Transfer Pricing Taxation

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I. Introduction

As globalization of the economy progresses, the role of multinational enterprises (MNEs) in cross-border trade is dramatically increasing. This poses hard problems of taxation for both tax administration and the MNEs themselves. Because the increased role of MNEs in the world is partly due to technological advancement, particularly in the area of communications, the issues of taxation are getting more complex for both the tax administration and taxpayers.

The prices to be charged between related persons, such as parent companies and their subsidiaries and in particular within a MNE for transaction (sales of goods, the provision of services, transfer and use of patents and know-how, granting of loans, etc.) are not negotiated in a free, open market. Therefore, these prices may deviate from prices agreed upon by non-associated, independent trading partners in comparable transactions under the same circumstances.

On the part of tax authorities in such cases, they would seek to adjust the prices in principle according to the "arm's length principle" under which the prices would be those of unrelated parties with each other wholly independently in the ordinary commercial terms of the open market.

In this way, there has given rise to a problem of transfer pricing taxation.

II. OECD Model Tax Convention

1. Historical Background

Since 1963, the OECD Model Tax Convention on Income and on Capital has had great influence on the negotiation, application and interpretation of tax conventions. The provisions of the Model have been incorporated into a majority of bilateral tax treaties and the commentaries on the provisions are widely accepted. In 1977, a new Model Convention and Commentaries was published which does not exclusively deal with the elimination of double taxation but also address other issues, such as the prevention of tax evasion, and non-discrimination.

In the 1980s, as the globalization of the economy proceeded, the methods of tax avoidance and evasion became more sophisticated. Consequently, in the course of its regular work program, the Committee on Fiscal Affairs continued after 1977 to examine various issues directly or indirectly related to the 1977 Model. This work resulted in a number of

reports, some of which recommended amendments to the Model Convention and its Commentaries.

In 1991, recognizing the revision of the Model Convention and Commentaries had become an ongoing process, the Committee on Fiscal Affairs decided to more timely update and amend without waiting for a complete revision. This led to the publication in 1992 of the Model Convention in its present loose-leaf format to ensure periodic update accurately.

The impact of the Model Convention has extended far beyond the OECD area. Most notably, it has been used as the basis for the United Nations Model Double Taxation Convention between Developed and Developing Countries of 1980 which reproduces a significant part of the provisions and Commentaries of the OECD Model Convention.(1)

2. Taxation of Associated Enterprises

(1) Overview

Article 9 of the OECD Model Convention since the 1963 Model deals with the taxation of associated enterprises (parent and subsidiary company and companies under common control, especially of MNEs). Concerning the transactions between the related entities, the concept of "separate accounting" was discussed during the preparation of the Model Tax Conventions for the allocation of business income at the task force committee of the League of Nations back in the 1920s and 1930s.

The same provisions of this article are also incorporated in the United Nations Model Double Taxation between Developed and Developing Countries.

(2) Arms Length Principle

Paragraph 1 of this article provides that the taxation authorities of a Contracting State may for the purpose of calculating tax liabilities re-write the accounts of enterprises if as a result of the special relations between the enterprises the accounts do not show the true taxable profits arising in that State. Recalculation will be made to obtain the tax liabilities if the transaction between such enterprises have taken place on normal open market commercial terms (on an arm's length basis).

Where business is transacted between two enterprises, one of whom controls the other or both of whom are controlled by a third (e.g. supplies of goods and services between affliated companies, grants of loans between company and shareholder, grants of licenses between company and shareholder, etc.), the prices and terms according to which the transaction is undertaken may differ from those which would prevail in the case of transactions between unrelated parties (e.g. increased or reduced buying or selling prices, excessive or inadequate royalties, interest-free loans, etc.). When such prices charged between related parties are adjusted to arm's length prices for tax purposes, this is described as the application of the arm's length principle.

(3) Corresponding Adjustment

According to paragraph 2, which was added in 1977, of Article 9, when the re-writing of the transactions between associated enterprises in the situation envisaged in paragraph 1

may result in the reduced profit in the associated enterprise of State A, State B shall make an appropriate adjustment so as to relieve the double taxation.

It should be noted, however, that this corresponding or correlative adjustment is not automatically to be made in State B simply because the profits in State A have been increased. It may need mutual agreement by the competent authorities of both States under Article 25 of the Model Convention. It is to be further noted any tax authorities are not obliged to make a corresponding adjustment under the Model Convention. The paragraph does not specify the method by which an adjustment to is be made.

III. U. S.

1. Historical Background

The United States is most experienced and sophisticated in the area of transfer pricing. Transfer pricing regulation has been part of U. S. tax history. In 1917, to meet the increased budget expenditures for World War I, at the Internal Revenue Service (IRS) the Commissioner was authorized to allocate income and deduction among affiliated corporations and request them to file consolidated tax returns to prevent arbitrary shift of income and deductions among related taxpayers. In 1921, the provisions were so revised that the filing of consolidated tax returns is elective, but the IRS can reallocate items of gross income, allowances and deductions, etc. among related taxpayers. The 1928 Revenue Act added two rationales for reallocation of income: to prevent tax avoidance and to determine the true taxable income of the parties. In 1935, the U. S. Treasury published a regulation defining the standard the Commissioner was to use in his allocation of income as the arm's length standard: that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.(2)

In 1954, in the present section 482 of the Internal Revenue Code (IRC) was instituted. Its core provision in part reads as follows:

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

When first introduced, the provisions were designed for domestic transactions.(3) The corporation doing business through separate subsudiary instead of unincorporated branch may be able to avoid and even to evade taxation by shifting income through artificial business transactions among these parent and subsidiaries. Section 482 empowers the Commissioner under circumstances to adjust the accounts of related businesses in order to eliminate distortion in taxable income. It is to be noted that the Commissioner may not under section 482, entirely disallow a proper deduction or create income where none exists,

since he is authorized only to allocate or apportion such items.

At the beginning, section 482 was employed somewhat sparingly by the Commission.

For the purposes of filing consolidated tax returns, an "affiliated group" consists of one or more chains of "includible corporations" which are connected through stock ownership of 80% or more to a common parent. With certain exceptions the term "includible corporations" means any domestic corporations. Generally, foreign corporations do not qualify, except those organized under the laws of Canada or Mexico.

The filing of consolidated returns is optional. Affliated corporations may therefore choose between filing separate or consolidated returns depending on which procedure appears to offer the greater tax advantage. The principal advantages of electing the consolidated returns are; (1) losses incurred by one or more members of the affiliated group may be offset against income of other members; (2) intercorporate dividends may be received tax free from other members; and (3) gain is generally recognized on sales of property and other transaction from other members. Of course, there are some known disadvantages.

The Commissioner is not bound in every case to accept the results of consolidation.

The purpose of section 482 is to place a controlled (the term "controlled" is not defined in section 482) taxpayer on a parity with an uncontrolled taxpayer by determing according to the standards of an uncontrolled taxpayer (on an arm's length basis) the true net income derived from the property of and business operated by the controlled taxpayer.

2. Traditional Transaction Methods

Until the early 1960s, section 482 was mainly applied to domestic transactions. However, with a view to coping with the expanded cross-border activities of MNEs, in 1968, the Treasury Department issued the detailed transfer pricing regulations on sales of tangible property, loans or advances. Performance of services, use of tangible property, and use or transfer of intangible property. (Internal Revenue Regulations 1482-1, -2)

The regulations set forth the following three methods to evaluate the arm's length price to be charged to transuctions between the affiliated enterprises. Later, these three methods have been accepted worldwide and incorporated into the OECD Guidelines and transfer pricing regulations of Japan and other most major countries.

(i) Comparable Uncontrolled Price (CUP) Method

The comparable uncontrolled price (CUP) method evaluates whether the amount charged in a controlled transaction in arm's length by reference to the amount charged in a comparable uncontrolled transaction. The CUP method offers the most direct and reliable way of determining an arm's length price if there are no differences or only minor differences between the controlled transaction under scrutiny and a comparable uncontrolled transaction. The transfer price is set by reference to the sales of similar goods between a buyer and a seller who are not affiliated enterprises while other circumstances are the same or similar.

(ii) Resale Price (RP) Method

The resale price (RP) method evaluates whether the amount charged in a controlled transaction is arm's length by reference to the gross profit margin realized in comparable uncontrolled transactions. If goods are purchased from a related person and sold to an unrelated party, the purchase price may be adjusted to the resale price minus a reasonable profits, reflecting the function and share of the risk of the reseller.

The arm's length transfer price under RP method is determined by subtracting the "appropriate gross profit" from the applicable resale price for the property involved in the controlled transaction under review. The "appropriate gross profit" is then computed by multiplying the applicable resale price by the gross profit margin (expressed as a percentage of total revenue derived from sales) earned in comparable uncontrolled transactions.

(iii) Cost Plus (CP) Method

The cost plus (CP) method evaluates whether the amount charged in a controlled transaction is arm's length by reference to the gross profit markup realized in comparable uncontrolled transactions. The CP method is ordinarily used in cases involving the manufacture, assembly, or other production of goods that are sold to related parties.

The CP method measures an arm's length price by adding the "appropriate gross profit" to the controlled taxpayer's costs of producing the property involved in the controlled transaction. The "appropriate gross profit" is computed by multiplying the controlled taxpayer's cost of producing the transferred property by the gross profit markup expressed as a percentage of cost earned in comparable uncontrolled transactions. Whenever possible, the gross profit markup should be derived from comparable uncontrolled sales made by the taxpayer involved in the controlled sale.

(iv) Other Methods

The methods mentioned in (i) to (iii) above are to be applied in their stated order. However, only if it is established by evidence that none of the three methods can reasonably be applied under the facts and circumstances. The regulations allow any other appropriate *other or fourth method,* such as a profit split method, rate of return on investment method, ultimate sales method, or functional method.

The traditional three methods are criticized for two reasons: one is negligence of the economy of scale and the other is the difficulties in ascertaining a specific price for the strictly "comparable" transaction. On the other hand, the fourth method is relatively free of these limitations. The fourth method, which is usualy the profit split method or the rate of return method, is generally based on profit rather than price in the transaction.[4] In fact, the most popular fourth method in the U. S. tax court has been the profit split, in which total profits of the related parties are divided among the individual members according to some formula.

3. Evolution of Regulations

(1) 1986 Tax Reform Act

In order to close the tax loophole of MNEs transferring intangible property, the Tax Reform Act of 1986 amended the IRC by adding a second sentence to section 482 and to section 367(d) (so-called super-royalty), requiring that payments to related parties for royalties and license fees and other licenced or transferred intangibles be "commensurate with income" (CWI) attributable to these intangibles. Congress then mandated the U. S. Treasury to investigate ways to incorporate the CWI standard into section 482.

(2) White Paper

In 1988, the Treasury Department and IRS published *A Study of Intracorporate Pricing* (the White Paper) which suggests, in valuing intangibles according to CWI, where exact or inexact comparables are unavailable, to use income approach. The income approach includes two methods: the basic arm's length return method (BALRM) and BALRM with a profit split. Both income methods use a functional analysis to allocate income between the two parties based on their shares of intangible assets measured in terms of industry-average rates of return. Income is then split between the parties according to their relative economic contributions.(5)

In those days, there were several studies to prove that foreign corporations were unfairly avoiding U. S. income tax by using transfer pricing practices. Whether these assertions were true or not, the IRS seemed to apply the anti-transfer-pricing legislation quite strictly.(6)

(3) The 1992 Proposed Regulations

In January 1992, the U. S. Treasury published the draft regulations which attempts to integrate the congressional directive on the CWI standard into the 482 regulations. Major features of the proposals are as follows:

The phrase "sound business judgement on the basis of reasonable levels of experience" is added. In interpreting this statement, closely related transfers of tangible and intangible property are to be considered together.

Another major change is a new definition of the intangible in accordance with CWI. Thus, the IRS can make periodic (annual) adjustments to the arm's length consideration to ensure that the royalty is commensurate with the income attributable to the intangible.

The proposals also introduces a hierarchy of three new methods for pricing intangibles: the matching transaction method (MTM), the comparable adjustable transaction method (CATM), and the comparable profit interval (CPI), which is later referred to as the comparable profits method (CPM).

The proposed CPI applies functional analysis. CPI was to be used as a check on the validity of taxpayers' pricing methods determined pursuant to the analyses required under the other applicable sections of the proporsed regulations.

The CPM computes an arm's length price by reference to measures of profitability of

uncontrolled taxpayers engaged in similar business activities with uncontrolled taxpayers in similar circumstances. The method does not apply when the tested party uses valuable, nonroutine intangibles. The regulations indicate that the CPM will provide an accurate measure of an arm's length price. This method can be applied in virtually all situations.

The CPM has certain comparability requirements. Adjustments must be made for material differences in the functions performed, risks assumed, and any other factors that affect profitability. The CPM can normally be applied to verify the results of other methods or as a stand-alone separate method.(7)

(4) 1993 Temporary Regulation

Taking into consideration the comments on the 1992 proposals from OECD various governments, and businesses, the U. S. Treasury issued in January 1993 the Temporary Regulations which came into force as from April 1998 for three years.

For the purposes of determining the arm's length prices, there is no fixed hierarchy among the traditional and other methods, but Regulations require the use of the "best" method or more precisely the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result (the Best-Method Rule). The CPI introduced in the 1992 proposals lost its priority to the traditional methods because it is not recognized internationally.

For transfers of tangibles, there are five methods: CUP (formally defined as a product comparable method) and RP and CP (both defined as functional comparable methods), other methods and CPM. In certain cases, a profit split method may also be used. CPM can only be used for pricing tangibles in certain cases.

For transfer of intangible property through a license or royalty, the temporary regulations require the taxpayer to distinguish between routine and nonroutine intangibles. Where neither party to the transaction owns nonroutine intangibles, three methods are outlined for pricing routine intangibles: the comparable uncontrolled transaction method (CUT), the comparable profits method (CPM), and other methods. The transfer is normally in the form of a royalty payment that is subject to annual adjustment to ensure that the payment is commensurate with earned income.

Where both parties to the transaction own valuable nonroutine intangibles, the proposals allow firms to use the profit split method only if it provides the most accurate measure of the arm's length result. There are four applicable profit split rules: (i) the residual allocation rule, (ii) the capital employed allocation rule, (iii) the comparable profit split rule and (iv) other rule.(8)

A safe harbor is provided for a small taxpayer. The safe harbor applied only if either the U. S. party or the foreign counter party to a cross-border controlled transaction had less than $10 million in gross receipts for the year.(9)

(5) 1994 Treasury Regulations

In view of the comments from the Committee on Fiscal Affairs of the OECD and foreign businesses, some changes were made to the Temporary Regulations of 1993 in July 1994.

Any changes were intended to clarify and refine the temporary rules without fundamentally altering the basic policies.

The best-method rule was kept and broadened. The list of pricing methods for tangibles now includes six methods: CUP, RP, CP, CPM, profit split, and unspecified method. The method chosen must follow the best-method rule: the more direct and reliable measure of an arm's length result.

The regulations prescribe two methods for pricing intangibles. The first method involves the licensing or sale of the intangible where a price (royalty) must be determined. Under section 482–F94, both lump-sum and per-unit royalty payments are subject to periodic adjustment in order to satisfy the commensurate with income (CWI) standard. The second method is a cost-sharing arrangement in which costs and benefits are allocated among the participants.(10)

The regulations list four methods for pricing licensing or sale of intangibles: CUT, CPM, profit split, and unspecified methods. There is no hierarchy of methods; again, the best-method rule must be employed to choose the method. It is to be noted that the CPM is considered to be the last resort for determining the arm's length price.

IV. OECD Guidelines

1. Overview

In connection with the international taxation principles set forth in the Model Tax Convention, the Committee on Fiscal Affairs has long been interested in the problems of transfer pricing. The OECD's involvement with taxation of MNEs goes back to the first guidelines it issued in 1976. The most recent is the ongoing work on new guidelines on transfer pricing. In 1976, the OECD countries adopted a *Declaration on International Investment and Multinational Enterprises,* to which appended *Guidelines for Multinational Enterprises.* The purpose of the OECD guidelines is to inform MNEs about matters host countries see sensitive, and to encourage MNEs to behave in appropriate ways vis-à-vis host countries. In terms of transfer pricing, the 1976 guidelines direct MNEs to provide information necessary to determine taxes correctly and to refrain from using transfer prices that do not conform to an arm's length standard.

In 1979, the Committee published a report entitled *Transfer Pricing and Multinational Enterprises* (the "1979 Report") which elaborated the arm's length principle as set out in Article 9 of the Model. Other reports are *Transfer Pricing and Multinational Enterprises—Three Taxation Issues (1984)* (the "1984 Report"), and *Thin Capitalization* (the "1987 Report"). These Guidelines also draw upon the discussion undertaken by the OECD on the proposed transfer pricing regulations in the U. S. [see the OECD Report *Tax Aspects of Transfer Pricing within Multinational Enterprises: The United States Proposed Regulations* (1993)].

In the 1975 Report, the OECD revised its Guidelines on transfer pricing. To determine the arm's length price, in addition to the traditional three methods, accepted is a fourth method, which includes (i) the comparable profits method, (ii) profit allocation method,

(iii) return on the capital invested method and expected yield on the capital method. Concerning the other method, the Report adds most member countries consider that since the comparable profits method is still in the workup stage, it should be regarded as a method of last resort and should not be given priority over transaction-based methods or other methods, including the profit split approach, in cases in which these methods can reasonably be applied on the basis of available information.

The aim of the revision of the Guidelines was to re-establish the international consensus in the field of transfer pricing adjustments: the U. S. became a member of the drafting committee. The Report recommends that its members adopt these U. S. methods not just for tangible but also for transaction in services and intangibles.

The 1984 Report supplements the 1979 Report in that it considered the relief of the double taxation which may be suffered by associated enterprises as a result of adjustments for the arm's length price. The Report provides a in-depth study of the issues of corresponding adjustments. It also logically deals with the problem of the mutual agreement procedure.

Incidentally, in the U. S., California and some other states have been employing the unitary method for allocating MNE income among taxing jurisdictions. In spite of this widespread use, the Treasury proposal does not accept the global formulary apportionment (GFA) method, which is equivalent of the unitary method, as the arm's length standard.

2. 1995 Guidelines

(1) Arm's Length Principle

In July 1995, the Committee on Fiscal Affairs published the *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration.* The draft of the new Guidelines was earlier published a year ago. At the same time, the U. S. Treasury made its final regulations public. Both are the results of negotiations and compromises among the member countries. All the member countries of OECD continue to endorse the arm's length principle, the U. S. set a limit of its profit-oriented method, whereas the OECD guidelines authorized the use of the profit-oriented method in certain conditions.[11]

The OECD has been aware of the comparable profits methods (CPMs) for many years but has restricted them. The best-method rule was established as a reaction to critisism, in particular by the OECD, of the U. S. Treasury Proposed Regulations' elevation of the comparable profit interval calculation to a mandatory method.[12]

When the three traditional transaction methods i.e., CUP, RP, and CP, cannot be reliably applied to satisfy the arm's length principle, "other methods" are recognized as follows:

(2) Transactional Profit Methods

A transactional profit method examines the profits that arise from *particular* controlled transactions.

(i) Profit Split Method (PS)

The profit split (PS) method splits the profits between the associated enterprises on an

economically valid basis that approximate the division of profits that would have been anticipated and reflected in an agreement made at arm's length. The combined profit may be the total profit from the transactions or a residual profit intended to represent the profit that cannot readily be assigned to one of the parties. The functional analysis is an analysis of the functions performed (taking into account assets used and risks assumed) by each enterprise. Thus, there may be contribution analysis and residual analysis.

(ii) Transactional Net Margin Method (TNM)

The transactional net margin (TNM) method examines the net profit margin relative to an appropriate base (e.g. costs, sales, or assets) that a taxpayer realizes from a controlled transaction (or transactions that are appropriate to aggregate under the arm's length principle). Thus, a transactional net margin method operates in a manner similar to the cost plus and resale price methods. The net margin of the taxpayer from the controlled transaction should ideally be established by reference to the net margin that the same taxpayer earns in comparable uncontrolled transactions. Where this is not possible, the net margin that would have been earned in comparable transactions by an independent enterprise may serve as a guide.

(iii) Global Formulary Apportionment Method (GAF)

As mentioned earlier, the global formulary apportionment (GAF) method (unitary method) is rejected as an alternative to the arm's length principle as a means of determining the proper level of profits across national taxing jurisdiction.

3. Rules for Intangible Property

The OECD issued a separate chapter (Chapter VI) of its *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration* in March 1996 for special consideration. The Guidelines include within the term intangible property rights to use industrial assets (e.g., patents, trademark, trade names, designs and models), literary and artistic rights, and other intellectual property (e.g., know-how and trade secrets). Such other intangible assets cannot be registered for protection but may have considerable value as "business rights" associated with commercial or business activities.

The Guidelines distinguish between marketing intangibles, such as trademarks and trade names, and other commercial intangibles that is referred to as trade intangibles. Trade intangibles are often created through risky and costly research and development. But not all research and development and marketing expenditures will result in the production of intangible property.[13]

The uniqueness of many intangible assets makes it difficult to establish transfer prices based on comparable uncontrolled transactions. Tax administrations are advised to take special account of whether an intangible asset has the same value and usefulness in the hands of the controlled licenses as it would have in the hands of an independent licenses. The Guidelines enumerate some special factors to be identified relevant to the transfer pricing of intangibles.

The CUP method may be employed when comparable uncontrolled transactions are identified; the RP method may be used when the intangible is sublicensed; and the profit split method may be acceptable in the case of highly valuable intangibles for which no comparable transactions can be identified.

The Guidelines have a separate chapter (Chapter VII) on special considerations for intra-group services. It points out that the transfer pricing of services is often complicated because, in many cases of MNEs, the services are rendered in connection with transfers of tangible and intangible property. When the service is performed solely because of the recipients' ownership interests, no charge is ordinarily required (shareholder activity). Shareholder activity is distinguished from stewardship activity, such as planning and technical advice, which may commercially benefit associated enterprises.

The Guidelines refer to the practice of charging for specific intra-group services as the direct-charge method and favors such arrangements when they are feasible. Otherwise, indirect-charge methods may be necessary for allocation and apportionment. When determining an arm's length charge for intra-group services, in principle, the CUP method or CP method may be used, with qualifications wherever necessary.[14]

V. Advance Pricing Agreements

1. OECD Guidelines

An advance price agreement (APA) is an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g., method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time. An advance pricing arrangement may be unilateral involving one tax administration and a taxpayer or multilateral involving the agreement of two or more tax administrations.

The OECD Guidelines discuss the use of unilateral and multilateral APAs. Advantages of APAs are: they can assist taxpayers by eliminating uncertainty: they may prevent costly and time-consuming examinations and litigation for taxpayers and tax administration; and bilateral and multilateral APAs substantially reduce or eliminate the juridical or economic double or non taxation since the all the relevant countries participate.

As disadvantages relating to APAs, especially unilateral APAs may present significant problems for tax administrations and taxpayers alike. Unlike bilateral or multilateral APAs the use of unilateral APAs may not lead to an increased level of certainty for the taxpayer involved and a reduction in economic or juridical double taxation for the MNE group. Another problem with a unilateral APA is the issue of corresponding adjustments. In a unilateral APA, a foreign competent authority is not to allow corresponding adjustments with enough flexbility.

At present, only a few OECD member countries have experience with APAs. Those countries which do have some experience seem to be satisfied, so that it can be expected that under the appropriate circumstances the experience with APAs will continue to expand. The Guidelines conclude: while it is too early to make a final recommendation

whether the expansion of such programmes should be encouraged, it seems likely that they will aid in resolving transferring pricing disputes. The Committee on Fiscal Affairs intends to monitor carefully any expanded use of APAs and to promote greater consistency in practice among those countries that choose to use them.(15)

2. The United States

Advance pricing agreements (APAs) enable taxpayers and the Internal Revenue Service (IRS) to agree in advance to a specific methodology for transfer pricing between a U. S. company and a related foreign company. This APA procedure was instituted in 1991. Initially, most international taxpayers were slow to seek such agreements with the IRS. But the issuance of the new Regulations seems to have increased the applications of APAs.

APA is a contract between the taxpayer and the office of the Associate Chief Council (International). APA can be unilateral between the taxpayer and the IRS or bilateral between the U. S. company, its foreign affiliate, the IRS, and the foreign government. Macquiladoras on the US-Mexican border most often have unilateral APAs.

The APA procedure requires the taxpayer to inform the IRS as to application of the transfer pricing methodology (TPM) actually selected as part of the advance pricing process. This information and explanation is called an "Annual Report". Failure to file the report can terminate the APA.

Under Revenue Procedure 91–22, the taxpayers and the IRS together can select the initial term for the APA. This term should be proposed by the taxpayer as part of the APA request and is subject to IRS approval. The initial term can extend for more than one year. The user fees imposed on the taxpayer were initially $5,000 for consolidated gross income of less than $100 million, $15,000 for the same kind of income of $100 million or more but less than $1 billion, and $25,000 for the same kind of income of $1 billion or more.(16)

According to the director of the APA program of the IRS, for calendar year 2000, the IRS received 92 new APA applications, approximately two-thirds of which involved bilateral APAs. The IRS completed 63 APAs in 2000 (up slightly from 60 completed in 1999), including 36 negotiating positions for bilateral APAs (mostly with Canada, Japan, Mexico, and the United Kingdom). The program has a current inventory of 212 pending applications (166 bilateral and 46 unilateral). Approximately 20 per cent of all APA applications involve taxpayers in California, the second highest concentration in the country. A full 25 per cent of APAs come out of New York City.(17)

3. Japan

Japan introduced an APA as early as in April 1987. Because of the complexity of the problems involved in the transfer pricing taxation instituted in July 1986, the prime concern of the National Tax Administration (NTA) was consistency of implementation. From this viewpoint, the NTA started a pre-confirmation system (PCS), a Japanese version of the APA, where a taxpayer can ask the NTA for confirmation of prospective adoption of transfer pricing methodology for certain future period, so that predictable factors may be provided for the taxpayer.(18)

Although the PCS applies to all the transactions with foreign affiliated persons, a taxpayer may request the PCS only for those whose arm's length prices are uncertain to them. The PCS is a domestic administration procedure, which has no effect on foreign taxation. However, in practice, by virtue of the tax treaties which Japan has concluded with most countries these days, the tax authorities will negotiate with foreign competent authorities under the provision of mutual agreement procedure for corresponding adjustment, if necessary.

VI. Transfer Pricing Taxation in Japan

1. Outline

As the globalization of business transactions has proceeded, the possibility of the shift of income abroad through transactions with foreign-affiliated persons has also grown. In order to deal with this transfer pricing problem and to realize fair and legitimate taxation in the field of international transaction, transfer pricing taxation provisions were introduced in 1986. (Special Taxation Measures Law, Art. 66-4).

The basic structure of these provisions, which were formally called 'Special Provisions for the Taxation of Transactions with Foreign-Affiliated Persons' is as follows:

(1) In the event that a corporation has conducted the sale or purchase of assets, provision of services, or other transactions with foreign-affiliated persons, if the proceed of such transactions is not at an arm's length price, and if this results in a reduction of the income of the corporation, the transactions shall be deemed to have been carried out at an arm's length price for the purpose of corporate income taxation.

In the above,

(a) foreign-affiliated persons refer to foreign corporations that have one of the following special relationships with said corporation:

(i) A relationship in which either of two corporations owns, directly or indirectly, a number of shares or an amount of contributed capital comprising 50 per cent or more of the total number of issued shares or total amount of contributed capital of the other corporation.

(ii) A relationship in which a number of shares or an amount of contributed capital comprising 50 per sent or more of the total number of issued shares or total amount of contributed capital of two corporations are owned, directly or indirectly, by the same person.

(iii) A relationship in which either of two corporations can, in substance, determine all or a part of the business policies of the other corporation.

(b) The arm's length price shall mean the amount that is computed in accordance with a method listed in the following paragraphs, depending upon the type of transaction in question listed in the following paragraphs:

(i) Sale or purchase of inventory assets: the following methods (the method listed in D can be employed only in cases where the methods listed in A through C cannot be used):

The methods listed in A through C are transitional ones: A is the CUP method, B, the RP method and C, the CP method.

D A method similar to the methods listed in A through C above, and other methods prescribed by Cabinet Order.

(ii) Transactions other than those listed in the preceding paragraph: The methods listed below (the methods listed in B can be employed only in cases where the methods listed in A cannot be used.):

A. A method that is equivalent to a method listed in A through C in the preceding paragraph

B. A method that is equivalent to a method listed in D of the preceding paragraph(19)

(2) The difference between the actual consideration amount in the transaction that is subject to the transfer pricing provisions and the arm's length price prescribed in (1) pertaining to the transaction shall not be deductible in computing the amount of taxable income for the business year for the corporation.

(3) In the event that tax authorities have requested that the corporation provide records or books or copies thereof, as are recognised to be necessary for computing the arm's length price in connection with the transactions for the business year, if the corporation does not provide those materials without delay, the District Director shall be able to correct or determine the amount of income or losses for said business year for the corporation by presuming the arm's length price to be that amount that is computed in accordance with methods listed above in (1) (b) (i) B and C or such similar methods in (1) (b) (ii) A as these, using as the basis the gross margin ratio of the business activity of a corporation engaging in a business activity that is of the same type as the business activity involving the transaction of the corporation and where the scale and other details of the business activity are similar.

(4) When it is mecessary in connection with an audit concerning transactions between a corporation and a foreign-affiliated person of said corporation, tax authorities shall be able to request from the corporation the disclosure or production of records or books or copies thereof, over which the foreign-affiliated person maintains custody. In this case, the corporation shall endeavor to obtain the records and books or copies thereof.

(5) When a corporation does not provide records, books, or copies thereof promptly and if it is necessary in order to compute the arm's length price in connection with the transactions between said corporation and a foreign-affiliated person of said corporation, tax authorities shall be able to interrogate or inspect the corporation in the same kind of business with said corporation.

(6) A corporation shall, in the event it has conducted transactions with a foreign-affiliated person of the corporation during the business year, attach to its final tax return for the business year a document that contains the name and location of the head or main office of the foreign-affiliated person and other items prescribed by Ministerial Order of the Ministry of Finance.

(7) Adjustment with respect to transfer pricing taxation can be made by tax authorities for six years (generally three years) after the deadline for filing the final tax return.

2. Correlative Adjustment

In the case where a transaction takes place between an enterprise in country A and its related enterprise in country B, the application of transfer pricing taxation to the related enterprise in country B and a resultant upward revision of its income based on the arm's length principle may give rise to double taxation on those two related enterprises, taken as a single economic entity, so long as the related enterprise is liable for tax on an amount of income that has already been taxed in the hands of the enterprise in country A.

A downward adjustment of income of the enterprise in country A to elminate such double taxation is generally called "correlative adjustment." Based on the tax treaty with respect to the consideration amount on which the taxable income should be assessed. Japan has a policy of making such correlative adjustments to its enterprises when a mutual agreement with the taxing authority of the country where the related enterprise is located is reached.

However, how the adjustments is made is not fully provided for in tax treaties. Therefore, along with the introduction of transfer pricing taxation provisions, a provision concerning correlative adjustment is introduced as article 7 in the Law Concerning Special Rules for Income Tax Law Regarding the Implementation of Tax Treaties.

According to this article, correlative adjustment in Japan is made when the following conditions are satisfied:

(1) The taxable income of a resident of one of the Contracting States other than Japan (country A, hereafter) has been determined pursuant to the provisions of the laws of country A, taking as the basis the amount of consideration differing from the actual amount in a transaction between a resident of Japan and said resident of Country A.

(2) The Finance Minister comes to an agreement based on the provisions of the tax treaty with the competent authority of Country A with respect to the amount of consideration with which taxable income will be determined.

(3) The resident in Japan requests correction of his or her taxable income, while accepting the above-mentioned agreement between the competent authorities.[20]

3. Revised Commissioner's Directive

On September 8, 2000, the NTA issued a Commissioner's Directive on "Interpretation of Special Taxation Measures Law (in relation to Corporation Tax Law), Chapter 12 Special Taxation Measures related to Transaction between Corporation and Foreign-Related Persons."

The following is the outline of the revised Commissioner's Directive:

(1) Comparable Uncontrolled Transactions

In the case of CUP, because prices *per se* are compared, the similarility of inventories is important. In contrast, in the cases of RP and CP under which the profit ratio is compared,

such similarility does not matter so much.

Therefore, even though the inventories partly differ in terms of their characterics, mechanism, functions, and the like, they may be treated as those of the same or similar kind, provided such differences are neglible enough not materially affect the calculation of the price under the CUP or the ordinary profit ratio under RP and CP.

Twelve factors to be considered to select comparable uncontrolled transactions, ranging from (1) kind of inventory, contents of service, etc. to (12) market forces, are enumerated.

(2) Transaction Unit

In principle, arm's length price is calculated with respect to each transaction. However, in the following cases, for example, the transactions may be treated as a single transaction for calculation purposes: (1) In a case where the pricing is determined by taking account of other transaction within the same product or the same product segmentation; and (2) in a case where the sales transaction of parts for manufacturing and licensing arrangements of know-how for the manufacturing are made as a package deal. It may be considered reasonable that these transactions are employed as a unit for the calculation of arm's length price.

(3) Application of the Profit Split Method

The profit split method which was hitherto employed as "Other methods provided by the Cabinet Order" has now been expressly provided for in the Commissioner's Directives. Both the comparable profit split method and residual profit split method are explicitly provided for. The split factors include the personnel costs and other expenses and the amount of equity investment.

(4) Application of Arm's Length Price Calculation Methods to Transactions Other Than Sale of Inventories

The term "same method" means as set forth in this section means a method whereby, as for the transactions other than sale of inventories, such as lease of tangible property in general, lease of machinery and equipment to manufactures in particular, loans, service contracts, licensing or transfer intangible property, etc., the arm's length prices will be determined according to the respective types of transactions, and pursuant to the corresponding method(s) of calculation.

It is to be noted that the treatment of licensing of intangible property is characterized by the possibility of application of the CP method.

(5) Adjustment for Taxable Income

A differece as may arise either in a case where the payment to be received by a corporation from a foreign-related person is more than the arm's length price or in a reverse case is not deducted from income as stated in the tax return and the like.

(6) Treatment of Foreign-Transferred Income

The difference between such an amount concerning a foreign-related transaction and the arm's length price with respect to the foreign-related transaction is not treated as undistributed profit, irrespective of whether a refund, in whole or in part, may be made by the foreign-related person. Previously, such difference was treated "in principle" as undistributed profit.

Notes

(1) OECD Committee on Fiscal Affairs. *Model Tax Convention on Income and on Capital,* September 1992, Condensed Version, 1993, p. 10.
(2) Lorraine Eden, *Taxing Multinationals: Transfer Pricing and Corporate Income Taxation in North America,* University of Toronto Press, 1998, pp. 383–390 & 448–453.
(3) Marvin A. Christein, Langdon Day, and Elizabeth A. Owens and Stanley S. Surrey (Correspondent), *United States,* World Tax Series. Harvard University Press, 1963, pp. 428–434.
(4) Minoru Nakazato "Transfer Pricing: the Japanese Perspective", pp. 144–145 and Yasuyuki Kawabata "International Transfer-Pricing Disputes: Some Comments on the Main Reports, p. 157 in Klaus Vogel, ed. *Interpretation of Tax Law and Treaties and Transfer Pricing in Japan and Germany,* Series on International Taxation, Kluwer Law International, 1998.
(5) Eden, *op cit.,* pp. 413–419.
(6) Nakazato, Vogel, ed., *op cit.,* p. 144.
(7) Eden, *op cit.,* pp. 419–424 および Robert Feinschreiber, "General Principles and Guidelines", in Robert Feinschreiber, ed., *Transfer Pricing Handbook,* Second Edition, Vol. 1, John Wiley & Sons, 1998, p. 7–10.
(8) Eden, op. cit., pp. 419–425.
(9) Stanley C. Ruchelman "Underlying Policy of the Regulations", Rober Feinschreiber, ed., *op cit.,* Vol. I, p. 3–19.
(10) Eden, *op cit.,* pp. 433–444.
(11) Nakazato, Vogel, ed., *op cit.,* p. 146.
(12) Charles W. Bee, Jr., "The Best Method Rule", Robert Feinschreiber, ed., *op cit.,* Vol. I, pp. 7–14.
(13) Deloris R. Wright, "OECD Rules for Intangible Property", Robert Feinschreiber, ed., *op cit.,* Vol. II, pp. 25–2–3.
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(14) William W. Chip, *op cit.,* Vol. II, p. 20–20.
(15) OECD, *Transfer Pricing Guidelines,* July 1995 "F. Advance Pricing Arrangements", 4.161.
(16) Robert Feinschreiber, "Using Advance Pricing Agreements for Transfer Pricing", Robert Feinschreiber, ed., *op. cit.,* Vol. 11, 1998, pp. 51–1–28.
(17) Robert Goulder and Cindy Heyd, "U. S. IRS Official Clarifies Averaging Rule for Advance Pricing Agreements" in *Tax Notes International,* Tax Analysts, 2 February 2001, pp. 596–597.
(18) Planning Division, National Tax Administration, *An Outline of Japanese Tax Administration 1999,* 2000, p. 79.
(19) Tax Bureau, Ministry of Finance, *An Outline of Japanese Taxes 2000,* Printing Bureau, Ministry of Finance, 2001, pp. 117–118.
(20) Tax Bureau, Ministry of Finance, *op cit.,* pp. 118–120.

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