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978-1-107-02659-9 - Resolving Transfer Pricing Disputes: A Global Analysis

Edited by Eduardo Baistrocchi and Ian Roxan

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## PART I

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### The context of transfer pricing disputes

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## 1

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## Introduction

IAN ROXAN

### 1.1 A transfer pricing dispute

Pharmaceutical companies need to have a continuing supply of good research developments to maintain their future profits. Their ability to profit from this research depends on exploiting patents based on the results of the research, but patents expire after a number of years, allowing other companies to compete with the developer, and some drugs are simply superseded by later developments.

In the 1960s, one major US pharmaceutical company had developed a number of valuable patents. The company naturally wanted to limit the amount of tax it would have to pay to exploit these patents. So in 1965 it established a subsidiary in Puerto Rico (a United States' dependency). At the time, US tax law permitted the transfer of patents to a Puerto Rican subsidiary tax free, and Puerto Rico offered tax haven treatment on the returns from exploiting the patents. The US parent therefore transferred the patents to the subsidiary without receiving any payment or royalties in return. The subsidiary relied on the patents in manufacturing the drugs they covered, and sold the products to the US parent.

Not unsurprisingly, the US Internal Revenue Service (IRS) was not satisfied with this, and reallocated all of the income of the subsidiary from the patents to the parent, on the basis that the subsidiary was only a contract manufacturer and that it should not be treated as the true owner of the patents.<sup>1</sup>

Here we have a striking example of a transfer pricing dispute. The taxpayer and the tax authority take different views of the basis on which related companies should deal with each other. The subject of this book is how such disputes are actually resolved around the world.

<sup>1</sup> *Eli Lilly & Co. v. Commissioner*, 84 T.C. 996 (1985), aff'd in part, rev'd in part, 856 F.2d 855 (7th Cir. 1988), discussed in Chapter 3, 'United States'.

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Transfer pricing is the most challenging issue in international taxation for multinational enterprises and tax administrators at the beginning of the twenty-first century. It is also a fundamental problem for tax policy-makers. After the publication of the first major revision to the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* since they were first issued in 1995,<sup>2</sup> this book seeks to present new and novel insights into the resolution of transfer pricing disputes. These insights will be immediately useful to experts working on transfer pricing issues, and will also greatly interest anyone studying transfer pricing in a broader context.

## 1.2 Objective and scope: the range of transfer pricing disputes

The objective of the book is to describe and analyse how the law on transfer pricing operates in practice by explaining how transfer pricing issues are dealt with in disputes between taxpayers and the tax administration. The book looks at how the resolution of transfer pricing disputes has developed since transfer pricing rules were first introduced to income tax systems, tracing their origins back to the start of the modern income tax in the United Kingdom in 1842. It describes how the resolution of transfer pricing disputes has responded to and helped to develop the arm's length principle (ALP) that forms the basis of the OECD Guidelines, used to a greater or lesser degree worldwide. And it builds on this analysis to explain how transfer pricing disputes are being resolved around the world today.

In the *Eli Lilly* case, described above, the dispute was decided in the US courts, first in the specialised Tax Court, and then in the Seventh Circuit of the US Courts of Appeals. This was a case where only one jurisdiction involved imposed tax on the transactions. Very often two, or even more countries, seek to impose tax, leaving the taxpayer facing double taxation, rather than the successful tax planning it may have sought. Today, the mutual agreement procedure (MAP) available under most double tax conventions (DTCs) is extensively used by many countries to help resolve transfer pricing disputes through negotiation between the tax authorities involved. Unfortunately, negotiation is not always enough, but the alternative of arbitration under the MAP or a separate treaty, as in the case of the European Union Arbitration

<sup>2</sup> *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD Publishing, 2010) ('OECD Guidelines').

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Convention,<sup>3</sup> has started to become more available, and it looks likely that it will become a major element in resolving transfer pricing disputes in the future.

Taxpayers now also often have the option of trying to resolve transfer pricing disputes before they develop by entering into advance pricing agreements (APAs) with one or more tax authorities. An APA can be a valuable alternative, at least when two (or more) tax authorities have agreed to the pricing regime, but it can require much time and documentation to settle the APA, and future events may make it less applicable than the parties expected.

Finally, even complex transfer pricing disputes are often settled by negotiation between the taxpayer and the tax authority. Indeed, this has often been the predominant method of settling transfer pricing disputes.

However, the dominance of different methods of resolution of disputes has changed over time, and still differs between countries. The book seeks to explain these differences and to enable practitioners to take advantage of the most effective ways of dealing with transfer pricing issues in a range of twenty countries around the world. This includes both developed and developing countries from all five continents.

### 1.3 Span of countries and disputes covered

The book provides details of transfer pricing explained through dispute resolution in twenty countries, using a representative selection of jurisdictions in transfer pricing on all continents. It covers over 180 transfer pricing disputes from representative countries from: (i) North America and Europe,<sup>4</sup> (ii) the Asia–Pacific region,<sup>5</sup> (iii) the BRIC countries,<sup>6</sup> and (iv) South America, Middle East and Africa.<sup>7</sup>

The countries included extend from developed countries with a long history of transfer pricing rules, such as Germany, Japan, the United Kingdom and the United States, to emerging countries that are in the forefront of transfer pricing developments, such as Brazil, Russia, India and China.

<sup>3</sup> See Chapter 5 ‘European Union’.

<sup>4</sup> Canada, Germany, Spain, United Kingdom and United States.

<sup>5</sup> Australia, Japan, Korea and Singapore.

<sup>6</sup> Brazil, Russia, India and China. The BRIC countries are analysed together here to identify any common trends in transfer pricing dispute resolution among these leading emerging countries.

<sup>7</sup> Argentina, Chile, Israel, Kenya, Namibia, South Africa and Tanzania.

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### 1.4 Approach and outline

In describing how the law actually operates in each country, the book uses the OECD Guidelines as a baseline. For countries where there has already been official reaction to the 2010 revision of the OECD Guidelines, the practical implications of the revision are also examined.

In order to understand current transfer pricing practice, it is important to examine it in perspective and see how it has developed over time. The analysis of what is happening and what happened in the past – understanding historical approaches to transfer pricing law and tax dispute resolution – is often very useful to understanding what happens today. This view is reflected throughout the book.

The book is organised in three main sections. The first section (Chapters 1 and 2) outlines the root of the transfer pricing problem. It includes an analysis of the central role that the ALP has played and continues to play in resolving transfer pricing disputes, as well as how the meaning and role of the ALP has developed over time.

The second section (Chapters 3 to 20) discusses the practice of transfer pricing dispute resolution in the twenty countries as it has developed since the introduction of corporate income tax in each tax system. All the country chapters broadly share the same general structure. They have been written by local experts – tax practitioners, tax scholars and tax administrators. The List of Contributors gives full details of each of the contributing authors.

The country authors started from seven questions drafted by Eduardo Baistrocchi regarding transfer pricing dispute resolution in the country at different points in time. The questions are listed at the end of this chapter. The final section of each country chapter gives the answers to the questionnaire in order to show further how the processes of transfer pricing dispute resolution have developed in the country.

All of the contributors participated in a global conference at the London School of Economics to discuss their initial findings. The country reporters had the opportunity to present their chapters and to obtain feedback from other country reporters and regional discussants, including other participants and Eric Zolt of UCLA.

The third section of the book (Chapters 21 and 22) offers a broader analysis of the issues. Chapter 21 presents the cross-country evolutionary path of transfer pricing dispute resolution since the United Kingdom introduced income tax in 1799. It shows that the ALP is a US invention with German origins. It also shows that central driving forces for the

emergence and evolution of the ALP have been two technological innovations related to globalisation: the emergence of multinational enterprises (MNEs) after the first globalisation boom (1820–1914) and the emergence of international trade in intangibles as of the second globalisation boom (1945–present). Chapter 22 considers the current state of how transfer pricing disputes are resolved and the present and future challenges in transfer pricing dispute resolution.

### 1.5 Interaction with the OECD Guidelines

The book offers the first global analysis of more than 180 transfer pricing cases emerging from the five continents. The book has been designed in such a way as to be an essential complement to the OECD Guidelines, which focus on transfer pricing issues, but do not refer to specific transfer pricing disputes. In order to achieve this, all of the transfer pricing cases discussed are linked to the relevant paragraphs of the OECD Guidelines by means of an Analytical Table of Cases called the Golden Bridge. The Golden Bridge lists each transfer pricing dispute discussed in the book according to the section or paragraph(s) of the Guidelines to which it refers, thus effectively providing examples of the application of the ALP in many settings. A more detailed explanation of the format is provided at the beginning of the Golden Bridge. The Table of Cases by Jurisdiction includes a complete list of the cases referred to in the book, including those that do not relate to any specific entry in the OECD Guidelines, or that do not concern a transfer pricing dispute.

### 1.6 Questionnaire answered by country experts

1. The structure of the law for solving transfer pricing disputes. What is the structure of the law of the country for solving transfer pricing disputes? For example, is the mutual agreement procedure (MAP), as regulated in the relevant tax treaty, the standard method for solving transfer pricing disputes?
2. Policy for solving transfer pricing disputes. Is there a gap between the nominal and effective method for solving transfer pricing disputes in the country? For example, has the country a strategic policy not to

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enforce the arm's length standard (ALS) for fear of driving foreign direct investment to other competing jurisdictions?<sup>8</sup>

3. The prevailing dispute resolution method. Which is the most frequent method for solving transfer pricing disputes in the country? Does it have a positive externality? For example, is the MAP the most frequent method, and if so, to what extent have successful MAPs been used as a proxy for transfer pricing case law?<sup>9</sup> The case of a US MNE successfully extending its bilateral advance pricing agreement (APA) concluded between two developed countries to a number of countries of the emerging world is a good example.<sup>10</sup>

4. Transfer pricing case law. What is the evolution path of transfer pricing litigation in the country? For example: (i) Is transfer pricing litigation being gradually replaced by either MAPs or APAs, as regulated in the relevant tax treaties? (ii) Are foreign/local transfer pricing precedents and/or published MAPs increasingly relevant as a source of law for solving transfer pricing disputes?<sup>11</sup>

<sup>8</sup> For examples of strategic interpretations of tax treaty law in India and South America, see E. Baistrocchi, 'The Use and Interpretation of Tax Treaties in the Emerging World: Theory and Implications' (2008) *British Tax Review* 352, available at SSRN: [ssrn.com/abstract=1273089](http://ssrn.com/abstract=1273089).

<sup>9</sup> For a seminal paper suggesting using APAs as a proxy for transfer pricing case law in order to provide an increasingly precise meaning to the arm's length standard (ALS), see R. Vann, 'Reflections on Business Profits and the Arm's Length Principle' in B. J. Arnold, J. Sasseville and E. M. Zolt (eds.), *The Taxation of Business Profits Under Tax Treaties* (Toronto: Canadian Tax Foundation, 2004), pp. 133–68.

<sup>10</sup> An official of Procter & Gamble said: 'We believe that our APA strategy gives us greater predictability and financial statement precision not only in markets where we have obtained rulings, but also in other countries with similar circumstances where we have [not] yet pursued a ruling. Essentially, because the business model is the same and the circumstances are similar, our rulings give us the ability to ask the next government why shouldn't the new audit produce the same tax result as the 15 APAs that we have already obtained on substantially similar facts. When we couple this strategy with our general corporate transparency, and global consistency in execution of our planning, and strong internal controls, we have a strategy that delivers more risk management certainty.' An interview with Tim McDonald, Vice President Finance & Accounting, Global Taxes in Procter & Gamble, *Tax Policy and Controversy Briefing, A Quarterly Review of Global Tax Policy and Controversy Development*, Issue 3 (February 2010) 2–6.

<sup>11</sup> For an example of an analysis of the evolution of transfer pricing case law in a developed economy, see R. S. Avi-Yonah, *The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation*, University of Michigan Law and Economics Olin Working Paper no. 07–017 (27 September 2007); University of Michigan Public Law Working Paper no. 92, available at [papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1017524](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1017524).

5. Customary international law and international tax procedure. Has customary international law been applied in the country to govern the relevant methods for solving transfer pricing disputes (such as the MAP)? For example, has the *OECD Manual on Effective Mutual Agreement Procedure* ‘OECD Manual’<sup>12</sup> been deemed customary international tax law in the MAP arena for filling procedural gaps (for example, time limit for implementation of relief where treaties deviate from the OECD Model Tax Convention)?<sup>13</sup>

6. Procedural setting and strategic interaction. Does strategic interaction between taxpayers and tax authorities depend on the procedural setting in which they interact when trying to solve transfer pricing disputes? For example, which procedural setting in the country prompts the relevant parties to cooperate with each other the most for solving this sort of dispute, and why?<sup>14</sup>

7. The future of transfer pricing disputes resolution. Which is the best available proposal in light of the interests of the country for facilitating the global resolution of transfer pricing disputes, and why?<sup>15</sup>

<sup>12</sup> The OECD Manual is available at [www.oecd.org/document/45/0,3343,en\\_2649\\_33753\\_36156141\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/45/0,3343,en_2649_33753_36156141_1_1_1_1,00.html).

<sup>13</sup> On the relevance of customary international law on international tax law, see R. S. Avi-Yonah, ‘International Tax as International Law’ (2004) 57 *Tax Law Review* 483. An early version of this paper is available at SSRN: [papers.ssrn.com/sol3/papers.cfm?abstract\\_id=516382](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=516382).

<sup>14</sup> For a comprehensive discussion on the strategic behaviour of lawyers in contexts arguably similar to transfer pricing litigation (such as large commercial litigation), see R. Gilson and R. H. Mnookin, ‘Disputing Through Agents: Cooperation and Conflicts Between Lawyers in Litigation’ (1994) 94 *Colum. Law Rev.* 509.

<sup>15</sup> Global proposals for simplifying the transfer pricing problem in both the developed and emerging world include the following options:

Option 1: improved methods for solving transfer pricing disputes. See the 2007 OECD Report, *Improving the Resolution of Tax Treaty Disputes*, available at [www.oecd.org/dataoecd/17/59/38055311.pdf](http://www.oecd.org/dataoecd/17/59/38055311.pdf).

Option 2: improved methods for solving tax treaty disputes in which certain MAPs are used as a proxy for transfer pricing case law. See Vann, ‘Reflections on Business Profits and the Arm’s Length Principle’, note 9 above.

Option 3: See R. S. Avi-Yonah and K. A. Clausing, *A Proposal to Adopt Formulary Apportionment for Corporate Income Taxation: The Hamilton Project*, University of Michigan Law and Economics Olin Working Paper no. 07–009 (April 2007); University of Michigan Public Law Working Paper no. 85, available at [ssrn.com/abstract=995202](http://ssrn.com/abstract=995202).

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## 2

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## The transfer pricing problem

EDUARDO BAISTROCCHI

### 2.1 Introduction

Imagine the following scenario. A French multinational (FM) manufactures cars in France and owns a valuable intangible: the specific industry know-how in marketing its cars. FM is willing to expand its business to country X, where intellectual property rights are not properly enforced. In order to minimise the transaction costs in safeguarding the rights, FM decides to create a wholly-owned subsidiary in X which will be in charge of selling its vehicles (FM Sub.), instead of supplying its intangible know-how to an independent reseller in country X (Indep Co.). This strategy allows FM to expand its business to country X, minimising the risk of compromising its intangible via internalisation of these transactions costs.

This example shows that FM is able to replace the FM–Indep Co. relationship with the FM–FM Sub. model. More generally, this way, multinational enterprises (MNEs) are able to replace the arm's length market (the external market) for products and services with an internal market of inputs.

The external and internal markets of inputs differ at least in one significant aspect in that the open pricing mechanism only applies to the external market.<sup>1</sup> Conversely, a system called *transfer pricing* operates in the internal market only. Here, transfer prices refer to prices at which an enterprise transfers physical goods and intangible properties or provides services to associated enterprises.<sup>2</sup> Such differences in price between internal and external markets are relevant because, although

<sup>1</sup> R. G. Eccles, *The Transfer Pricing Problem: A Theory for Practice* (Lexington, MA: Lexington Books, 1986), p. 19.

<sup>2</sup> OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 2010) ('OECD Guidelines'), p. 19, para. 11. The OECD Guidelines are available at [www.oecd.org/document/34/0,3746,en\\_2649\\_34889\\_1915490\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/34/0,3746,en_2649_34889_1915490_1_1_1_1,00.html); see also A. Gabor, *Pricing: Concepts and Methods for Effective Marketing* (Cambridge: Cambridge University Press, 1988), pp. 113–14.