her confidential data have not been properly deleted. Second, the proposal establishes that a mandatory time lag (*e.g.* three years) must elapse between the APA issuance and its publication. This time lag is functionally equivalent to that witnessed between the emergence of the facts that triggers a given litigation, and the publication of the decision that solves that litigation. If the mechanism serves as an effective proxy for case law as intended, the meaning of the ALS will be clearer than it currently is given the lack of transfer pricing case law with public good features in both the developed and developing worlds.[47]

In the early nineties, a multilateral APA similar to that suggested in the proposal was successfully issued to solve a transfer pricing problem relating to the global trading of derivatives and commodities. In the context of a multilateral APA among tax treaty partners, the U.S, the U.K. and Japan agreed to develop a profit-split formula for the allocation of income derived from the global trading of derivatives and commodities (APA

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[47] Some commentators have stated, but not elaborated, the idea of using the APA system for providing relatively precise meanings to the ALS. For example, Richard Vann has argued the following: “[a]t the administrative level, the heavy compliance demands that the particularistic nature of transfer pricing creates may be ameliorated by the ongoing development of advance pricing arrangements (APAs) which are acknowledged and encouraged by the [OECD] guidelines. The potential here is that eventually precedential principles will emerge from the many different APAs that are issued. Such a development requires that the general content of APAs become public, which is already occurring to some degree. Once it is clear how tax administrations will treat particular fields of activity, taxpayers are likely to be inclined to follow the guidance as a way or reducing compliance cost and have more certainty of outcome.” See Richard Vann, Reflections on Business Profits and the Arm's-Length Principle, op. cit, at 168. See also Jinyuan Li, Global Profit Split: An Evolutionary Approach to International Income Allocation Vol 50, N° 3 Canadian Tax Journal 823-83 (2002).

on Global Trading).[48] The contracting states considered that the agreed profit-split formula was consistent with the ALS as codified in Article 9.1 of the relevant OECD-based tax treaties.[49] Finally, the Internal Revenue Service issued a notice with a summary of the multilateral APA on Global Trading without disclosing private information.[50] That notice implies a step towards using the multilateral APA process for the production of a proxy of case law with public features in the transfer pricing area.

If the proposal had been applied to the APA on Global Trading, the system would have worked as follows. The APA on Global Trading would have been transformed into a rule-based norm (the new rule) by the competent authorities. And three years after the APA was produced, the new rule would have been incorporated into the domestic tax laws of the U.S., the U.K., and Japan, provided the taxpayer involved in the APA on Global Trading had not decided to veto the release of the norm on the grounds that her confidential data had not been properly removed.[51]

Finally, the new rule could have been applied retroactively to open fiscal years to grant other qualified taxpayers the option of being governed by the new rule.[52] Hence, the issue of the proposal's potential inconsistencies with liberal democratic principles would have been minimized.[53]

The proposal might be worded as follows in order to facilitate its addition to Article 9 of the OECD model:

> Contracting states can implement the arm's-length standard via a system of rules regulated by this Article (the system of rules). The system of rules 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) 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.

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[48]Libin, Jerome B., Formulary Apportionment for Global Trading in the Manufacturing Industry: Can It Work? Tax Notes Int'l, p. 1375 (Nov. 20, 1995).

[49] This position is consistent with the current OECD view according to which under some circumstances, a multifactor formula reflects the ALS. See OECD, Discussion Draft of the Attribution to Permanent Establishments (PES: Part III (Enterprises Carrying on Global Trading of Financial Instruments), paragraphs 157-160 (March 4, 2003), 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.)

[50] See Internal Revenue Service Notice 94-40, 1994-1, C.B. 351. It is published at http://www.irs.gov/pub/irs-apa/notice_94-40.pdf

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

[52] Because the System of Rules, as defined by the proposal, is expected to be 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.

[53] Diane Ring, note 17.

> Every APA shall be transformed by the competent authorities into a rule (the new rule) without revealing any confidential data. The new rule shall be added to the system of rules three years after the APA is concluded. The said person is entitled to veto the addition of the new rule to the system of rules if he considers that his confidential data has not been properly deleted from the new rule. 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 rule shall have retroactive effect to open fiscal years to provide other qualified persons the option of being governed by the new rule.

A- General Remarks

1. *Definition and Working of Bilateral or Multilateral Advanced Pricing Agreement*

An 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.[54]

The central difference between bilateral and multilateral APAs is the number of tax authorities involved (in addition to the taxpayer) in the transfer pricing dispute. In bilateral APAs, two competent authorities are involved; multilateral APAs involve three or more competent authorities.[55]

The APA process is an alternative to the standard taxpayer practice of completing the transaction, filing a return, facing an audit (some level of audit is more likely with larger taxpayers), and, finally, a possible appeal of the audit with either settlement or litigation (or both). 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 transfer pricing method. Following discussion and negotiation, the parties may reach an agreement on how the taxpayer should

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[54] *See* OECD guidelines, 4.124. By the same token, an APA has been defined by the U.S. 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).

[55] For instance a multilateral APA was recently signed by France, Germany, the United Kingdom and Spain for Airbus Industries. See Steven S. Saeger, Rahul Tomar and Deloris R. Wright, Comment on PATA Guidance for bilateral APAs, International Transfer Pricing Journal, 3-6, footnote 3 (January/February 2005).

handle the pricing of those anticipated related-party transactions. The understanding is then embodied in the APA agreement which, in the U.S., typically lasts for three years.[56]

In 1991, the APA system was first designed and applied in the U.S. It was then emulated by countries of different legal traditions. To date, the emulators include Australia, Canada, China, Germany, India, Japan, Mexico, the Netherlands, New Zealand, Spain, Thailand, the United Kingdom, and Venezuela.[57]

2. Why Bilateral or Multilateral APAs Play a Central Role in the Proposal

Representative transfer pricing litigation can be modeled as a one-shot prisoner's dilemma between the taxpayer facing a transfer pricing adjustment, and the domestic tax authority (the first prisoner's dilemma). Since the first prisoner's dilemma is unsolved for certain strategic reasons explored below, both parties have the incentive not to cooperate by hiding information unfavorable to their interests. Thus transfer pricing litigation gives rise to asymmetries of information; this leads courts to produce case law which is a private good, rather than a public good, because it can only solve one case.

A bilateral or multilateral APA can also be modeled as a prisoner's dilemma among two or more contracting states, rather than the taxpayer facing a transfer pricing adjustment and the local tax authority (the second prisoner's dilemma). The second prisoner's dilemma, unlike the first one, can be solved spontaneously by iteration if certain elements are present.

A bilateral or multilateral APA has a central role in the proposal because, unlike litigation, it can spontaneously solve the prisoner's dilemma which is pervasive in the transfer pricing context. Moreover, the transformation of APAs into a proxy for case law with public good features can arguably provide relatively precise *ex ante* guidance on the requirements of the ALS in the different factual scenarios in which the ALS is applicable.

***a-* Transfer Pricing Litigation as an Unsolved Prisoner's Dilemma**

The prisoner's dilemma is a useful heuristic to illuminate the strategic interactions of the players involved in a representative transfer pricing litigation. Those players are the domestic tax authority and the taxpayer facing a transfer pricing adjustment. Both players typically have two alternative individual choices within that litigation framework: to defect or to cooperate. Both options can be defined as follows.

First, to defect means using information strategically, such as hiding from the court unfavorable information. Second, to cooperate means providing the court all relevant information that helps the court produce case law with public good features. For example,

[56] Diane Ring, note 17.

[57] *See* Jose Manuel Calderon, note 17, at 9-11. The current features of APA procedures of OECD countries are outlined at the OECD Web site. *See* http://www.oecd.org/document/31/0,2340,en_2649_37427_29601439_1_1_1_37427,00. html. See also China Issues Formal Advance Pricing Agreements Rules, Deloitte, http://www.deloitte.com/dtt/cda/doc/content/TP0504%281%29.pdf. Strategy Matrix for Global Transfer Pricing, Deolite Touche Tomatsu (2004).

the cooperative strategy may imply the provision of information to the court that may be useful for applying a formula (such as the profit split) based on a compelling rationale rather than on arbitrary grounds. Case law based on a compelling rationale (rather than on arbitrary grounds) may be a good thing for both the taxpayer and the tax authority: it may be instrumental for minimizing international double taxation. [58] Indeed, it is more likely that local case law based on a compelling rationale will be shared by foreign competent authorities than that case law grounded on an arbitrary rationale because of its persuasiveness. Indeed, case law based on a compelling rationale would facilitate the working of, say, the secondary adjustment mechanism which minimizes the risk of international double taxation.[59] In short, a critical by-product of the simultaneous cooperation of both parties is to help the court produce transfer pricing case law with public good features.

The transfer pricing litigation game (*i.e.*, the first prisoner's dilemma) can be modeled as follows:

		Tax Authority	
		Cooperate	Defect
Taxpayer	Cooperate	2,2	4,1
	Defect	1,4	3,3

Transfer Pricing Litigation as a Prisoner's dilemma

In the matrix above, both players may chose between two alternative outcomes labeled Cooperate or Defect. This implies that there are four alternative outcomes represented by the four cells of the matrix. Each cell has a specific payoff structure for the players. In each cell, the first payoff goes to the taxpayers facing transfer pricing adjustment whereas the second payoff goes to the Tax Authority. The numbers stand for the payoffs for each combination, ranked by an ordinal representation (thus, for each player 1>2>3>4).

[58] Transfer pricing case law based on arbitrary grounds is a frequent element in both the developed and developing worlds. For example, a commentator has argued the following: "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." *See* Reuven Avi-Yonah, note 18, at A-123.

[59] The secondary adjustment mechanism is regulated by Article 9.2 of the OECD Model.

The prisoner's dilemma strategic interaction gives both players incentives to use information strategically. Defect is the strictly dominant strategy because it is the optimal choice for each player no matter what the other player does. [60] Hence, the equilibrium point in the prisoner's dilemma situation is represented by the lower right cell (*i.e.*, 3,3).

The upper left cell (*i.e.* 2,2) is a Pareto efficient outcome of the prisoner's dilemma. This is so because the simultaneous cooperation of both players led them to provide the courts all available information that facilitates the production of transfer pricing case law grounded on a compelling rationale. The compelling rationale of local transfer pricing case law maximizes the likelihood that it will be accepted by all competent authorities of other relevant tax jurisdictions. Hence, the risk of international double taxation is minimized.

As said, a critical by-product of the simultaneous cooperation of both parties is to help the court produce transfer pricing case law with public (rather than private) good features. Transfer pricing case law with public good features is crucial for offering precise *ex post* meanings to the ALS which minimizes uncertainty on how taxpayers (and tax authorities) are expected to behave in the transfer pricing area.

The counterintuitive consequence of the prisoner's dilemma game is that the spontaneous result of mutual defection (*i.e.*, 3,3), which is the rational choice for each person considered individually, is Pareto-inferior to mutual cooperation (*i.e.*, 2,2). That is, each player is better off if they both cooperate than if both defect because cooperation would facilitate the production of transfer pricing case law with a compelling rationale that would minimize the problem of international double taxation. But the dominant strategy is to defect because it is the strategy that earns each player a larger payoff than any other regardless of what the other player does. Thus, the players in a prisoner's dilemma scenario are normally not able to spontaneously reach an equilibrium point in which both parties cooperate simultaneously (*i.e.*, 2,2).

Transfer pricing litigation is arguably similar to large commercial litigation because they both can be modeled as an unsolved prisoner's dilemma. The dominant strategy of both pair of players normally is to defect by hiding unfavorable information.[61] Indeed, lawyers involved in transfer pricing litigation (like those involved in large commercial litigation) have the incentive to build up a reputation of being difficult and obstinate, rather than cooperators.

[60] See Robert Gibbons, Game Theory for Applied Economics, Chapter 1, Princeton University Press (1992). (maintaining that a given strategy is strictly dominant if it is the best choice for a player in a game for every possible choice by the other player. As said,, the non-cooperation strategy is strictly dominant for both players in a prisoner's dilemma).

[61]Ronald Gilson & Robert H. Mnookin, *Disputing through agents: Cooperation and conflict between lawyers in litigation,* 94 Colum L. Rev 509,5 40 (1994) (arguing that large commercial litigation can be modeled as unsolved prisoner's dilemma).

Unfortunately, judges are typically unable to solve this type of prisoners' dilemma. This is so because judges have difficulty verifying and sanctioning defection of the players. As has been argued in the context of large commercial litigation,

> [t]he information structure of the litigation game can explain the presence of significant conflict in litigation even though most lawyers claim to play tit-for-tat. Litigation is quite ´noisy´. Clearly identifying whether the other side has cooperated or defected in a competitive environment where cooperation is defined as being not too conflictual, is quite often difficult.[62]

A signal that transfer pricing litigation normally is an unsolved prisoner's dilemma is the frequency with which courts complain about the lack of cooperation of both tax authorities and taxpayers in this area. The U.S. Tax Court has recently said:

> [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.[63]

In short, a representative transfer pricing litigation can be studied as a one-shot prisoner's dilemma. Consequently, the parties of a transfer pricing litigation lack the incentive to provide the courts with all the available information critical for producing transfer pricing case law with public good features. This strategic scenario results in most current transfer pricing precedents being private goods: they are typically applicable only to the case at hand.[64]

b- APAs as Solved Prisoner's Dilemma

Both transfer pricing litigation and APA can be framed as prisoner's dilemmas modeled by the matrix studied in the previous section. However, there are two critical differences

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[62] *Ibidem.*

[63] See *Sundstrand*, 96 T.C. at 374-75. See also Michael C. Durst & Robert E. Culbertson, Clearing Away the Sand: Retrospective Methods and Prospective Documentation in Transfer Pricing Today, 57 Tax L. Rev. 37 (2003-2004) footnote 78.

[64] 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, note 18 at A-113.

between both prisoners' dilemmas. On the one hand, the players of a transfer pricing litigation are a taxpayer and the tax authority, whereas the players of a representative APA are the relevant competent authorities –e.g. the US, the UK and Japan as the APA on Global Trading studied above shows. On the other hand, transfer pricing litigation normally is a one-shot prisoner's dilemma that can not be solved for the reasons stated above. Conversely, the APA can be studied as an iterated prisoner's dilemma that may be solved spontaneously. This section shows why a representative APA, unlike transfer pricing litigation, may be solved spontaneously without exogenous intervention.

A prisoner's dilemma problem can be spontaneously solved if it is played repeatedly (iterated prisoner's dilemma). The iterated prisoner's dilemma may lead 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.[65]

Tit-for-tat emerges if certain conditions are met. They are the following: (i) the relationship between the players is perceived as durable; (ii) cooperation is based on reciprocity; and (iii) the players have the ability to identify defection when it occurs.[66] That is, the player must have the ability to retaliate to the other party's uncooperative move.[67] The basic idea is that a player must not be able to get away with defecting without the other individual being able to retaliate effectively. One player must 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.[68] If those conditions are met, an iterated prisoner's dilemma may be solved spontaneously without exogenous intervention.

The bilateral or multilateral APA is a procedural framework that, unlike standard transfer pricing litigation, can facilitate the emergence of an iterated prisoner's dilemma in transfer pricing because the three elements listed in the previous paragraph may be met for the following reasons. First, the APA should allow the competent authorities of the contracting states to interact simultaneously in a given transfer pricing problem since they are expected to act at the same time.

Second, the relationship among competent authorities should be perceived as durable if the proposed APA mechanism is included in the relevant tax treaty. Indeed, if the proposal is accepted, competent authorities will acknowledge that future interaction among them is likely.

Third, cooperation among competent authorities should tend to be based on reciprocity. That reciprocity will probably emerge if the turnover of public officials involved in the APA process is relatively low.[69]

[65] Robert Axelrod, The Evolution of Co-operation (1984).

[66] Id. at 140.

[67] *Id.* at 29-182.

[68] *Id.* at 132.

[69] *Ibidem.*

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.

The lawyers participating in a given APA should have the incentive to develop a tit-for- tat pattern of behaviour when representing the interests of the competent authorities. Within the context of APAs, lawyers should be willing to build up a reputation of cooperation for two main reasons. First, lawyers will most likely be evaluated by the professional market according to the numbers of successful APAs they have been involved in. Second, the number of lawyers involved in bilateral APAs may be smaller that those involved in representative domestic transfer pricing litigation. The probability that lawyers consider themselves as repeated players is therefore higher in the bilateral APAs context than in domestic transfer pricing litigation. Thus tit-for-tat may emerge in the bilateral APAs scenario. This should be contrasted with transfer pricing litigation transpiring at domestic courts in which lawyers tend to be difficult and obstinate, as it is often the case in large commercial litigation. [70]

In sum, the proposed APA mechanism is arguably more capable than transfer pricing litigation to meet the two fundamental elements for triggering an iterated prisoner's dilemma: (i) increasing the frequency of repeated play between players (*i.e.* competent authorities as defined by Article 25.3 of the OECD model); and, (ii) sanction defection as soon as it occurs.[71]

3. Why Treaty Law (rather than Domestic Law) is the Best Available Legal Framework for Implementing the Proposal

The proposal has been written to facilitate its addition to Article 9 of the OECD model (rather than to domestic law) for two major reasons. On the one hand, the OECD model has been an effective legal device for signaling to both developed and developing countries 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 OECD-based tax treaties. Moreover, the OECD-based tax treaty theoretical framework normally permeates over time into the domestic law of both developed and developing countries for certain reasons.[72]

On the other hand, tax treaty law is typically less volatile than domestic tax law. That proposition is particularly applicable to 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. In sum, the proposal should be implemented via tax treaty law (rather than domestic law).

4. Implementation of the Proposal: The Transitional Phase

[70] Gilson, note 61.
[71] Ibidem at 550 (arguing that both elements are crucial for solving prisoner's dilemmas via iteration).
[72] See Richard Vann, *International Aspects of Income Tax in* Tax Law Design and Drafting, 718-809 at 728 (Victor Thuronyi ed., International Monetary Fund, 1998).

The 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 multilateral APAs only or to continue using the older transfer pricing regime. Phase II should be implemented three years after starting phase I. Phase II implies the start of the process of including the new rules (created via the APA procedure) to the system of rules. In phase III, an organization, like the OECD or the American Law Institute, may spontaneously emerge with the goal of inferring general rules from the set of fact-specific rules of the system of rules. An example of a general rule might be a formula applicable to the allocation of income derived from global trading of derivatives.[73] If phase III emerges at some point in time, the character of the ALS will effectively have migrated from a standard-based norm into a rule-based norm.

The new rules 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 new rules that the APA will gradually produce. The taxpayer should have the option of using the old regime or the system of rules. Over time, the older transfer pricing regime may fall into desuetude.

5. Frequency of Reforms of the Transfer Pricing Legal Framework

Since the proposed system of rules is based on the APA mechanism operating as a proxy for case law, and case law becomes less relevant over time, periodic updating of the proposed system would be desirable.[74] The frequency with which the system of rules is updated will mainly be driven by the requirements of the taxpayer community. Taxpayers are ordinarily better informed than governments in identifying the scenarios in which a given transfer pricing regime will no longer prevent the emergence of international double taxation. Needless to say, the content of the new rules of the system of rules will be basically under the competent authorities' control.

6. Evaluating the Performance of the Proposal

Two criteria should be used to evaluate the performance of the proposal. 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 relatively precise meaning of the ALS. The second element is the extent to which rule-based norms provide a precise meaning of the concept of the ALS.

7. Expected Affect of the Proposal on both Developed and Developing Countries

[73] See note 50.

[74] W. Landes and R. Posner, Legal Precedent: A Theoretical and Empirical Analysis, 19 Journal of Law and Economics (1976) (arguing that the body of legal precedents is a capital stock that yields a flow of information services which depreciates over time as new conditions arise that were not foreseen by the framers of the existing precedents).

The proposal arguably benefits the interests of both developed and developing countries for two major reasons. First, the proposal aims to transform the unsolved, one-shot prisoner's dilemma that normally emerges in representative transfer pricing litigation between a taxpayer and a local tax authority into an iterated prisoner's dilemma among contracting states in the context of a bilateral or multilateral APA. This transformation is desirable because the transfer pricing prisoner's dilemma may be solved spontaneously via iteration.

Second, the proposal may result in an increasing ratio of transfer pricing norms having a predominant rule-based (rather than a standard-based) feature. Those norms will be largely self-enforcing because violations of rules usually are more visible to public opinion than violations of standards.[75]

Moreover, the self-enforcing character of rule-based norms arguably substitutes for human capital endowment which is relatively scarce in the developing world. Indeed, the proposal allows developing countries to use their scarce human capital endowments more efficiently than it would be the case under the current ALS. 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 most new self-enforcing transfer pricing rules are effectively created. [76]

8. Can the Proposal Deter the Emergence of Avoidable Litigation (such as **Glaxo***)?*

Since 2003, a new wave of major transfer pricing litigation has emerged in both the developed and developing world.[77] The *Glaxo* case is a case in point in the developed world. The facts are as follows. After nearly a decade of effort to resolve its transfer pricing dispute with the IRS without having to go 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. [78]

The *Glaxo* case involved three central issues. 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

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[75] Reinier Krakman & Bernard Black, A Self-Enforcing Model of Corporate Law, 109 Harvard Law Review 1911 (1996) (arguing that violation of rules is more visible to public opinion than violation of standards. Hence, rules, unlike standards, normally are self-enforcing).

[76] See Schafer, Hans-Bernd, note 5.

[77] 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 U.S. regarding the *Glaxo* case.

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

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 often unpredictable profit-split method.[79]

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 too 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.[80]

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) report[81] 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 appearing in the pages indicates[82] that the IRS has allowed U.S. multinationals to shift an inordinate amount of profit to tax havens.[83]

Cases like *Glaxo* could have been avoided if the proposed APA mechanism had been included in Article 9 of the U.S.-U.K. tax treaty for the following reasons. 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 would be allocated in both jurisdictions, according to the view of both the IRS and the U.K. Inland Revenue under Article 9 of the tax treaty. Three years after the issuance of the APA, the competent authorities would have transformed the APA into a new rule. The new rule would have been incorporated into both U.S. and U.K. domestic laws (the system of rules) without revealing SmithKline's confidential data. SmithKline would have been provided an opportunity to veto the addition of the new rule to the system of rules if it had considered that confidential data had not been properly deleted from the new rule. Subsequently Glaxo (i.e. SmithKiline main competitor) could have requested to be governed by the new rule retroactively to open fiscal years.

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79 Ibidem.

80 *Id.*

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

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

83 *Id.*

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 is consistent with the ALS codified by Article 9 of the OECD model)[84]. 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 four years without litigation (instead of the 10 years, plus litigation time, that the *Glaxo* case has now consumed).

In summary, the proposed APA mechanism is consistent with the main lesson emerging from the Argentine and U.S. experience on transfer pricing: in the area of frequent cross-border transactions, the ALS should be basically implemented by a procedural rule-based norm capable of producing a proxy of transfer pricing case law with public good features.

C. Commentary on the Paragraphs of the Proposal

The purpose of this section is to explain the working and justify the rationale of each paragraph of the proposal. The proposal has been written to facilitate its addition to Article 9 of the OECD Model Tax Convention on Income and on Capital.

1- Paragraph One

Paragraph 1 reads as follows:

> Contracting states can implement the arm's-length standard via a system of rules regulated by this Article (the system of rules). The system of rules shall be so that the result shall be in accordance with the principles contained in this Article.

a. Justification of the Structure of the Proposal

The proposal offers taxpayers two alternative legal regimes in transfer pricing: (i) a rule-based regime, called the system of rules, regulated by paragraph 1; and, (ii) a standard-based regime, named the default legal regime, regulated by paragraph 2. If a given taxpayer is not happy with the system of rules, she can request to be governed by the default legal regime, i.e., the OECD guidelines implemented via a bilateral or multilateral APA only.

[84] See Part IV.a.

The structure of the procedural proposal has a major purpose. As stated above, the lack of case law in transfer pricing currently makes the precise meaning of the ALS prospectively unknowable. The role of the proposed system of rules is to solve that problem given that each rule of the system of rules (which should have been inferred from APAs) is expected to provide a relatively precise meaning to the ALS that may be updated periodically. Hence, the system of rules is functionally equivalent to transfer pricing case law with public good features.

The system of rules should be implemented by contracting states via domestic law.[85] Examples of norms that may be included in the system of rules are norms inferred from bilateral or multilateral APAs, such as the formula agreed by Japan, U.K. and the U.S. in the global trading of derivatives referred to above.[86]

The interaction of the system of rules and the default legal regime is expected to produce a virtuous circle. It should contribute to periodically updating the precise meaning of the domestic ALS to the changing circumstances of the countries in which it operates.[87]

The proposal assumes that, over time, most taxpayers will prefer the system of rules (rather than the default legal regime or the current domestic transfer pricing regulations) because the system of rules 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, such as contract law. Indeed, areas like contract law are largely self-enforcing because case law has effectively transformed standard-based norms into rule-based norms.

Finally, the proposal also assumes that a representative taxpayer will prefer the bilateral/multilateral APA procedure over litigation for obtaining certainty on the transfer pricing area. This assumption is based on the fact that the APA procedure as implemented by the proposal (unlike litigation) can protect confidential information effectively.[88]

b. The Interaction of the Proposal with the International Tax Regime

The proposal is consistent with the international tax regime as embodied by the network of OECD-based bilateral tax treaties because it introduces no changes to the ALS. The proposal only provides a procedural dimension of the ALS. Hence, the proposal is consistent with both Article 7 and 9 of the OECD model.

c. Implementing the Proposal

The system of rules should be implemented basically via administrative regulation (rather than statutory legislation) to make the system of rules readily responsive to the new rules periodically produced by the APA procedure. This responsiveness may facilitate the

[85] See Part IV.B.1.c.
[86] See note 50.
[87] On the depreciation of precedents over time, see W. Landes note 74.
[88] See Part IV.B.3.

emergence of the iterated prisoners dilemma referred to above because the parties´ behavior would be readily visible to each other.[89] Current examples of that method of implementing the transfer pricing regime are the section 482 of the U.S. Internal Revenue Code and Article 14 of the Argentine income tax law. In both examples, the core of the transfer pricing regime is implemented via regulations (rather than through statutory provisions).

The proposal might work better in practice if an arbitration clause is included in the relevant tax treaty because a credible threat of arbitration may induce the competent authorities to reach an APA within a reasonable period. That arbitration clause might be triggered at the discretion of the taxpayer if the competent authorities are unable to reach an APA within certain period.

d- A Criterion for Accepting APA Requests: The Test of Frequency

Taxpayers might request more APAs from competent authorities than those authorities can deliver in a timely way. The APA procedure may encounter congestion delays.

One plausible way of addressing this congestion problem would be to set a priority list according to which the frequency of the transactions involved is a critical element for accepting APA requests. In other words, the competent authorities should prefer to address APAs requests involving frequent transactions over those that do not meet this test.

The test of frequency is consistent with the theoretical framework according to which rules should be preferred over standards for those conduct that are frequent.[90] If conduct will be frequent, the additional costs of designing rules –which are borne once- are likely to be exceeded by the savings realized each time the rule is applied.[91] Interestingly, the criterion based on the frequency of transactions for accepting request of APAs is already used by U.S. regulations.[92]

2- Paragraph Two

Paragraph 2 of the proposal states the following:

> 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) 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.

a. Why the OECD Guidelines are Used in the Proposal

[89] See Part IV.A.2.b.
[90] See Part II.2.
[91] See Louis Kaplow, note 5.
[92] See #3 2005 TNT 86-3 IRS Chief Counsel Announces New APA Program Initiative (Section 482 -- Transfer Pricing) (Doc 2005-9445) (May 04, 2005).

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 apply the ALS as codified in Article 9 of the OECD model. Because most countries reproduce the language of Article 9 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 ALS as precise as possible. Austria and Venezuela, for example, have already transformed the OECD guidelines into domestic regulation.

b. Why APAs Should Only Be Bilateral or Multilateral (rather than Unilateral)

Making the OECD guidelines applicable only through bilateral or multilateral APAs has three grounds. First, the bilateral or multilateral APA as a procedural method is more likely to be effective than the unilateral APA for preventing international double taxation because the positions of all tax jurisdictions involved in a given case can be represented in the same procedural setting.

Second, because an APA is bilateral or multilateral (rather than unilateral) and the identity of the public officials involved in each APA will be in the public domain, the proposal should minimize agency costs like corruption of public officials. Moreover, because every APA should be transformed into a public rule, the chances of providing powerful taxpayers an unjustifiably favorable regime should be reduced.

Third, APAs may create a suitable environment for experimentation in transfer pricing because the information asymmetries faced by APA players are relatively lower that that faced in transfer pricing litigation. Indeed, the iterated prisoner's dilemma referred to above, unavailable in transfer pricing litigation, may induce contracting states to behave cooperatively in the APA context.

c. 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.[93] Moreover, there is

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[93] 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

international consensus, backed by the OECD, that bilateral and multilateral APAs are governed by Article 25 of the OECD model.[94]

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 OECD model. That role will allow them, for example, to produce APA decisions inconsistent with domestic law if this is necessary to comply with the ALS.[95]

d. OECD Guidelines and Statutes Period of Limitations

In order to promote legal certainty, taxpayers should be granted a relatively short period for choosing the OECD guidelines (rather than the system of rules). For example, 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 *iuris et de iure* that the taxpayer wishes to be governed by the system of rules.

e. Construing the OECD Guidelines: Static versus Ambulatory Approaches[96]

For familiar reasons complex treaties, such as tax treaties, are likely incomplete as to unforeseen contingencies. Tax treaties are, in a certain sense, incomplete contracts. States may then benefit from various public international law devices to fill the gaps in their agreement. As in the literature on default rules for private contracts, it seems reasonable to argue that default rules (such as those provided for the Vienna Convention) should be applied to tax treaties in such a way as to replicate what the contracting states would have negotiated expressly if they had addressed the matter.[97]

The method of interpretation of the OECD guidelines should be correlated to 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 best available option because their views are normally represented in the periodic updating of the OECD guidelines.

Conversely, it seems reasonable to infer that the OECD guidelines should, in principle, be construed on the basis of the static method of interpretation (rather than an ambulatory one)

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."

[94] *See* OECD guidelines and Jose Manuel Calderon, note 17.

[95] This proposition assumes the rule, which is effective in most jurisdictions, according to which tax treaty law preempts domestic law under.

[96] 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).

[97] Alan O. Sykes, The Economics of Public International Law (forthcoming in A. Mitchell Polinsky & Steven Shavell, eds., Handbook of Law and Economics).

given that developing countries do not normally participate in the updating of the OECD guidelines.[98] In other words, the static method of interpretation should govern in the case of asymmetric tax treaties, unless there are compelling reasons to believe that in a particular tax treaty the parties would have preferred the ambulatory method if they had addressed the matter.[99] This principle of interpretation is based on the conviction that to hold otherwise would imply that developing countries' contracting states would lose control of the content of their own international obligations.

f. Default Regulation of APAs

Those aspects of the APA which are regulated by neither the relevant tax treaty law nor domestic legislation should be regulated by customary public international law. This is because international tax law *is*, to a large extent, customary public international law.[100] Consequently, the OECD guidelines might be relevant in the context of APAs if there are reasons to consider those guidelines to be customary public international law.[101]

g. 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, the APA cannot automatically be considered binding. 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. Finally, judicial and administrative review on the APA should be narrow for legal certainty reasons.[102]

3-Paragraph Three

Paragraph three reads as follows:

> Every APA shall be transformed by the competent authorities into a rule (the new rule) without revealing any confidential data. The new rule shall be added to the system of rules three years after the APA is concluded. The said person is entitled to

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[98] The OECD is increasingly responsive to non-member countries´ views on the OECD model without losing control of the model's content. For example, in 1991 the Committee on Fiscal Affairs adopted the concept of an ambulatory Model Tax Convention. It also decided that because the influence of the Model Tax Convention extended far beyond the OECD member countries, the ongoing process through which the Model Tax Convention would be updated should be opened up to benefit from the input of non-member countries. Only 25 non-OECD member countries are participating in this process. Most of them are developing countries. See Model Tax Convention on Income and on Capital, Condensed Version, OECD, at 343-374 (July, 2005).

[99] 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 ALS.

[100] Avi-Yonah, Reuven, International Tax as International Law, in 57 Tax L. Rev. 483 (2004).

[101] *See* OECD guidelines, IV-41 to IV-53.

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

> veto the addition of the new rule to the system of rules if he considers that his confidential data has not been properly deleted from the new rule. 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 rule shall have retroactive effect to open fiscal years to provide other qualified persons the option of being governed by the new rule.

a. Balancing Public with Private Interests

Paragraph three has been designed to balance three competing interests that may emerge if the proposed APA mechanism is adopted. The interest of governments is to transform an APA (private good) into a rule-based norm (public good). The interest of taxpayers is to avoid having confidential information reach the public domain (secrecy interest); and finally, the contracting states' duty to respect the principle of horizontal equity under which all similarly situated taxpayers should be treated alike (horizontal equity interest).

The balancing of these conflicting interests is implemented by paragraph three as follows. The transformation of the private good (*i.e.* APA) into a public good (*i.e.* new rule) should be done to use the new rule a vehicle for communicating to the taxpayer community the precise meaning of the ALS in the particular set of facts involved in each APA procedure. However, paragraph three offers the taxpayer the right to veto the publication of the new rule if the confidential information has not been properly excised from the new rule.

Paragraph three has been designed with the purpose of inducing the taxpayer not to veto the addition of the new rule to the system of rules. That is the reason why the taxpayer is penalized if she exercises her veto power. Moreover, the taxpayer may be granted a monetary incentive if she does not exercise the said veto power. This monetary incentive is justified on the grounds that the taxpayer would be involved in the creation of a public good: a rule that provides an ex-ante meaning to the ALS. The monetary incentive might take the form of a right of making tax deductible (with a cap) the costs incurred by the taxpayer in the APA process.[103]

b. Balancing Accountability and Discretion

The taxpayer's secrecy concern interest is protected through a three-pronged mechanism: (i) the three-year delay in transforming the private good into public good;[104] (ii) the governments' duty to make this transformation without revealing private information of the involved taxpayer;[105] and, if the previous two mechanisms fail, (iii) the taxpayer's right to veto the publication of the new norm. However, the exercise of that veto has a cost for the taxpayer. She will be unable to request a new APA for a considerable period.[106] Thus, it is

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[103] I am grateful to Robert Cooter for the idea of tax deductibility of APA expenses.

[104] 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 intangibles (such as software) which are normally subject to rapid depreciation.

[105] The new norm should not be precise enough to make the identity of the taxpayer involved in the APA process (and its confidential data) knowable to an intelligent layperson.

[106] The taxpayer's decision to veto the inclusion of the new norm to the domestic law implies a cost to her. It seeks to deter her from exercising her veto power. This deterrence is justified on the following grounds. As

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 three because it provides the precise cost that the veto decision would imply for the taxpayer.[107]

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.

In sum, paragraph three 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 ALS as defined by the OECD Guidelines.

C- Superiority of the Proposal to other Options for Simplifying the Transfer Pricing Problem

This section argues that the procedural proposal is superior to other options for solving the transfer pricing problem because it is the best equipped for being applied in both the developed and developing worlds.

In order to demonstrate this proposition, this section presents three major alternative regulatory options and identifies their weaknesses *vis-à-vis* the procedural proposal. Those options are the following: (i) the ALS as currently embodied in the OECD model; (ii) the formulary apportionment at the sub-national levels as implemented in Canada and the U.S.; and (iii) the formulary apportionment at a regional level, as suggested by the European Commission for the European Union.

1-The ALS as currently embodied by the OECD Model

The ALS as currently embodied in Articles 7 and 9 of the OECD Model faces a structural problem in both the developed and developing worlds. As said, it does not work properly because domestic courts are normally unable to produce transfer pricing case law with public good features. This problem is triggered for a variety of reasons including strategic ones that are explored above. Hence, the meaning of the ALS is largely unknowable in both the developed and developing worlds. [108]

2- Formulary Apportionment[109]

said, one of the main goals of the proposal is to transform Advance Price Agreements into a proxy for case law. This transformation is prevented each time the veto is exercised.

[107] 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.

[108] See Part II.

[109] This section closely follows Joann Martens Weiner, Company Tax Reform in the European Union: An Analysis of some Key Issues under Formulary Apportionment and Consolidated Base Taxation, (October 2005) (unpublished manuscript on file with the author).

The basic goal of formula apportionment is to assign income to the locations where a multinational enterprise conducts its business activity. The apportionment is implemented on the basis of a formula, rather than the ALS. The apportionment formula normally has elements, referred to as "factors," which represent the shares of business activity in each location.

Formulary apportionment is used at the sub-national level in both the U.S. and Canada. Moreover, the European Commission has recently proposed that the formulary apportionment should be used at a supra-national level: the European Union.

a. The Approach of Canada and the US

Canadian Provinces and U.S. States that tax corporate income apply a multifactor formula for the apportionment of income for tax purposes. For example, the Canadian Provinces apply a payroll and gross receipts formula with equal weights to each factor. This formula determines provincial profits as follows: [½ (payroll in province/total payroll) + ½ (sales in province/total sales)] * total profits. This formula would work as follows. Suppose a Canadian corporation conducts its business activities in two Canadian provinces: Province A and Province B. It generates a total income of $1000. Total payroll is $5000 ($3000 in Province A, and $2000 in Province B). Total gross receipts are $ 8000 ($ 6000 from Province A, and $2000 from Province B). The tax base would be allocated $ 675 to Province A, and $ 325 to Province B.[110]

b. The Approach of the European Commission

The European Commission recently set forth its new strategy in corporate taxation in the European Union (EU). This new long-term comprehensive strategy argued in favor of two key changes in how the individual Member States would tax EU multinational enterprises. First, instead of computing their tax base under the rules in each individual Member States, EU companies would have the option to use a single set of tax rules to compute a common tax base at the EU level. Second, these enterprises would distribute this tax base across individual Member States where they did business using an agreed common apportionment formula. Consistent with preserving Member State sovereignty in direct tax matters, the individual Member States would apply their own local tax rate to their apportioned share of the single consolidated EU tax base.

c. The Assumptions of Formula Apportionment

Formulary apportionment is workable only if certain elements are present in the relevant tax jurisdictions. Those elements are common accounting standards, common currency, and a common formula. It presupposes common accounting standards because they normally provide a uniform definition of concepts like payroll, sales, and profits which are crucial for the workability of the formula. It also presupposes a common currency in order to avoid problems like currency exchange rates. Finally, it presupposes a common formula for self-

[110] Province A [½ (3/5) + ½ (6/8)] * 1000: $ 675. Province B [½ (2/5) + ½ (2/8)] * 1000: $ 325.

evident reasons. If all these elements are not present simultaneously in all relevant tax jurisdictions, formula apportionment can not work properly.

Unfortunately, those elements are not simultaneously present in the developed and developing world. In effect, there are neither world-wide accepted accounting standards nor common currency. Moreover, there is no internationally accepted formula for allocation of cross-border income. The likelihood of reaching a world-wide consensus on these elements in the foreseeable future is low given the high collective action cost involved: there are over 250 countries. Hence, formulary apportionment is unworkable at a global scale until elements such as those listed above are met.

The proposal appears superior to both formulary apportionment and the substantive dimension of the ALS. This superiority is grounded in two major reasons. First, the proposal faces less collective action cost problems than those faced by formulary apportionment. The relevant players interacting within the proposal framework do not have to share common accounting standards, currency and formula as it is usually the case in the formulary apportionment scenario. Second, the proposal, unlike the ALS as traditionally defined, does not presuppose a network of domestic courts able to produce case law with public good features. Indeed, the proposal itself is expected to produce a proxy for this kind of case law. In sum, the proposal seems better equipped than formulary apportionment and the substantive dimension of the ALS for working in both the developed and developing worlds.

3- Some Doubts and Difficulties

This section identifies some objections that may be made to the proposal suggested in this Article. And it offers a response to them.

(a) It may be maintained that the proposal is unworkable in practice. This is so, the argument goes, because it will not be possible to infer rule-based norms from APAs given that transfer pricing problems normally are substantially fact-specific.

Certain standards are relatively costly to transform into rules because of, *inter alia*, the limits of language. An example of this type of cases is the meanings of "immoral behavior". Indeed, it is difficult to state the set of immoral behavior precisely and succinctly. [111] The application of the proposal should not face problems such as those emerging from the attempt to define immoral behavior precisely and succinctly. The multilateral APA case on global trading of derivatives and commodities referred to above is a case in point. Indeed, that multilateral APA involved a substantial number of facts. However, the U.K., U.S., and Japanese competent authorities that participated in that APA case were able to agree on a rule-based norm to solve that transfer pricing problem: a formulary apportionment tailored to global trading of derivatives and commodities.[112]

[111] Kaplow, note 5.
[112] See note 50.

(b) It may be argued that the proposal will have no relevance in the interaction among developing countries in the transfer pricing area given that to date there have been no APAs concluded among developing countries.

It is correct to maintain that there is no APA concluded in the transfer pricing arena between developing countries as of 2006. The current prisoner's dilemma in the context of foreign direct investment among developing countries may explain this *status quo*. The structure of international taxation does not militate in favor of developing countries engaging in cooperative behaviors such as those required for concluding multilateral APAs.

However, the proposal itself may be instrumental for solving this prisoner's dilemma spontaneously in the context of transfer pricing via iteration. Alternatively, other solutions may be implemented in ways that facilitate the success of the procedural proposal.[113]

VI. Conclusion

This Article focuses on the problem of transfer pricing from an international taxation perspective. It elaborates two major points using game theory as a theoretical framework.

First, it argues that both developed and developing countries are facing the same fundamental problem in the transfer pricing arena; the meaning of the arm's length standard (ALS) is increasingly unknowable because of the absence of transfer pricing case law with public good features.

Second, this Article proposes a solution to the transfer pricing problem within the ALS legal framework. The proposal consist of a procedural, rather than a substantive, system in which multilateral advance pricing agreements are used in such a way as to produce a proxy of case law with public good features.

The procedural proposal is arguably superior to other options (such as the formulary apportionment and consolidated base taxation elaborated by the European Commission in 2001) because it can be applied by both developed and developing countries and is consistent with the current structure of international taxation. The proposal has been written to facilitate its addition to Article 9 of the OECD Model Tax Convention on Income and on Capital.

[113] For example, Reuven Avi-Yonah has made a proposal for solving the said prisoner's dilemma. See Avi-Yonah, Reven, *Globalization and Tax Competition: Implications for Developing Countries* (unpublished manuscript on file with author) (arguing that there are three elements necessary for solving the prisoner's dilemma;.first, all OECD member countries should agree on a coordinated basis to tax their multinationals currently on their income from abroad; second, passive income held by non-resident taxpayers should be subject to withholding taxation by OECD countries, unless the relevant taxpayer proves that she has provided her country of residence information regarding her income; and finally, a world tax organization should be set up for monitoring the enforcement of the said proposals).