

A transfer price is the amount charged for goods, technology, services, or other items sent between units of a multinational corporation. If the units of the corporation, the home office, its branches and subsidiaries, are located in different countries, the transfer price can be used to allocate the total income of the enterprise between taxing jurisdictions, and directly affect the net income of both the sending and receiving unit.¹ By manipulating transfer prices, multinationals may also defer recording the value added to a good by each production unit until that good reaches the jurisdiction with the lowest tax rate.

Transfer Pricing: Determining a Safe Haven Price

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Responding to these manipulations, governments have begun examining the transfer prices selected by the corporate units within their jurisdictions to ensure that a sufficient proportion of income earned by those units is made subject to local taxation. However, should taxing authorities not agree on the proper transfer price, multinationals may be taxed more than once on the same tax base; one jurisdiction may adjust the price to increase its tax revenue while another jurisdiction may not recognize the adjustment, forcing the multinational to treat the same value added as income taxable in two jurisdictions. Even if double taxation and tax avoidance could be eliminated, transfer pricing would continue to be critical in calculating foreign tax credits within the parent jurisdiction and in determining subsidiary income for taxation by the subsidiary's host country.

At present, transfer prices are determined on a case-by-case basis, either unilaterally or through a complex process of intergovernmental negotiation and government-firm negotiation. The result is inconsistency and high administrative costs for both governments and companies. If a single safe haven price could be established which would be unchallengeable by either the country of sale or purchase, the high costs and inequities of current unilateral *ad hoc* determinations could be reduced. Such a compromise could help settle cases and provide taxpayers with a certain standard against which to measure and shape future transactions. This article proposes a method for determining such a safe haven price.

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1. Ritter, W., *Allocation of Expenses in International Arm's Length Transactions of Related Companies*, Cahiers de Droit Fiscal International, Volume LXb, (London, 1975). See Associated Business Programs, *Multinationals in Search of Tax Formulae*, (1975).

BACKGROUND

Elements of a Workable Safe Haven

In providing a safe haven for transfer pricing, four important criteria should be followed.² First, there should be no undue frustration of legitimate business conduct. Transfer pricing affects the allocation of goods and resources³ because the tax and administrative costs of transferring a good influence the decision to make the transfer. Business expects to be restricted only reasonably in making its commercial arrangements and not to be exposed, without compelling reasons, to the danger of double taxation.⁴ It is impossible for taxation to have no influence on the actions of business, but all desire that distortion be planned or minimized. Similarly, a safe haven should be written so as to minimize the possibilities of its use as a means of avoiding tax.

Second, to facilitate international trade and to minimize the costs of tax administration, the guidelines must be administrable and provide fair notice. The problems of compliance will depend on the rationality of the guidelines.

If the tax rules find their counterpart in criteria recognized in economic fields other than taxation, where similar competing pulls for a proper share of profits are operative, then taxpayers using criteria developed in those fields will have some assurance that their transactions will also pass a tax scrutiny.⁵

Pricing has consequences for exchange control, monetary or fiscal policy, national economic aspirations, and the general flow of commerce, as well as for taxes. Price may be used for customs duties by governments, and measures of unit operation by business.⁶ If either the taxpayer or the taxing authorities must accumulate large amounts of data which can be used solely in pricing for tax purposes, the safe haven may produce no savings.

Third, the rules must not favor a single country involved, if there is to be any hope for acceptance. Although, at the United Nations' Group of Experts meeting, "it was agreed on all sides that the problem [transfer pricing] was not peculiar either to developing or to developed countries, nor, indeed, involved matters in which the interest of one group of countries were adverse to the

2. United Nations Department of Economic and Social Affairs, *Tax Treaties Between Developed and Developing Countries*, Fifth Report, p. 99, (ST/ESA/42), (N.Y., 1975).

3. Nieckels, J., *Transfer Pricing in Multinational Firms*, p. 27, (1975).

4. Ritter, W., *op. cit.*, (fn 1), p. 1155.

5. UN, Fifth Report, (fn 2), p. 91.

6. Surrey, S. and Tillinghast, D., *Criteria for the Allocation of Items of Income and Expense Between Related Corporations in Different States, Whether or Not Parties to Tax Conventions*, Cahiers de Droit Fiscal International, Volume LVIIb (Washington, 1971), p. 3.

interests of the other group,"⁷ any safe haven may affect the tax revenue of various countries differently because of the nature and extent of the transfers between them. There is also a current tendency for "industrialized countries and, to an even greater extent, the developing countries to seek to extend their tax jurisdictions and to improve the possibilities of implementing them."⁸ Because a safe haven must limit a country's ability to challenge certain prices, it cannot systematically decrease the tax base of a country below that which it is currently enjoying. The tax base in the country of both seller and buyer must be protected.

Finally, the safe haven must conform to currently accepted principles of international taxation and equity. It must leave both the countries and the companies feeling that they have neither made excessive concessions in, nor born too much of the burden of, solving the problems of international taxation. The generally accepted thesis that the geographic source of income should determine the incidence of taxation leads to the problem of trying to allocate the income of an otherwise homogeneous enterprise. It is as difficult to determine how much of an enterprise's profit is attributable to a given unit thereof, as it is to determine how much of a workman's salary is attributable to his hands, feet, or brain. But the international community has had substantial experience with the problem of allocation and has built up expectations around that experience, however unsatisfactory. A safe haven which departs radically from prior experience and accepted principles is not likely to be accepted.⁹

To satisfy these criteria, a safe haven must be based on data readily available to both business and taxing authorities, and on a system of pricing currently found acceptable; it must fit within the current tax convention system, and protect the tax base of each country; it must be uniformly applicable as well.

Two Income Allocation Methods

Before evaluating particular methods of transfer pricing, it is necessary to analyze the two basic methods of allocating income: "formula" allocation, and "arm's length" allocation. "Any resolution of the income allocation problem must be based on either the arm's length or the formula theory, either in a pure

7. UN, Fifth Report, (fn 2), p. 20. The Group of Experts is an *ad hoc* group of tax experts from various nations. The nations represented at the fifth meeting were: Argentina, Brazil, Chile, France, the Federal Republic of Germany, Ghana, India, Israel, Japan, the Netherlands, Norway, Pakistan, the Philippines, Sri Lanka, Sudan, Switzerland, Tunisia, Turkey, the United Kingdom, and the United States. The aim of the group is to develop guidelines for tax treaties between developed and developing nations.

8. Ritter, W., *op. cit.*, (fn 1), p. 1153.

9. United Nations Department of Economic and Social Affairs, *Tax Treaties Between Developed and Developing Countries*, Sixth Report, (ST/ESA/42), (1976), p. 41.

or modified form.”¹⁰ The arm’s length theory provides that each unit of a multinational enterprise must be treated as a separate entity and that all transfers between such units must be at prices equal to those charged unrelated firms, *i.e.*, arm’s length prices.¹¹ The formula theory treats a multinational enterprise as a single entity, and the total income of the enterprise is allocated between its units in accordance with a formula based on the activity in each unit. Both approaches are subject to practical and theoretical criticism.

Requiring a parent corporation to transfer goods to its subsidiaries at the same price the parent sells to unrelated parties ignores any additional profit that may be attributable to the subsidiary because of vertical integration and scale. All the benefits of margin and size are attributed to the parent, or transferring unit, as it will charge the full market price for the good, though savings may arise from the operation or existence of the subsidiary.¹²

The practical difficulties with “arm’s length” pricing arise because in many situations there will not be a market price for the transferred good.¹³ The price will have to be determined by looking to presumptively similar situations or “comparables.” There are four common forms of comparables. (1) The comparable uncontrolled price (CUP) is the price charged by the selling unit to an unrelated party, to the buying unit by an unrelated party, or, as a last resort, between unrelated parties for the same, or nearly the same, product in the same or similar circumstances. It is the most accurate, direct and difficult method of allocating profits according to the arm’s length standard. “The comparable uncontrolled price method will apply for the most part only to stable, uncomplicated markets where the affiliated parties assume traditional roles of manufacturer, wholesaler and/or retailer or dealer. But many markets and the arrangements between commonly controlled entities are far more complex.”¹⁴ The items traded are often at a different stage of completion or only vaguely similar to those traded between other parties.

(2) The cost-plus method requires one to determine the cost of the item produced and add a mark-up comparable to that charged by other companies which make similar products, or better, by the same firm selling other similar products to an unrelated party. It is often difficult to find an appropriate mark-up and to determine the costs to which the mark-up should be applied.

10. Note, “Multinational Corporations and Income Allocation Under § 482 of the Internal Revenue Code,” 89 *Harv L Rev* 1202, 1205 (1976).

11. Treas. Reg. §1.482-1(b). TD 6952 (1968).

12. Musgrave, P., “International Tax Base Division and the Multinational Corporation,” 27 *Pub. Finance* (1972) 394, 404. See, Special Subcommittee on State Taxation of Interstate Commerce of the Committee on the Judiciary, *State Taxation of Interstate Commerce*, H.R. Rep. No. 1480, 88th Cong., 2d Sess. 165, (1964).

13. *Ibid.*, p. 165.

14. Rubloff, G., *Transfer Pricing and International Allocations of Income: Approaches to the Determination or Estimation of an Arm’s Length Price*, unpublished article produced as consultant to the United Nations Secretariat, (1977), p. 8.

(3) The resale price method is applied by averaging the gross mark-ups or commissions charged on resale of similar items by enterprises which perform services similar to those performed by the buyer. Usually, marketing services are involved. The average mark-up is then subtracted from the final resale price of the buyer. This method is endorsed by economists over the cost-plus method because it is believed that marketing functions earn more uniform mark-ups than manufacturing functions.¹⁵ This method, however, is the least frequently used because neither firms nor tax agents have access to the data from foreign countries necessary to determine the appropriate mark-up. In addition, it can be applied only if the buyer is performing solely marketing functions, and the product involved is substantially similar to other products being marketed locally.

(4) The proportionate profits method is actually any one of a number of methods of determining the price by allocating the final profit on resale to the units involved. The allocation is intended to mirror that experienced by unrelated firms. This method can divide income according to arbitrary percentages, i.e. 50-50 or 75-25 as has been suggested,¹⁶ or it can be used to divide income according to a standard which attempts to reflect market allocations. The primary problem with this approach is finding an acceptable basis for allocation, for the basis of proration will determine how closely the resulting allocation will approach market allocations.

Each pricing method is a guide to the most reliable and relevant evidence to establish what price would have resulted if commonly controlled enterprises had been unrelated and independent. All of these methods depend on "comparables," without which there are no answers to the problem of allocation using strictly separate accounting standards.¹⁷ However, as each method draws comparisons further removed from the actual activity of the firm involved, it tends to estimate the allocation of profits in the market place, rather than the price the firm would actually charge.

The expenses incurred by a unitary business in any particular country are not incurred solely in furtherance of the business within the country's borders; thus it is felt that separating the profits of any portion of a unitary business from the rest leads to an inaccurate tax base. The use of comparables is seen as an arbitrary method of allocating the profits of a given transaction because it is based on *ad hoc* determinations.¹⁸ For these reasons it was concluded in the Business

15. *Ibid.*, p. 11.

16. Hammer, Morrione & Ryan, *Concepts & Techniques in Determining the Reasonableness of Intercompany Prices Between United States Corporations and Their Overseas Subsidiaries*, N.Y.U. 30th Institute on Federal Tax, (1972), 1407, 1437.

17. Rubloff, G., *op. cit.*, (fn 14), p. 6.

18. Walsh, F.; Orlin, H.; Toder, J., *Developments in Intercompany Pricing Under §482*, Seventh Annual Institute on International Tax, Kroll, T., Chairman, Practising Law Institute, (N.Y.U. 1976), p. 114. Keesling and Warren, "The Unitary Concept in the Allocation of

International Corporations' study *Solving International Pricing Problems* that the "division of net income approach (the formula approach) might replace these cost-plus formulas as the most acceptable pricing basis for national revenue services, thereby eliminating the greatest weakness of the cost-plus system—failure to relate the transfer price to the final price in the market place, and the need to determine cost allocations."¹⁹

The formula approach divides the total net income of an enterprise among its various units in accordance with the activity of each unit. The activity of one unit is compared with the total activity of that type performed throughout the enterprise. For example, if it were decided that the only important activity was the ownership of property, the formula would be: total income of the enterprise multiplied by the value of property owned by the unit over the total property owned by the entire enterprise. The net income of all of the corporate units is combined; intercompany sales, rents, services, charges, and the like are ignored. The method eliminates the need for a safe haven or pricing guidelines. If all nations were to adopt a single unitary formula, the threat of double taxation would be minimized.

Though in principle the formula approach has been advocated by a number of tax scholars,²⁰ practical application of the approach is subject to formidable problems. As the formula is applied to the income of the "entire" enterprise, it is necessary to determine which branches' and subsidiaries' income should be aggregated. Of course, threshold determination of what constitutes control of a subsidiary must be made for all transfer pricing problems. However, to use the formula approach it must be determined whether it is appropriate to aggregate the income of a subsidiary which makes shoes and a subsidiary which distributes movies, with the income of a parent which manages a hotel. California, one of the three states which applies the formula approach on an international basis, has faced the most difficulty in promulgating objective standards for aggregation, especially for diversified firms.²¹ No satisfactory

Income," 12 *Hastings L. J.* 42, 45 (1960).

19. Business International Corporation, *Solving International Pricing Problems*, (N.Y. 1965), p. 31.

20. See, Keesling and Warren, *op. cit.*, (fn 18), p. 43.

21. Lohr, S., "Developing Jurisdictional Standards for State Taxation of Multistate Corporate Net Income," 22 *Hastings L.J.* 1035, (1970-1971). The international complexity of this problem is demonstrated by a European firm's international organization: There is one parent. There are four divisions each with numerous subsidiaries as follows:

- 1) Pharmaceutical Division with six subsidiaries and three branches in three countries.
- 2) Product Division with seventeen subsidiaries and five branches in eight countries.
- 3) European Division with twenty-two subsidiaries in eleven countries.
- 4) W. Hemisphere Division with seven subsidiaries in seven countries.

Source: Arpan, J., *International Intracorporate Pricing, Non-American Systems and Views*, (1971) p. 122.

solution has been found, as *ad hoc* determinations of "interdependency" prevail.²² In addition, the formula approach requires that each country in which a unit of the enterprise is located receive records from all the other units of the enterprise.²³ Unless every country in which an enterprise operates were a party to the tax convention, the danger of double taxation would continue, if not increase, and the necessary records would be difficult or impossible to acquire.

Since "net income" is allocated, it is necessary to determine which forms of income should be aggregated, and how net income should be calculated. If a subsidiary sells a capital asset, should the gain be allocated with the other gains of the entire enterprise? Though it would be possible to allocate certain income specifically to a given location, *e.g.*, capital gains on the sale of real property, it is often difficult to determine which forms of income should be considered specifically allocable, *e.g.*, capital gains on the sale of moveable property. Even if it were decided that only "business" income should be allocated, it would still be necessary for all countries to agree on how to calculate "net income." The possibility of a uniform international definition of net income is slight considering the current diversity in national codes. Internationally, the problem of determining "net income" is especially acute because the basic definition of the tax base differs, *e.g.*, some countries impose schedular income taxes, while others use an aggregate income approach. Without a uniform definition of "net income" double taxation would continue.²⁴

It is equally difficult to determine which factors should be included in the formula and how they should be computed. California's formula, prior to 1967, involved five factors: sales, purchases, expenses, manufacture, payroll, value and situs of tangible property: thereafter it adds "or other factors."²⁵ Other states have included gross receipts, average inventory, business costs, or business done, and others. Between countries, where it may be argued that value and monetary amounts are not comparable, the number of employees, the number of hours worked, the acreage of land, or cubic footage of building space could be added.²⁶ In addition, a risk variable to equalize the risks involved in different countries has been suggested, though its calculation is unclear.²⁷ "Just as there is no single 'right' tax rate for the source country to

22. Keesling and Warren, *op. cit.*, (fn 18) pp. 47, 78.

23. This requirement has led the United Kingdom to object to California's formula allocation. *See*, Report of the Dept. of State, June 24, 1976. Treaties CCH, Para. 8103EE.

24. UN, Fifth Report, *op. cit.*, (fn 2), p. 22.

25. Cal. Rev. and Tax Code §25101 (West Ann. Code, 1955); currently §25128 provides for the use of a property, a sales, and a payroll factor (West Ann. Code, 1970).

26. Peterson, R., "California Franchise Tax: Combined Income Report Affects Foreign Companies," 44 *J. Taxation* 184, 186 (1976). Also: Musgrave, R.A. and P.B., "Inter-Nation Equity," in *Modern Fiscal Issues*, editors: Bird, R.M. and Head, J.G., p. 83, (1972).

27. Note, *op. cit.*, (fn 10), p. 1229.

apply in an economic sense, the solution being largely a matter of international equity, so the activity approach [formula] lends itself to various interpretations resulting in different allocation formulas."²⁸ International agreement is extremely unlikely considering that the comparatively homogeneous states of the US have been unable to reach agreement, despite numerous attempts.

Even if it could be concluded that assets, sales, and payroll were the appropriate factors, methods of measurement and comparison would be subject to contention. For example, sales and intangible assets are hard to localize or value, and guidelines would be necessary. Finally, currency conversions create difficulties, as currency exchange rates will not affect valuation, if and only if the currencies are freely traded.²⁹

The geographical basis for jurisdiction to tax raises problems; if an activity is attributable to a country without jurisdiction, a portion of the tax base will escape taxation entirely. This problem is significant both to countries which tax only local source income and to those which provide a foreign tax credit on an overall basis.

The formula theory, moreover, cannot deal with the objection that unrelated firms allocate income on an arm's length basis and the acquisition of control of a previously unrelated firm should not change such allocation.

The requirements under fiscal and commercial law for maintaining accounts, the differences in accounting methods, in language, in currency and the incidental problems of valuation and exchange all tend to support the method of separate accounting.³⁰

In addition, the impossibility of determining an appropriate basis for aggregation of the income of various subsidiaries and the problems of jurisdiction to examine records would make it difficult to devise a satisfactory international formula system. Until countries can agree on a definition of net income and factors for allocation, double taxation will continue, for a partial acceptance by the international community of the formula approach does not result in an operable system.

A decision to base transfer prices on arm's length standards does not, however, solve the problem. Developed countries have enacted provisions or applied general definitions of income to require "arm's length" type pricing, but no consensus of definition or standards has been reached.³¹ Generally, a

28. Musgrave, *op. cit.*, (fn 12), p. 399.

29. Lorensen, L., *Reporting Foreign Operations of U.S. Companies in U.S. Dollars*, (1972), p. 11.

30. Carroll, M., *Taxation of Foreign and National Enterprises, Volume IV, Methods of Allocating Taxable Income*, League of Nations, Fiscal Committee, 1933 IIA, p. 188.

31. Surrey, S., *op. cit.*, (fn 6), p. 8.

case-by-case analysis has been applied, resulting in uneven enforcement and high administrative costs.³² Developing countries similarly rely heavily on the arm's length standard, but admit to a greater use of apportionment formulas than do the developed countries.³³ Because both sets of countries have difficulty determining arm's length prices, both rely on comparables. However, because of the different composition of trade, the developed countries tend to use a cost-plus system, which tends to preserve the tax base of selling countries, while developing countries tend to use either proportionate profits or resale price methods to protect the tax base in their countries.³⁴ Few countries have promulgated guidelines for transfer pricing and rely on whatever data are available to make adjustments. No country provides a safe haven for the pricing of goods.³⁵

National Interests and Experience

The concerns of nations in areas related to the transfer prices of goods also vary. Developed nations are concerned primarily with the ability of parent corporations to allocate home-office expenses and obtain recognition abroad of license fees, management fees, and overhead.³⁶ Developing nations, in contrast, are most concerned that they are not overcharged for such expenses. If the price of technology or management is included in the price of goods sold to a subsidiary, a separate charge for such items should not be made. Developing countries wish to encourage transfers of technology, but do not wish to be charged for it in excess of the benefit they receive.³⁷

Of special concern to many developing nations are particular extraction or agricultural industries upon which their economics rely heavily.³⁸ There is little likelihood of agreement on a price or safe haven for an economy's sole or primary export. Most extraction and large agricultural projects tend to be subject to special arrangements, customized as to tax and terms between the company and the developing country.³⁹ Any safe haven must surely provide

32. Chown, J., *Taxation and Multinational Enterprises*, (1974), p. 95. Green, J. and Durr, N., *Intercompany Transactions in the Multinational Firm*, National Industrial Conference Board, (1970), p. 128. See, discussions of national systems in: Ritter, W., *op. cit.*, (fn 1); Sutry, S., *op. cit.*, (fn 6); Associated Business Programs, *op. cit.*, (fn 1); Fordham Corporate Law Institute, *International Transfer Pricing 1976* (1976), p. 108.

33. See, sources cited in fn 32. See also, UN, Fifth Report and Sixth Report, *op. cit.*, (fn 2 and 9).

34. *Ibid.*, generally.

35. *Ibid.*, generally.

36. Ritter, W., *op. cit.*, (fn 1), p. 11267.

37. UN, Sixth Report, *op. cit.*, (fn 9), p. 46.

38. Kauder, L., "Allocation of Income: Problems of Administration and Compliance," *9 J Int'l L & Econ* 1, 45, (1974).

39. See, e.g., Walcott, J., "Corporate Objectives for Developing Mineral Properties in Africa," in *Current Legal Aspects of Doing Business in Black Africa*, Highet, K., editor, (1975), p. 87.

sufficient flexibility to take account of an economy's heavy reliance on a particular extraction or agricultural product.

A more difficult problem typical of developing countries, is the belief that "full enforcement of arm's length pricing would, if anything tend to increase the [developed country's] profits tax base share."⁴⁰ This is caused in part by the tendency of firms to shift profits into the developing countries which have lower tax rates or allow special treatment of multinationals.⁴¹ A strict enforcement of arm's length pricing would mean a loss of tax base for these countries. Moreover, arm's length pricing tends to shift increased profits caused by any increased efficiency or savings of vertical integration to the upstream seller. Any safe haven which looks solely to the arm's length price in the exporting country, without determining the consequences of such pricing in the importing country, will have to deal with the possibility of losses to the importing country.

The practical experience of countries trying to determine an arm's length price indicates the need for a safe haven. Reliance on price lists or customs values is extensive where they exist, but frequently the products transferred within a multinational are not on such lists.⁴² A complete price list would, of course, be impossible to compile and would be obsolete before completed.

Despite the avowed preference for the comparable uncontrolled price, taxing authorities have had only marginal success in finding it. In the United States, which has had the most extensive documented experience with transfer price allocations, no consistent choice of any one method has been made. According to the US Treasury Department's "Summary Study of International Cases Involving Section 482 of the Internal Revenue Code," issued on January 8, 1973:

Of the 174 pricing adjustments made in the study 20.7% were based on the comparable uncontrolled price method, 10.9% were based on the resale price method, 27.6% were based on the cost-plus method and 40.8% were based on an improvised fourth method. Where a pricing adjustment was not made, however, the comparable uncontrolled price method was applied in 56.1% of the cases (234 cases of 417 in which adjustments were considered but not made), usually on the basis of evidence of sales to third parties offered by the taxpayer. A fourth method was applied in 27.6% of the cases in which a pricing adjustment was not made.⁴³

40. Musgrave, *op. cit.*, (fn 12), p. 410.

41. *See*, Kauder, *op. cit.*, (fn 38), p. 44.

42. UN, Fifth Report, *op. cit.*, (fn 2), p. 13.

43. Treasury Department's "Summary Study of International Cases Involving Section 482 of the Internal Revenue Code," Issued January 8, 1973 (Official Text) reprinted in 5 *Taxation and Finance*, J-7, (1973), and 737 CCH Para. 6419.

This indicates that taxpayers must accumulate data on comparable sales, data which might otherwise be worthless, to provide its best defense, but the IRS will use such prices as a basis for adjustment only about 1/5th of the time. The single most frequently used method of adjustment was based on the cost-plus method.

If comparables were available, they were invariably used as the basis for decision by American courts.⁴⁴ Courts did show a tendency to use an allocation of profits method, but the most recent attempt to do so by the US Tax Court led to a reversal by the Circuit Court of Appeals.⁴⁵

Not surprisingly, both the United States and other countries have resorted to pricing methods which analyze the effect of the price on profits in both countries. Commentators have stated that it is well known that, in practice, the IRS agents resort to some variation of proportionate profits analysis, determining whether an allocation should be made on the basis of an "entities'

44. See, *Woodward Governor Co.*, 55 *Tax Ct.* 56 (1970, acq. in 71-1 Cum. Bull. 2) in which the court found sales by the taxpayer to a third party under a set aircraft pricing policy comparable to sales to a subsidiary. *American Terrazzo Strip Co.* 56 *Tax Ct.* 961 (1971 acq. 1973-2 Cum. Bull. 1) in which sales of standard strips to third parties were used as a starting point. In this case, the special relationship of the parties was considered. "This reallocation will compensate for intangible factors involved in the Caribe (subsidiary)-petitioner relationship which is not normally present in the relationship of organs not commonly controlled. (These intangible factors were benefits enjoyed by Caribe from the parent, which, instead of resulting in arm's length pricing, resulted in an adjustment in the resale price adjustment which was used.) Sales of rods to third parties were also found comparable. In *Hall v. Commissioner*, (294 F. 2d 82, 5th Cir. 1961), sales of oil drilling equipment were found comparable. See *Oil Base Inc. v. Commissioner*, (362 F. 2d 212 9th Cir. 1966), in which commissions paid unrelated firms were considered comparable. See, *PPG Industries, Inc.*, 55 *Tax Ct.* 928 (1970), in which glass sold at the same prices between another subsidiary and an unrelated party were found comparable. However, in this case the profit split between parent and subsidiary was considered relevant — it was approximately 50-50 (46.2 — 53.8). In *Eli Lilly and Co. v. U.S.*, (372 F. 2d 990 Ct. Cl. 1967) an arbitrary 50-50 split of profits by the revenue agent was upheld because it approximated the correct result based on market discounts and the "marginal market" of the subsidiary (p. 997). These cases indicate that comparables are used when found, but that where, how and in what context they are found varies considerably. Also, in at least three of the cases, the court considered the consequences of the transaction to both parties.

45. In *Lufkin Foundry & Mach. Co. v. Commissioner*, 468 F. 2d 805 (5th Cir. 1972) rev'g 30 CCH *Tax Ct. Mem.* 400 (1971), the tax court had held that a 50-50 split of the profit was satisfactory for 482 purposes. The Circuit Court, however, held that, no "quantum of evidence as to a taxpayer's internal transactions, standing alone, [can] be sufficient to establish arm's length dealing between them[.]" This array of cases demonstrates the difficulty that both tax authorities and taxpayers have in determining an arm's length price, and the approximations that occur in reaching an agreement. A further example is found in the statement by the counsel for the government in *E.I. du Pont de Nemours & Co., v. U.S.*, Ct. Cl. #256-66 & 371-66, while explaining why evidence would be introduced under each of the three priority methods and under a fourth method, in which it was admitted that the government was at a loss to predict under which of the three pricing methods it would ultimately be required to proceed by the court. See, Brief for Defendant at 72-73 & fn 29 (March 1974) and Note, *op. cit.*, (fn 10), p. 1221, fn. 97.

proportionate share of the total costs allocated to the transaction.”⁴⁶ “The amorphous standard of a ‘reasonable split’ of overall profits among members of a controlled group has crept into the pricing analysis of nearly every country, even though no allocation statute contemplates such a test.”⁴⁷ Of course, an *ad hoc* “reasonableness” test is not satisfactory if double taxation is to be avoided and prices are to be accepted by countries at both ends of the transaction; guidelines are necessary.

Business Concerns

The problems business faces in determining an appropriate transfer price mirror those of taxing authorities. Though the purposes of business include unit as well as enterprise profit evaluation, business, nevertheless, uses either cost-based⁴⁸ or proportionate profits⁴⁹ approaches to transfer pricing. The most frequently used basis for pricing is cost, if a market price is unavailable.⁵⁰ Of course, in the absence of uniformly enforced standards of tax base division, business also uses transfer pricing for tax avoidance.

The two primary complaints advanced by business are that an adjustment made in one country will not necessarily be recognized in another country,⁵¹ and that even a conscientious firm may be subject to high administrative costs, because it is unable to determine what standard the taxing agents will apply.⁵² Finally, business complains that gathering “comparables” to support a given price is wasted effort, even if the price is never challenged, for the resulting data are of little use outside the tax area.⁵³ Ideally, business desires a uniform and easily administered rule, preferably based on cost, which will give some assurance that its prices will not be challenged.

46. See, Note *op. cit.*, (fn 10), p. 1223. See, UN, Fifth Report, *op. cit.*, (fn 2), p. 109. See, Green, J. & Duerr, M., *Intercompany Transactions in the Multinational Firm*, National Conference Board Inc. (1970), p. 274. See, Kauder, *op. cit.*, (fn 38), p. 29. See, Arpan, *op. cit.*, (fn 21), p. 27.

47. Madere, G., “International Pricing: Allocation Guidelines and Relief from Double Taxation,” 10 *Texas Int’l LJ* 108, 115, (1975).

48. Hirshleifer, J., “On the Economics of Transfer Pricing,” 29 *J. of Business*, 3 (1956). See, Nieckels, *op. cit.*, (fn 3), p. 43.

49. Green & Duerr, *op. cit.*, (fn 46), p. 10, 21.

50. *Ibid.*, p. 11.

51. Duerr, *Tax Allocations and International Business Corporate Experience with §482*, Conference Board, (1972), p. 66.

52. Kauder, *op. cit.*, (fn 38), p. 25-27.

53. Duerr, *op. cit.*, (fn 51), p. 6; UN, Fifth Report, *op. cit.*, (fn 2), p. 15.

Existing Treaty Structure

The current treaty system provides for arm's length pricing between a parent and a subsidiary. Some treaties do allow other methods of determining profits of branches and home offices in limited situations.⁵⁴ Treating given branches and wholly owned subsidiaries differently does not seem justified by the purely formal distinction between them. Currently, many treaties of developing nations provide for tax-sparing credits, or tax exemption of some multinationals. Such provisions increase the pressure on a company to transfer its profits to the low tax country.⁵⁵ Similar pressures arise under treaties which exempt dividends paid by a subsidiary.⁵⁶ Generally tax conventions have left the problem of transfer pricing to the local taxing authorities.

The permanent establishment provisions which are part of most modern treaties limit the jurisdiction to tax and will affect the safe haven. The intent of the permanent establishment provisions is at least in part to allow a company to perform a minimum amount of activity in a country without requiring the company to file tax returns or pay taxes in the country.⁵⁷ Because the formal independence of parent and subsidiary corporations is generally recognized, a parent corporation can sell to its subsidiary without subjecting itself to the tax jurisdiction of the subsidiary's country. Though a safe haven need not affect the jurisdiction to tax, it will require that the records of a unit, otherwise outside the jurisdiction of a country, be subject to inspection or local independent verification. The current tendency to allow or require international exchanges of information indicates that reasonable additional exchange requirements will not impose an onerous burden on either companies or countries.

Two proposed treaty provisions would allow correlative adjustments and exchanges of information. Correlative adjustment provisions require that adjustments in one country be given recognition in the other country, and mechanisms for consultation are provided. The information provisions would assist a country in determining whether transfer prices have been used to avoid

54. Organization for Economic Cooperation and Development, Fiscal Committee, *Draft Double Taxation Convention on Income and Capital*, (1963), Article 7, Commentary p. 79(2), 82.

55. Hellowell, "U.S. Income Taxation and Less Developed Countries: A Critical Appraisal," 66 *Colum. L. R.* 1393, 1418 (1966). Surrey, S., "The United States Tax System & International Tax Relations, Current Developments," 65-66 *Tax Policy* 2, 14, (1965).

56. See, *Tax Convention with Thailand*, Hearings Before the Subcommittee of the Committee on Foreign Relations, U.S. Senate, 89th Cong. 1st Sess., (1964), p. 20.

57. Fiscal Committee, *London & Mexico Tax Convention*, League of Nations Publications II, Economic and Financial (1946), Protocol, Article V, Para. 8, p. 40. OECD, *op. cit.*, (fn 54), p. 70, 71.

tax. However, to date, these provisions have either not been included in tax conventions or, if included, have not been applied.⁵⁸

ASSESSMENT: THREE COST-BASED SYSTEMS

The current state of international practice indicates that an acceptable safe haven would have to be based on arm's length pricing. Due to the lack of comparable prices and the general use and availability of cost data, a cost based system seems most likely to be administrable. The remainder of this article will analyze three possible cost based systems: (1) A "mark-up list" system requires a firm to determine the costs of making an article, and then use the mark-up on a list of industry average mark-ups; (2) A "cost-of-capital" system requires that a firm determine the entire cost of an article, including a mark-up representing the cost of capital; (3) A "value-added" system requires a firm to determine the costs which increase the value of a good and then to price the good so that total profit is allocated in proportion to the costs incurred by each unit. The first two systems are forms of cost-plus systems, while the third is a cost based proportionate profits system.

The Mark-up List System

The mark-up list system requires a uniform definition of cost and a list of industry or product line mark-ups. So long as the elements of cost are uniformly applied in generating the list and calculating the price, exactly which elements are included is not very critical. Because overhead and indirect costs are often calculated as a percentage of direct costs, direct costs may be sufficient. The difficult practical problem with a "list" system is the generation of an acceptable list of mark-ups.

Mark-ups based on industry averages rather than product-line averages are probably all that is possible. Product-line guidelines would be as difficult to generate as individual product prices. Industry wide average mark-ups, however, are themselves scarce. The most pertinent data which are available generally indicate "profit per dollar of sales." This figure, of course, is equivalent to the mark-up costs only after conversion. The conversion equation is $Y = X / 1 - X$, where Y is the mark-up over costs and X is the profit on total sales. However, the primary problem is the applicability and the availability of data which will yield meaningful prices. Major compilations of net return on sales on an industry by industry basis in the United States are found in the *Corporate Source Book of Statistics of Income*, a set of unpublished worksheet tables, which are used to generate "Statistics of Income — Corporate Income Tax Returns."⁵⁹ Numerous other sources of data exist for individual firms,

58. Fordham, *op. cit.*, (fn 32), p. 26; Ritter, W., *op. cit.*, (fn 2), p. 69.

59. I.R.S. Pub. 647 (2-69). See, Gifford, W., *International Tax Planning* (1974), p. 162.

separate industries or groups of industries.⁶⁰ None of these sources can be used directly because the ratio of sales to profits depends on the "cost" measures chosen for the particular category, the sources of income included, and the products considered within the same industry. For example, a comparison of data from the *Quarterly Financial Report for Manufacturing, Mining and Trade Corporations*, of the Federal Trade Commission,⁶¹ with the Source Book statistics discloses a wide divergence in mark-ups for a single industry. Other than sampling distinctions (both the IRS and the FTC studies claim about a 5% standard deviation for manufacturing),⁶² the FTC statistics are based on financial reporting accounting conventions, which differ from IRS reporting conventions, *e.g.*, in the more frequent application of accelerated depreciation on tax returns. There are other differences in the reporting of various expenses which result in the IRS mark-up being between twenty and forty percent lower than the FTC mark-up. On the other hand, if one tries to compare the IRS data with those of the US Census of Manufacturers, large discrepancies arise because the Census figures are based on unit rather than establishment data, thus allowing double counting of intracompany transfers. The IRS and FTC data are based on consolidated returns, so that intracompany transfers are ignored. The large variation, which depends on what accounting method is used, has led some to conclude that no set of industry averages is usable.⁶³ It does indicate that when using a set of industry averages, one must make sure that the accounting methods and choices used in generating the cost to which the mark-up is applied are the same as were used to generate the mark-up list. Because of the extent and detail of the data available to the IRS, it is probable that the *Source Book* is the most promising candidate for a mark-up source in the United States.

Using the *Source Book*, however, raises additional problems. First, the IRS categorizes firms according to the industry from which the enterprise received a majority of its gross receipts. Even though the firms are categorized into the four-digit groups provided in the *Standard Industrial Classification Manual* (SIC),⁶⁴ a substantial amount of cross-industry inclusion will occur. A widely diversified firm may be included in the statistics for an industry in which the firm has only a small percentage of its activity. As importantly, even within

60. See, Exhibit 600-3, Audit Techniques, Internal Revenue Manual, (1974).

61. *Quarterly Financial Report, for Manufacturing, Mining and Trade Corporations*, Third Quarter, 1976, Federal Trade Commission, p. 16.

62. *Ibid.*, p. 8.

63. Duerr, *op. cit.*, (fn 51), p. 24. See, Ruffalo & Isaacs, *Tax Management: Foreign Income: Section 482 Allocations*, BNA, (1976), p. A-70.

64. *Standard Industrial Classification Manual*, Statistical Policy Division of the Office of Management and Budget, Executive Office of the President, (1972).

these narrow industry groups, many different products will be included. Though for some products, such as individual passenger vehicles, the mark-ups may all be similar, some categories, such as "pharmaceutical preparations" (which include chapsticks and tranquilizers), will include such disparate products that the mark-up for the entire category will bear little relation to the actual mark-up charged for individual products. The distortion caused by the differences in products within an industry category will be exaggerated if the mix of products sold in different areas varies, as it almost certainly does. However, generating a product-by-product list, as mentioned above, is as difficult as generating a price list.

A second problem is that the IRS statistics include expenses and sources of income other than those which would be included in a sale of goods to a related unit. Many of these can be eliminated, such as capital gains and ancillary investments, because the income and expenses are broken down separately. Others cannot. Probably the most critical of these is selling to a related party. Only if it could be presumed that all costs, regardless of the function on which they are incurred, result in the same mark-up, would their inclusion not cause distortion. This presumption is difficult to test directly, but the available statistics indicate that the mark-up on selling costs is not the same as on manufacturing costs. Another aspect of the same problem is that the mark-up on selling expenses varies according to the location in which the costs are incurred. The IRS statistics are not location specific.

A third problem is that the mark-up will vary according to the destination of the goods. In a perfect world market, mark-ups would be the same no matter where the goods were sold, but in reality the demand for the product and the competition in the particular market will greatly influence the price a seller is able to charge an unrelated party. The Bureau of Economic Analysis' *Special Survey of U.S. Multinational Companies*, 1970, indicates that the mark-ups vary according to the country of destination and to the function performed.⁶⁵ If adjustments are to be made depending on the destination of the sale, extensive data both from the purchaser's country and the selling firm will be necessary. If a mark-up list system were to be instituted on an international basis, each country would have to keep a detailed set of records based on comparable accounting principles.

A fourth problem with industry averages is the variation of the profit on sales of individual firms within even a narrow industry band. The deviations from the averages in various industries are not given in either the IRS or FTC surveys (only deviations based on sampling errors are given); however, *Business Week* and *Business International* figures for particular enterprises indicate that the average gross profit on sales within an industry (only two-digit classifications

65. The data are crude at best. See, *Special Survey of U. S. Multinational Companies*, 1970, Bureau of Economic Analysis, U. S. Department of Commerce, (1972), p. 81.

were used) varies substantially from the industry average.⁶⁶ Even a 40% range in most industries includes only slightly over half the firms listed. This indicates that if a single mark-up is used, it will substantially distort the earnings on many transactions and if a range of mark-ups sufficient to include even a small percentage of firms is allowed, this will enable firms to adjust their prices to shift profits. "A main conclusion is that if there is any variance possible in the transfer price, this should be utilized in order to increase total profits."⁶⁷ A meaningfully broad range which would include over half the firms would be objectionable to both the seller's and buyer's country, for both would suffer from shifting depending on the circumstances, *i.e.*, relative tax rates, exchange controls, customs duties and the like.

Finally, if income tax statistics are used the elective provisions of the tax law will cause added distortion. For example, if an industry had a large amount of research and development, some firms would elect to deduct the expenses, while others might elect to amortize them. For the mark-up to be accurate, a firm must use the same system of computing costs as those used to construct the industry averages.

The use of current lists of mark-ups will be difficult and inaccurate because the data are inappropriate for conversion of costs to transfer price. The construction of an appropriate list of mark-ups will require worldwide statistics based on uniform accounting principles, as well as function-specific statistics. Division into selling and manufacturing functions should be as detailed as possible.

In conclusion, the mark-up list system has the advantage of not requiring extensive allocations of costs to various items, because a cost figure based solely on direct costs only will probably be sufficient. (A more detailed cost figure would increase the accuracy of the system, but not sufficiently to justify the cost of doing so.) However, the data necessary to produce a list of mark-ups are so far completely unavailable. Because of the inability to narrowly define the activity of particular firms or to avoid lumping various products within the same industry, any list system will result in allocations of income which only fortuitously coincide with arm's length allocations.

The Cost-of-Capital System

The second method of determining price is to reconstruct it from a total of all costs incurred, including the "cost-of-capital." Though in many ways similar to the "list" method, "cost-of-capital" is both theoretically and practically distinct. The "list method" depends largely on the industry wide mark-ups,

66. *Business International*, September 23, 1975, p. 20; *Business Week*, August 16, 1976, pp. 15-18.

67. Nieckels, *op. cit.*, (fn 3), p. 163.

while "cost-of-capital" allows the firm to determine its price by using its own cost of capital, without making as many external comparisons. However, unlike the prior method, "cost of capital" requires an extremely detailed analysis of the costs to be included in the price of a good. To avoid reiterating all the problems of cost accounting, this article will discuss only a couple of the problems that arise when one tries to determine the "full" cost of a good.

Direct costs are most easily determined. One problem is depreciation; although it is a relatively small portion of costs in most industries,⁶⁸ both the base for and the rate of depreciation will be a source of contention if a uniform basis for calculation is to be mandated. The base is a problem primarily because of different rates of inflation experienced in different countries.⁶⁹ No developed country allows adjustments for inflation, but some developing countries do.⁷⁰ Capital costs, either interest or dividends, reflect inflation to some extent, and so inflation adjustments to depreciable cost of assets will involve some double counting. The allowable rate of depreciation also varies from country to country; many allow faster than straight-line depreciation for equipment, but there is little uniformity of method.⁷¹ As business has increasingly used straightline depreciation for non-tax purposes, it would probably be acceptable in a safe haven.⁷²

A second problem raised by inflation is the proper accounting for inventoried items, such as materials and the goods themselves. It will be necessary for countries to uniformly decide whether a "cost of capital" mark-up should be imposed on LIFO (last-in, first-out) or on FIFO (first-in, first-out) costs.

There are also direct costs which should be exempt from mark-up both here and under the list system. The most obvious of these are transportation costs.⁷³ Though these should be treated as any other costs if the seller uses his own carriers, a question arises when the seller simply pays an unrelated shipper to transport the goods. It is argued that these costs should be recovered, but not subject to a mark-up, both because they could equally well be billed to either party and because they already include a mark-up. If an unrelated seller were to charge a mark-up on transportation charges, a buyer would simply pay the charges himself. Secondly, if a mark-up is allowed on such costs, they can be

68. See, FTC, *op. cit.*, (fn 61), Utilities are a major exception.

69. Brinner, R., "Inflation, Deferral and the Neutral Taxation of Capital Gains," 26 *National Tax Journal* 565, 570, (1973); See, Wezler, J., *Capital Gains and Losses*, (from Brookings Conference on Comprehensive Income Taxation, 1976) p. 16 *et seq.*

70. Kopits, G., *International Comparison of Tax Depreciation Practices*, OECD, (1975), pp. 11-17.

71. *Ibid.*, p. 18.

72. See, e. g., Dearden, J., *Cost Accounting and Financial Control Systems*, (1973); See, Anthony, R., *Management Accounting Principles*, (1975), p. 143.

73. Ruffalo, *op. cit.*, (fn 6), p. II/230.

easily billed so as to shift income. A similar cost is insurance during transport. The same argument has been made for such things as specialized machining done by outside parties. However, the analogy is not compelling, because there is little possibility that the buyer would or could just as well have had the machining done himself.

The most difficult costs to deal with in reaching "full" cost are indirect costs, including administrative costs, research and development costs, and general overhead. Both accounting and taxing authorities have had great difficulty in treating these costs consistently. Business almost invariably includes administrative expense and overhead in its full cost determinations, unless they are performed outside the plant.⁷⁴ Research and development costs are rarely included, because of the problems of allocation. General executive salaries are also often excluded for similar reasons. However, a company must inevitably recover all of these costs, though in some instances it may do so by separate charge rather than inclusion in the cost of goods sold. The treatment of most of these costs is difficult primarily because of the problems of allocation. Business generally allocates these costs according to their nature. For example, the industrial relations department's costs may be allocated according to the relative number of people, miscellaneous plant costs to direct labor dollars, and property tax and insurance to relative floor space occupied.⁷⁵ The French categorize general costs for tax purposes depending on whether they relate directly to the item produced for the subsidiary, or are incurred for the benefit of the enterprise as a whole. If directly allocable to the item sold, they should clearly be included.⁷⁶ On the other hand, if they are general supervision of investment expenses, or expenses which do not relate to the item sold, they should be excluded. Any allocation will include some judgments by the company, for there is no empirical or theoretical means of determining all questions of allocation. Neither accounting nor tax authorities have been able to solve the problems of allocation completely satisfactorily.

Research and development expenses have often been considered the most important because they are the most difficult to allocate, and they are of greatest importance to many industries. Suggested allocations have included a fixed percentage of direct costs, which is arbitrary, and an allocation on the basis of gross receipts, which is impossible because price, gross receipts, is what

74. Green & Duerr, *op. cit.*, (fn 46), pp. 29-33.

75. Horngren, C., *Cost Accounting: A Managerial Emphasis*, 3rd Ed. (1972), pp. 403-405. "The literature is replete with conflicting and not mutually exclusive criteria for choosing a cost-allocation base," (403). (See Chart in appendix of various allocation bases.) U. S. cases have accepted the allocation bases of accountants. An extensive discussion of the allocation done by an account is found in Lufkin, (fn 45 supra); *See also*, Seghers, P., "Inter-company Pricing in the Light of the Lufkin Victory", 49 *Taxes* 627, 630 (1971).

76. Surrey, *op. cit.*, (fn 6), p. 11/230.

is being determined.⁷⁷ Probably the best that can be done is to allocate directly those R&D expenses which can be reasonably so allocated and to allocate other R&D expenses on the basis of direct costs.

Having computed a rough approximation of the total direct and indirect costs of the product, it is necessary to calculate the "cost of capital" for the firm. It must be presumed that capital invested in a firm must yield a rate of return sufficient to pay the "cost of capital," which yield is at a minimum equivalent to the return paid by other firms incurring similar risks. To use the cost of capital as a mark-up on costs, it must be further assumed that each product produced by the firm contributes equally to paying the cost, adjusted, of course, for the turnover rate of the particular product. The turnover, or number of times per year a firm can incur costs and recover them, divided into the return on investments yields gross profit on sales, which can then be converted to a mark-up. Of course, lists of profit margins can be obtained, but this requires a return to the problems of the "list" system safe haven.

The interest rate that a firm pays on its bonds can be used as its cost of capital. A second source of return on investment can be derived from the actual return on the parent's stock, computed by adding the appreciation of the stock to the dividends paid, divided by the current selling price of the stock.⁷⁸ However, neither is a perfect measure, the former includes an investor's assessment of the future inflation rate, while the latter involves the prediction by investors of future growth. The advantage of such an approach is that the cost of capital is specific to the firm involved and does not require a search for comparable returns. The practical and theoretical problems of such an approach are nonetheless as serious as those of the "list" system.

First, in diversified firms the return on investment will be an average of all activities of the firm. Since the return on investment varies according to the risks of a particular activity,⁷⁹ it is not reasonable in many situations to presume that each activity of a firm is equally risky. Similarly, not all products or sources of revenue contribute equally to the cost of capital because of different risks. Any adjustment for the differences in risk will again require one to look for comparables. Second, the turnover for each activity will vary, and adjustments will require, in part, a search for comparables. There is no reason to believe that either statistics for comparable risks or for turnovers will be any more easily found than would be the case under the "list" system.

As an alternative to the calculation of a firm's cost of capital, an arbitrary

77. See, Treas. Reg. 1.861-8(C) (3), CCH Para. 411F (1977).

78. See, Mullins, D., *Diversification, The Capital Asset Pricing Model, and The Cost of Equity Capital*, Harvard Business School, (1976).

79. Feldstein, M., Green & Sheshinski, *Inflation and Taxes in a Growing Economy with Debt and Equity Finance*, Discussion Paper 481, Harvard Institute of Economic Research (1975), p. 6.

figure such as 10% could be used.⁸⁰ However, the variation of return on investment among viable firms and industries is from about 5% to 20%, and any single figure would clearly be arbitrary.⁸¹

In conclusion, neither the "list" nor the "cost of capital" cost plus safe haven will be easy to administer, and both rely on rarely valid assumptions of substantial homogeneity within a firm. The technical problems of arriving at an acceptable definition of costs coupled with the substantial difficulties with finding a reasonable mark-up indicates that the use of a strict cost-plus computation will not necessarily yield an allocation of profits that is equivalent to the allocation that would occur between unrelated parties.

It is also unlikely that either system will meet the test of acceptability, for any increase or decrease in the efficiency of a particular seller will be reflected entirely in the buyer's country. For example, if the seller can produce an item at half the cost of other sellers in the industry, the additional profit will arise in the buyer's country because his seller will have to sell at a deflated price. For internal business purposes this is unsatisfactory as there is no inducement for a unit to decrease its costs. For countries, this results in lower tax revenues if the producer is efficient and higher revenues if inefficient. A related objection is that a cost-plus system can result in a buyer continually suffering a loss. There is no seller who can continually force his unrelated buyer to realize a loss. Arm's length dealings over any extended period of time will result in both parties' earning a profit (absent very exceptional circumstances — such as a buyer purchasing at a loss to round out his line of products). However, a seller who prices within a cost-plus safe haven may be pricing so as to cause the buyer to continually suffer a loss. The buyer will not object as the profit of the enterprise rather than the individual unit is of concern; yet, the taxing authorities in the buyer's country will definitely object. Of course, the cost-plus systems thoroughly protect the tax base in the seller's country, even if the seller is actually operating at a loss.

The Value-Added System — A Proportional Profits Alternative

The proposed alternative to both cost-plus systems is a proportionate profits system, which solves some, but not all, the problems of the cost plus systems. The system is based on the proposition that profit on the market place is distributed in proportion to the effort expended on or value added to a product. Because cost with certain exceptions is the most uniform measure of effort expended it can be used as a basis for allocation. The transfer price would be calculated by determining the total profit earned on the sale of a product to any unrelated party, multiplying that profit by the percentage of the total

80. Green & Duerr, *op. cit.*, (fn 46), p. 20.

81. Rubloff, *op. cit.*, (fn 14), p. 43; *See*, FTC, *op. cit.*, (fn 61).

value-adding costs (basically direct costs and overhead minus the cost of raw materials) of producing the product incurred by the selling unit, and adding that profit margin to the costs used to allocate the profit, plus other non-value adding costs incurred, i.e. the cost of raw materials.⁸² The primary non-value adding costs are the costs of raw materials and transportation costs, if a common carrier is used. Transportation is excluded for the same reasons it was excluded under the discussion of the "cost of capital" method. The costs of raw materials are excluded because though direct costs, they do not represent effort expended by the seller. For example, the profit of a radio manufacturer is not increased by the costs of buying transistors, but by the costs of assembling the transistors into a radio. A particularly advantageous purchase of transistors may increase the manufacturer's profits, but such profits will probably be in part reflected in his purchasing agent's salary (the salary is an allocating cost, and will increase the unit's share of the total profit) and in part passed on to his buyer. As the costs of raw materials do not represent effort expended or value added, they are not used in the allocation formula.

Though no country has officially adopted a proportionate profits method based on value added, such method has been used administratively. The most frequent form of proportionate profits methods is based on the assumption that "each dollar of costs earns the same rate of profits." As described by accountants:

In their essential relation to revenues, as in their essential relations to assets . . . , all costs are homogenous and rank abreast; this is a basic principle in the development of a reasonable scheme of matching charges and revenues. Costs, in other words, are not recovered through revenue in preferential order. This proposition rests on the familiar assumption that if two or more factors are essential to a given goal or objective no ranking is permissible which results in excluding or minimizing the effect of any particular factor. The amount or weight of a particular component may be more or less than that of another, but its proportionate contribution to the product may not be denied.⁸³

Many economists have disagreed on the grounds that while this method offers a practical approach to a difficult problem it does not reflect sound economic theory.⁸⁴ Each cost in whatever capacity incurred does not yield the same degree of profit. Some costs, if they must be incurred will decrease profit though

82. For example, P produces an item for \$100, which includes \$50 of materials. P transfers the item to its subsidiary, S, which completes the item and sells it at a cost of \$30, including \$5 of raw materials. S sells the final product for \$160, or a total profit of \$30. The transfer price of \$120 properly allocates the total profit. The total value-added costs incurred, excluding materials, was \$75, of which P incurred \$50. Two-thirds of the total profit is therefore added to P's total costs.

83. Paton & Littleton, *An Introduction to Corporate Accounting Standards* (1940), p. 67.

84. Ruffalo, *op. cit.*, (fn 63), p. A-55.

essential to it, such as safety inspections, while others will greatly increase it, such as putting on a trade mark. The basis for such an approach is that to the extent that every cost is necessarily incurred in the furtherance of profit, it is impossible to tell which costs caused more of the profit. Unfortunately, there are no statistics currently available which prove that the split between unrelated parties will correspond to the efforts or costs they have expended. However, it seems at least highly likely that unrelated parties receive profits which at least vary directly with the effort they expend. The inability to prove that market profits are allocated on the basis of effort expended (value-adding costs) does not make this method any less appealing than the cost-plus systems which do not necessarily result in market-like allocations of profit either.

The proportionate profits method eliminates the necessity of determining a list of comparable mark-ups for an industry. It also eliminates the necessity of allocating all costs of the firm as required by the cost-of-capital approach. Expenses which may be directly allocated will be attributed to the cost of the goods, but unrelated research and development expenses,⁸⁵ as well as general executive or home office expenses, must either be charged separately to a related unit or attributed to dividends. The ability to separate out nonallocable expenses allows them to be treated separately under other tax convention provisions. However, despite the technical advantages of a proportionate profits approach, there are difficulties with it.

The primary administrative problem is the determination of the total net profit on the sale. Since the calculation of net income varies from country to country, there is no way to reach an acceptable single figure for apportion if the tax system of only one country is involved. Though an international definition of net profit would solve the problem, it is extremely unlikely that a definition acceptable to all could be found. An alternative is to allow each country to compute its own total, and divide it according to its own computations. However, because it is likely that the resulting figure would differ, double taxation or under taxation would result. To avoid this problem the computation of costs should be according to the country in which the costs are incurred. If a country allows a particular deduction which is attributable to the product, then the deduction should be treated as a cost to be subtracted from the total profit. For example, if one country allowed accelerated depreciation, while the other did not, the measure of the expense should be in accordance with the tax law of the country where the depreciable asset is located. This rule would require that both companies and countries know the tax law of the various countries of operation. This information is readily available, if not already known. Further, the allocation would be made on the basis of the same costs. Finally, only costs which are deductible in the final calculation of taxable

85. Determining which R & D expenses are directly related, and how these are to be allocated to the products to be produced over a number of years, remains a problem.

income for all companies would be allowed. This would prevent countries from generating "deductions" simply to increase their tax base; however, it is unlikely that such "deductions" would become so significant as to force a country to rewrite its tax laws.

A complementary problem is the comparison of costs incurred in various countries in various currencies. It is probably appropriate that the costs be converted to either the seller's or buyer's currency at the exchange rate in effect on the date the costs were incurred. Special tax costs, such as depreciation, will probably have to be converted at the time of transfer. An alternative, if the above method is found administratively burdensome, would be to convert all costs at the end of the year of transfer. Though the second method would cause some distortion, it is not clear that the distortion would be great compared to the cost of conversion at the time an expense was incurred.

A more fundamental objection is that costs incurred in various countries do not represent an equivalent amount of effort expended or profit producing potential. Although this may be true, it is difficult to quantify. In any event, the multinational corporation is probably best able to shop in the international market place and obtain the most advantageous use of its costs. Therefore, at least in theory, the multinational is best able to insure that costs do represent effort expended. If all effort expended contributes equally to profit, then so should all costs, regardless of where incurred.

A similar objection is that risk differences between operations in different countries are not taken into account. The argument is that costs incurred in some countries must yield a higher profit than those incurred in other countries because of higher risks. A risk adjustment could be made by comparing returns on equity investment in the same industry in various countries. This would be difficult for those countries without a well developed equity market. Alternatively, interest rates could be compared, but these include a large inflation component, which would be difficult to eliminate. Of course, the risks between industries or activities also vary at least as broadly as inter-country variations. Also, the return on equity within an industry is at least as wide as between countries or industries.⁸⁶ Finally, risk is born by different costs in different proportions. The risk to permanent assets is undoubtedly greater than to labor costs. There appears to be no way to quantify these differences, nor to determine their importance. Some adjustment may be necessary, especially if the claim of business that foreign operations are expected to earn one and one-half times domestic operations is true, but no reasonably manageable method of making the adjustment seems possible.

The theoretical objection has been raised that the proportionate profits method never results in a loss to only one party to the transaction, unlike oc-

86. Compare FTC, *op cit.*, (fn 61) with *Business Week*, *op. cit.*, (fn 66).

curances in reality. However, if a strictly cost-plus safe haven is used, it is possible for one unit to continually show a loss, and there would be no basis upon which to challenge the arrangement. It is much more probable that companies which continue to deal with each other over the long run will both be earning a profit, rather than one continually suffering a loss.

A similar objection is that the less efficient a particular unit the greater will be its share of profits. Though this is true, it is less than in a cost-plus system. It does indicate, however, that a proportionate profits method price will not be particularly useful to a company wishing to use the price for unit evaluation. However, a cost-plus system also cannot be used to evaluate the selling unit, as it will inevitably reap a profit. The proportionate profits method at least is neutral in its bias. That is, it will increase the profit of whichever unit incurs "excessive" costs, while the cost-plus system will only increase the profit of the selling unit. Of course, if a net loss is incurred under the proportionate profits method, the loss will be borne primarily by the unit incurring the higher percentage of allocating costs, a not entirely unreasonable result.

Another theoretical objection is that the proportionate profits method is unable to allocate the profit derived from a particularly valuable trade-mark or salesman. It is improbable that any safe haven would be able to account for such intangibles; however, the proportionate profits method does tend to allocate the advantage to both units. In the case of a valuable trademark, the seller will earn more because of its value, but so presumably will the buyer-reseller, for otherwise he would not pay a premium for the trade-marked goods. To the extent the sellers development costs are higher, or the buyer pays his (re)salesmen more, a greater percentage of the total profit will be allocated to the units bearing these costs. Whether the allocation will be perfect is impossible to tell; it is equally difficult to determine what a "perfect" allocation might be absent a free market price.

The usefulness of a particular safe haven will depend on its applicability to various forms of international trade. The cost-plus systems can be applied so long as the selling unit incurs its costs in dealings with unrelated parties. If the costs involve purchases from related parties it is necessary that either the related party be located in a treaty country or the purchase be independently inspected to insure arm's-length prices. The proportionate profits method requires that purchases of both the selling and purchasing unit be from an unrelated party and that any resale of the goods be to an unrelated party, unless any related party in the transaction is in a treaty country. This additional requirement of the proportionate profits method will decrease its applicability, the significance of which depends on the complexity of the trading pattern dealing with the particular goods involved. No available statistics clearly indicate how often related units purchase goods for resale to other related units in

third countries, but the United States' treatment of "foreign controlled corporations" gives some indication that such a pattern is not "normal."

The requirement of record exchange to calculate a proportionate profits transfer price should not be excessively burdensome to either companies or countries. Since the use of a safe haven is voluntary, a company will be required to transfer records in advantageous situations and not when there are only *de minimus* transfers between the units.

CONCLUSION

Each of the cost-based safe havens has its weaknesses. Nevertheless it is unlikely that any other form of safe haven would be acceptable because both national taxing authorities and business use cost based pricing methods in the absence of market prices. This brings into question the basic nature of safe havens. Because a safe haven for the transfer price of goods must deal with the full spectrum of international trade, it is impossible that any safe haven will perfectly reflect the allocation of profits that is produced in the market place. However, the very inability to determine a market price for many items indicates that a surrogate for market allocation is necessary. The safe haven will decrease the administrative costs and double taxation that arise from a case-by-case analysis and thereby facilitate trade. However, any safe haven will allow some tax avoidance. If a case-by-case determination would yield a particular allocation, a firm may be able to use the safe haven to its advantage in reaching a different allocation. If a range of mark-ups or a divergence from exact proportionality is allowed the possibility of tax avoidance will increase. The fiscal question which cannot be answered with available data, is whether the administrative savings to both companies and countries of a safe haven and the trade induced thereby will exceed the actual tax loss from avoidance and the administrative costs of the safe haven itself. It is probable that the value added proportionate profits approach will better protect the tax base of all countries and will be administratively less expensive than other safe havens.

Each of the three suggested safe havens should be tested against the four criteria suggested above. First, any of the systems, if bilaterally accepted, will minimize double taxation. None will frustrate legitimate business activity as they are based on arm's length allocations and do not intrinsically burden any particular form of operation. Second, each system will require the incursion of some administrative costs. It is probable that some agreement on international accounting, or reliance on the accounting profession in the country of a trading partner will be necessary. However, the enormous accumulations of data necessary to produce and update a "mark-up list" limit the appeal of the "list" system. The cost-of-capital system may also depend on "comparables," and to the extent comparables are necessary, accumulation costs will be in-

curred. Both the cost-of-capital and the proportionate profits methods place a great deal of reliance on the accounting profession, but some international accounting agreements are necessary even under current conditions. The degree to which a proportionate profits method is less generally applicable than the other systems will depend on the nature and structure of international trade. The proportionate profits method's ability to avoid the search for comparables indicates that it will be the least expensive to implement.

The neutrality of the various systems indicates that a proportionate profits system will be more acceptable. The cost-plus systems favor exporting countries as they insure that a profit will be realized by the selling unit even if the entire enterprise is operating at a loss. The proportionate profits system insures both units a profit (or loss) in all situations. Finally, as all systems have been used administratively at various times and each is based on separate accounting and arm's length pricing, it is unlikely that any country would feel that its taxing system had made inordinate sacrifices in order to solve the problems of transfer pricing. The requirement that additional records be exchanged between trading units to calculate the proportionate profits figures is probably no more onerous than the accounting verifications that will be necessary under any safe haven. Nonetheless, the proportionate profits method is the least similar to prior methods and may require empirical comparison with arm's-length divisions of profits before complete acceptance can be expected.

In conclusion, a value added proportionate profits safe haven for the transfer of goods, with an exception for specific extraction and agricultural products, has sufficient merit to deserve consideration for inclusion in modern tax conventions. Its greater neutrality and avoidance of comparables recommends it above other possible safe havens, and it is a clear improvement on the current *ad hoc* unilateral case-by-case determinations which result in high costs and double taxation.