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The taxation of international income in developing countries*

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Introduction

1. The issue of greatest concern in international tax today — and indeed for the past 15 years or so — is transfer pricing. Because of the large amounts of tax revenue at stake, difficulties in complying with the pertinent tax rules, the potential for abuse and the risk of double taxation of income, it is an important issue for tax administrators and multinational business enterprises alike. Although several other issues that affect the taxation of international income by developing countries today will be discussed, much of the present commentary will centre on transfer pricing due to its current importance in the international tax area.

2. Inter-company transfer prices are prices charged among members of a multinational group of affiliated companies for goods, services, property and loans transferred on an inter-company basis from one country of operation to another. The prices charged for goods, services and loans by one group member to another affect how much tax will be received by each country in which the group operates. If the prices charged for transactions between group members operating in different countries are set too high or too low, then income is effectively shifted from one country to another. Not surprisingly, tax authorities around the world want to ensure that income is not understated because a distributor overpays its foreign manufacturing affiliate or a manufacturer undercharges its foreign distributor.

3. If a United States parent company charges its foreign subsidiary $1,000 for goods to be resold in the foreign country, the foreign subsidiary's profit in the foreign country, absent a transfer pricing adjustment, will be the subsidiary's resale price over its $1,000 cost. If the United States Internal Revenue Service (IRS) determines that the appropriate transfer price is $1,200, the United States parent will have an additional $200 of income in the United States. Does that mean that the foreign subsidiary then adjusts its cost to $1,200 and reports $200 less income in the foreign country? Not necessarily. It depends on whether the foreign country has rules similar to the IRS for determining appropriate transfer prices. It then further depends on whether the foreign country's tax authorities agree with the IRS as a factual matter on how much income the parent earned based on all the relevant data.

4. If the foreign country's tax authority agrees that the appropriate transfer price is $1,200, then tax revenues are moved from the foreign country to the United States. In many cases, however, the multinational in that example would be indifferent whether the transfer price is $1,200 or, for example, $800. If it pays more taxes in the foreign country because the transfer price on goods sold to its foreign subsidiary is lower, the taxes in its home country will be correspondingly lower, and therefore its overall tax liability may be substantially the same. The main reason is that tax rates in many major trading countries are similar and have tended to converge in the past 12 years. From a tax point of view, the multinational is often merely a stakeholder between the tax authorities of the two countries. Obviously, however, in which country the tax is paid matters very much.

5. The situation for the multinational is quite different if one country has a lower effective tax rate than the other country. In that case, the multinational might have an incentive to shift income from the high-tax jurisdiction to the low-tax jurisdiction, particularly if the high-tax jurisdiction is unlikely to examine the multinational's transfer prices.

6. The situation for the multinational is also quite different if the multinational is being challenged in both countries on its transfer prices and the multinational is unable to persuade the tax authorities to adopt the same price. If the IRS says that the appropriate price is $1,200 but the foreign country tax authority says the appropriate price is only $800, the multinational group will pay tax twice on the same $400 of income. Whether the rates are the same is beside the point. Double taxation may be avoided if the IRS and the other country are able to resolve their dispute through the competent authority provisions of the applicable tax treaty.

I. How industrial countries have addressed transfer pricing issues

7. There have always been significant administrative difficulties in making sure that taxpayers set appropriate transfer prices for tax purposes in international transactions with related parties. As international commerce grows, that becomes a more and more important question. With the encouragement of the United States of America, the world community has largely adopted the so-called arm's length standard, which sets transfer prices based on prices charged in transactions between unrelated parties. That standard has been widely accepted as the theoretically correct pricing rule. The problem is that it is usually difficult to find a transaction from which to derive an arm's length price. As a result, the United States and other countries have tried to find alternative rules, involving functional analysis, comparative rates of return and profit splitting. Those approaches, while theoretically flawed, may be practical supplements to the arm's length standard.

A. The arm's length standard

1. Arguments in favour of the arm's length standard

(a) International norm

8. The arm's length standard has been adopted by nearly every country as the guiding principle for determining transfer prices between members of a group. Its use has been recommended by both the United Nations and the Organization for Economic Cooperation and Development (OECD).

9. In the United States, the Revenue Act of 1921 contained the first articulation of the arm's length standard in the income tax area. The 1935 regulations interpreting a predecessor to section 482 provided that the standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer. They did not, however, require the use of any particular method. The courts applied a number of different standards for determining when transactions were conducted at arm's length, such as whether the related party received a "fair and reasonable price" or a "fair price including a reasonable profit."

10. By the early 1960s, the international and business climate had changed considerably. Congress became increasingly concerned that United States companies were shifting income to their foreign subsidiaries. The United States House of Representatives proposed legislation that required the United States taxpayer to demonstrate that its transfer prices with its foreign affiliates were supported by comparable prices with unrelated third parties; if not, the group's income was to be apportioned between the related members under a formula based on their relative economic activities. The United States Senate rejected the proposal, concluding that it was better to address improper multinational allocations through guidelines and regulations.

11. The IRS issued regulations under section 482 in 1968 that governed transfer pricing practices for United States taxpayers until July 1994, when a new set of section 482 regulations was issued. The 1968 regulations reaffirmed the arm's length standard, and provided the first detailed articulation of the arm's length approach by establishing rules for specific kinds of inter-company transactions, including the performance of services, the licensing or sale of intangible property and the sale of tangible property. The United States approach influenced other countries to adopt the same arm's length approach. Under most of its bilateral tax treaties, the United States is obligated to apply the arm's length standard to transactions by persons subject to its tax jurisdiction.

(b) Less arbitrary than formulary approach

12. The arm's length standard uses real transactions that occur in the market place as the standard for allocating income between countries. That market-based approach is believed by its supporters to be more acceptable to taxpayers and tax administrators than arbitrary formulas that depend on relative assets and employees, for example, without regard to how the market place really operates.

(c) Double taxation risk is lower

13. Because the arm's length standard is so widespread, its consistent use throughout the world minimizes the problem of double taxation. Any industrialized country that were to depart from its use without coordinating the departure with other countries would increase the double taxation risk. The use of different methods places more pressure on competent authorities under the international treaty system to work out the differences, and the competent authority process is known for taking a long time to resolve cases.

2. Problems with the arm's length standard

(a) Complexity

14. Determining an appropriate transfer price can be very complex, particularly because the taxpayer rarely has available information on comparable third party prices. In many cases, comparable third party prices simply do not exist. The work necessary to compile data and properly analyse the related and unrelated transactions can be extremely burdensome and costly.

(b) Uncertainty

15. The determination of an appropriate transfer price is often very subjective. Taxpayers complain that the tax authorities use the benefit of hindsight to adjust prices, providing much uncertainty in the business environment. If a multinational taxpayer has a significant amount of inter-company cross-border transactions, even small changes in transfer prices can result in huge increases in tax liability.

16. Uncertainty also provides room for abuse by taxpayers. Transfers within multinational corporations often involve enigmatic subjects, such as intangible property and non-standardized products. In such cases, there are usually no comparable transactions involving third parties to judge the reasonableness of the multinational's transfer price.

(c) Failure to reflect economic reality

17. Many economists believe that the arm's length standard does not reflect economic reality because related group members do not behave the same way as unrelated parties. When companies are integrated into a multinational corporation, there are usually greater cost savings and efficiencies than if the companies were unrelated, and the arm's length standard's focus on unrelated parties fails to take those economies of scale into account.

18. Moreover, contrary to what the IRS and other tax authorities may believe, transfer prices are often set with little regard for tax consequences. In the real world, corporate executives frequently set prices based on such non-income tax considerations as costs, competition, supply and demand, import duties, anti-dumping rules and local regulatory requirements. In addition, there are often internal political considerations within the organization, such as the relative power of executives in charge of the manufacturing and distribution functions within the group, and the need for management to justify the success of its strategic decisions regarding the location of a plant or the selection of a market. Imposing the arm's length standard may interfere with the way that business would otherwise operate.

B. United States experience in enforcing the arm's length standard

1. United States Internal Revenue Service attempts to move away from the arm's length standard

19. The 1968 regulations stood the test of time quite well but by the 1980s were showing signs of strain caused by several factors. In the 1986 tax legislation, United States Congress made one significant but narrow change to the basic transfer pricing law by requiring income of the transferor from sales, licenses and transfers of intangible assets to be commensurate with income generated by the related transferee. Congress also directed the IRS to study whether legislative or regulatory change to the scheme of the existing transfer pricing regulations was needed. It was recognized that change was needed because the 1968 regulations reflected the United States' status as a major capital exporter.

20. In response to the Congress directive, the IRS issued its 1988 White Paper on transfer pricing. The White Paper was received with hostility from some commentators because they believed it represented a retreat from the arm's length standard. Instead, in their view, the Treasury Department proposed applying arm's length rates of return in circumstances where inadequate comparable pricing data was available.

21. After much reflection, in January 1992 the IRS proposed new transfer pricing regulations to provide more detailed guidance on transfers of tangible property and to implement the 1986 legislation that requires royalties on intangible property to be commensurate with the income derived by the transferee from such property. Those regulations also added a requirement that the taxpayer's transfer prices be justified by comparing the taxpayer's profits to the profits of its competitors. That requirement evoked significant protest from multinational business and foreign Governments. Businesses claimed that sufficient information about their competitors was not available. Foreign Governments claimed that the "comparable profits" requirement undermined the arm's length standard's focus on comparable transactions rather than comparable profits.

22. After taking into consideration comments received from the 1992 regulations and temporary and proposed regulations issued in 1993, the IRS issued final transfer pricing regulations in July 1994. Those regulations reaffirm the use of the arm's length standard, and require the taxpayer to determine arm's length pricing using the best method available, i.e., the method that yields the most reliable measure of arm's length results. The comparable profits test is no longer required as a confirming methodology but may be used as a method for determining transfer prices if there are no closely comparable transactions for which reliable information is available. Those regulations represent an extraordinary good faith effort by the United States to make the arm's length standard work in a complex world, in 40,000 words to be exact.

23. The issue still with us, however, is how much importance should be placed on comparable profits of competitors. Several non-United States tax authorities have asserted that any method keyed to comparable profits is impossible to reconcile with the arm's length standard. But if comparable transactions simply do not exist or are too difficult to find, then some form of comparable profits approach or perhaps even a formulary apportionment approach may be the only way to determine an appropriate allocation of international income.

2. Possible United States legislation

24. The United States Congress has introduced several bills in recent years that would require a minimum amount of taxable income to be reported by certain foreign-owned United States corporations or United States branches of foreign corporations that engage in more than a threshold

level of transactions with foreign-related parties. Under such a proposal, the taxpayer's taxable income from any category of business would be no less than 75 per cent of the amount determined by applying an applicable profit percentage to the taxpayer's gross receipts from that business category.

25. Despite the defeat of the Democrats in the 1994 elections in the United States, Senator Dorgan, a Democrat who has been a strong advocate of formulary apportionment, has continued to push for adoption of that method. That formulary apportionment is similar to the manner in which income among states is allocated and apportioned, as if the multinational were a unitary worldwide business. Most states use a three-factor apportionment formula of sales, property and payroll, with each factor equally weighted. A "unitary" formulary apportionment formula used by a few states (e.g., California) combines the income of the entire affiliated group and then applies the three-factor formula to that larger income base. Although Senator Dorgan has found some sympathetic ears among the Republican majority, the prevailing view among legislators is to maintain the arm's length standard. However, although Republicans are opposed to new taxes they are least likely to resist more efficient taxation of foreign multinationals as a means of keeping with the principles of the Contract with America. Renewed interest in formulary apportionment is therefore likely.

26. The IRS will continue to object to formulary apportionment, citing the need for the harmonization of international standards, the uncertainties created by the differences in accounting methods and record keeping, the administrative burdens imposed by formulary apportionment on United States and foreign multinationals alike, the potential for double taxation of income, and the intense international resistance to moving away from the arm's length standard. In that respect, the United States Treasury Department last year sponsored a formulary apportionment conference, at which Deputy Secretary Lawrence Summers reaffirmed the United States Government's full, unqualified support of the international consensus for the arm's length standard. He emphasized that a move to a formulary approach would require the international community to agree upon a definition of total income and a formula to apportion that income, problems similar to those now being addressed under the rubric of the arm's length standard.

27. It is likely that Congress will grant the IRS the time to allow the final regulations and the rapidly developing advance pricing agreement procedure — in which multinationals and tax authorities negotiate unilateral, bilateral or multilateral agreements with respect to transfer prices — to be implemented and evaluated without further substantial change. Also, pleas will continue to be made about the need for United States competitiveness as an argument against formulary apportionment for United States multinationals, and the need not to discourage needed foreign investment of capital as an argument against formulary apportionment for foreign multinationals.

3. United States problems in enforcing arm's length standard

(a) United States Internal Revenue Service problems in litigating section 482 cases

28. The 1986 tax legislation permitted the IRS to shift its attention away from tax shelters, which had comprised as many as 50,000 of the 82,000 cases docketed in the Tax Court. In the mid-1980s, the IRS began to step up its international audit focus by forming litigation teams of economists, engineers, accountants and attorneys; devoting more resources to section 482 cases through the Coordinated Examination Program; and identifying key international tax issues for litigation. At the end of 1994, there were 105 section 482 cases pending in the Tax Court and the United States Court of Federal Claims, with at least $3.7 billion of section 482 deficiencies at issue (a total of $33 billion in deficiencies was pending in federal courts). Audits of foreign corporations increased more than 350 per cent from 1990 to 1993. Despite the IRS emphasis on auditing and litigating section 482 cases, its victories in the area have been few and far between. Some of the reasons for that lack of success are set out below.

(b) Inability to access foreign-based documents

29. Before it was equipped with some of the weapons discussed below, the IRS experienced difficulty in gaining access to information used by related parties in making pricing decisions, particularly where foreign-based documents were in the custody of foreign parents of United States subsidiaries. Summons were often unenforceable because courts lacked jurisdiction over the foreign parent. In other cases, foreign-based documents did not exist due to lax record-keeping standards in foreign jurisdictions. Information exchange provisions in treaties have been ineffective in providing the IRS with the requested information because of exceptions for measures that would violate the other country's laws or require the disclosure of trade secrets, as well as long delays in negotiating with the foreign Government concerned over what information is accessible.

(c) Inability to impose regular tax penalties

30. The IRS had authority to impose the general 20 per cent accuracy-related penalty in transfer pricing cases before the 1990 legislation discussed below, and periodically did so. However, the authors have been unable to find any cases in which the taxpayer actually paid that penalty. In 1990, former IRS Commissioner Fred Goldberg explained in Congressional hearings that a 20 per cent penalty based on negligence or a substantial understatement is a possibility only in a flagrant case because there are usually reasonable points of view on both sides. There are cases where IRS pricing turns out to be as wrong as the taxpayer's pricing. If the IRS says it is $10 and the taxpayer says $20 and the court comes in at $15, both are half wrong. Application of the 20 per cent penalty based on grounds other than negligence, such as a substantial understatement of tax, is also difficult.

(d) Limited reach of general record-keeping requirements

31. United States tax law requires all persons liable for United States tax to keep records sufficient to establish their correct federal income tax liability, for inspection by the IRS. There is little guidance on the scope of that requirement. Courts have held that the IRS may not use that requirement to compel a taxpayer to create new records during the audit process if its existing records otherwise meet the minimum record-keeping requirements. Moreover, that requirement does not apply to foreign parents that are not themselves liable for United States tax.

(e) First legislative reaction: section 982 (1982)

32. Section 982 of the Internal Revenue Code provides that the IRS may issue a "formal document request" for foreign-based documentation after an "informal" document request has been issued and rejected. If the taxpayer does not "substantially comply" with the formal request, the taxpayer will be precluded from later introducing in court any foreign-based documentation covered by the request. The exclusionary rule does not apply if the taxpayer shows "reasonable cause" (e.g., difficulty of producing documents). The potential violation of foreign law is not an excuse. Section 982 precludes only the introduction of documents, not testimony.

(f) 1989 expansion of section 6038A and 1991 final regulations

33. Based on concerns that foreign multinationals were not paying their fair share of United States tax by artificially reducing the United States tax liability of their United States subsidiaries, the United States Congress completely reworked section 6038A (enacted in 1982). That reworked version has eliminated many difficulties the IRS had experienced in obtaining foreign-based documents in the custody of foreign multinationals.

34. First, because of expanded reporting requirements many new foreign parties and transactions are now brought under IRS scrutiny. Second, United States taxpayers must maintain records that are sufficient to establish the correctness of their United States tax returns with respect to transactions with foreign-related parties. Third, every foreign-related party is required to designate the reporting corporation in the United States as its agent for service of process in the United States. Fourth, a $10,000 civil penalty may be imposed on reporting corporations for non-compliance with the annual information reporting and record-keeping requirements, with an additional penalty of $10,000 for each 30-day period of continuing non-compliance after the taxpayer has been notified by the IRS.

35. Fifth and most important, the IRS has been granted sweeping new powers by Congress to impose the "non-compliance penalty" if (a) a foreign-related party fails to designate the reporting corporation in the United States as its agent for service of process, or (b) a reporting corporation refuses to comply with a summons issued to such corporation directly or as agent for the foreign party, even if there is reasonable cause for such failure. When the non-compliance penalty applies, the IRS has the sole discretion to determine transfer prices between the reporting corporation and the foreign-related party with respect to the transaction for which documents or testimony are requested. The IRS may apply the non-compliance penalty to any year not closed by the statute of limitations.

36. Those strong United States enforcement measures are not without their critics, however. Some commentators have noted that the existence of penalty documentation provisions, combined with aggressive transfer pricing audit procedures, may prompt multinationals to overpay taxes in a country to avoid penalties and minimize controversy costs. Thus, such penalties and audits may pose a threat to the tax bases of the other countries in which such multinationals operate, particularly countries in which enforcement is lax.

(g) President Clinton's plan to target foreign multinationals

37. During his 1992 presidential campaign, former Arkansas Governor Clinton pledged to collect $45 billion in tax revenues by cracking down on foreign companies that prosper in the United States and manipulate tax laws to their advantage. Once in office, President Clinton pledged to

increase transfer pricing enforcement and to require multinationals — both United States and foreign — to support their transfer pricing calculations with more thorough and contemporaneous documentation. The revenue estimate, however, was reduced to $3.8 billion (from $45 billion) over five years. Clinton's proposal was enacted by the United States Congress in 1993. Clinton's 1994 budget also proposed additional funding to double the audit rates on foreign multinationals' United States subsidiaries.

38. More recently, the Clinton administration has emphasized the continuing global consensus for the arm's length pricing principle and the development and successes of the advanced pricing agreement programme, which appears to be well received by taxpayers and tax administrators alike.

(h) 1993 transfer pricing penalties

39. In 1993, the United States Congress enacted new penalties equal to 20 per cent, or as high as 40 per cent for more aggressive cases, of the tax underpayment attributable to a transfer pricing adjustment. To avoid those penalties, a taxpayer must maintain sufficient documentation to establish that given the available data and the applicable section 482 pricing methods, the chosen method for determining transfer prices provides the most reliable measure of an arm's length result. The documentation must exist when the tax return is filed, and must be provided to the IRS within 30 days of request.

40. Those penalty rules and the final transfer pricing regulations are inextricably linked. The extent to which taxpayers wish to adopt aggressive positions under the transfer pricing rules is controlled by the requirements in the penalty rules to act reasonably. The penalty rules are intended to change taxpayers' behaviour by forcing them to justify their transfer pricing prior to filing tax returns, rather than many years afterward in response to an IRS examination. Taxpayers must now prepare contemporaneous documentation of their transfer pricing methods and provide such documentation to the IRS upon request. Those penalty rules are the culmination of years of IRS complaints that taxpayers wait until the audit stage to justify their related party transactions. That tactic resulted in delays in (or denial of) IRS access to taxpayer's transfer pricing information, and therefore caused more controversy between the IRS and the taxpayer. Contemporaneous documents are more probative since they do not allow a taxpayer to delay stating its reasoning. Thus, the taxpayer is denied the advantage of post-return rationalizations.

C. Transfer pricing practice of other industrial countries

41. A task force of nine OECD member countries prepared part I of a discussion draft of guidelines regarding transfer pricing on 8 July 1994, under a mandate from the OECD Committee of Fiscal Affairs, and released part II of the discussion draft on 8 March 1995. On 27 June 1995, the Committee on Fiscal Affairs approved the final version of the transfer pricing guidelines. In March 1996, supplemental chapters to the final guidelines were approved. Those OECD transfer pricing guidelines, which are a revision of an OECD report from 1979, were prepared to reflect and update OECD members' views on transfer pricing issues in light of the increased globalization of national economies and the change in legislation and practices of a number of countries since 1979. OECD plans to periodically review and revise the guidelines on an ongoing basis.

1. Commitment to arm's length standard and transaction-based methods

42. OECD believes that each enterprise within a multinationals' worldwide group should be treated as a separate entity. The arm's length standard for establishing transfer prices on cross-border transactions is believed to be the best method of taxing those separate entities, avoiding double taxation, minimizing conflict between tax administrations and promoting international trade. The arm's length principle is believed to place multinational enterprises and independent enterprises on a more equal footing for tax purposes, thereby avoiding the creation of any tax advantages or disadvantages attributable to operating as either a multinational or an independent.

43. OECD recognizes the difficulty of applying the arm's length method and the administrative burdens it causes for both taxpayers and tax administrators, but it nonetheless believes that the costs are worth the benefits. To depart from the arm's length principle would threaten the international consensus and increase the risk of double taxation. The degree of experience and common knowledge among taxpayers and tax administrators has established a sufficient body of common understanding. That understanding should continue to be streamlined in order to improve the administration of the arm's length principle. Those concepts derive from the 1968 studies by Assistant Secretary of the United States Treasury Department, Stanley Surrey, and the IRS.

44. The OECD guidelines are premised on the assumption that the most direct and reliable way to determine arm's

length prices is by use of either the comparable uncontrolled price method, resale price method or cost plus method. After considerable criticism of the comparable profits method originally provided in the draft guidelines, the final guidelines replaced that method with the "transactional net margin method," a similar profits-based method that emphasizes the comparability of the transactions upon which the profit comparisons are made. The primary criticism of the comparable profits method included in the draft guidelines was that it tended to diverge from the arm's length pricing principle, instead substituting a so-called arm's length profits or rate-of-return principle. Critics contended that when applied to complex, diversified multinational enterprises, misapplication of the comparable profits method was likely because, as described in the draft guidelines, it did not expressly prohibit the aggregation of operating profits over broad product lines. There was also concern that even when functional similarity exists between two enterprises, those enterprises may be fundamentally non-comparable because factors other than products and functions — such as valuable intangibles, like a brand name, or simply greater management efficiency — can influence profitability. Concern was also expressed that the dependence on comparable "profits" would lead to undertaxation of unusually profitable firms and overtaxation of firms with abnormally low profits. In the light of those concerns, the OECD drafters eventually replaced the comparable profits method with the transactional net margin method, which attempts to address all those concerns.

45. Notwithstanding differing nomenclature and emphases, most commentators expect that there will be a fundamental accord in the practical application of the comparable profits method in the United States regulations and the transaction net margin method as it is adopted in other OECD countries. In both instances, the so-called profits-based methods are methods of last resort, to be used only when there is insufficient data to use the methods more closely linked to specific transactions, namely, the comparable uncontrolled price, resale price and cost plus methods.

2. Rejection of global formulary apportionment

46. OECD rejects global formulary apportionment as an alternative to the arm's length principle for determining the proper level of profits across national taxing jurisdictions. A global formulary apportionment formula would presumably allocate global profits of a multinational group on the basis of some combination of relative cost, assets, payroll and sales. To effectively avoid double taxation, a world consensus would be needed on the measurement of global income and the associated accounting system, the factors to be used for apportionment and the relative weight of each factor. Each country would want to emphasize factors that maximized its revenue. There also is concern that any formula would be arbitrary, and would disregard market conditions and relative functions and risks. In addition, differences in treatment of exchange-rate movements would skew the formula's application.

3. Monitoring OECD member nation compliance with the 1995 guidelines

47. Jeffrey Owens, head of fiscal affairs for the OECD, has indicated that the Committee on Fiscal Affairs will monitor the implementation of the 1995 transfer pricing guidelines by member nations. Monitoring will entail peer reviews of each country by two or three other countries. The peer review teams will examine legislation, regulations and practice, and will identify any issues that should be discussed with the reviewed country. Such peer reviews should assist in refining legislation, regulations and practices and should encourage consistent application of the guidelines.

4. Advanced pricing agreements

48. As mentioned above, when a multinational is attempting to set appropriate transfer prices between two tax jurisdictions with comparable tax rates, in many instances it is more like a stakeholder between the two jurisdictions and is mainly concerned with avoiding double taxation. Realizing that fact and the desire of multinationals to avoid compliance problems in the factually complex transfer pricing area in general, in 1991 the IRS formalized a procedure for obtaining advance pricing agreements. The procedure allows multinationals to enter into an agreement with the IRS covering the prospective determination and application of transfer pricing methods for certain international transactions. Under that procedure, the multinational proposes a transfer pricing method and provides data showing that it produces arm's length results between the taxpayer and the specified affiliates with respect to specified inter-company transactions. The IRS then analyses the proposal and discusses it with the taxpayer. If the proposal — which may be modified to address IRS concerns — is acceptable to the IRS, the parties execute an advance pricing agreement.

49. Tax authorities in a number of countries have adopted, formally and informally, programmes similar to the IRS advance pricing agreement programme. In appropriate cases, a multinational may obtain an advance pricing agreement that is either unilateral, bilateral or multilateral. Of course,

multinationals prefer the latter two arrangements in that they are the only way of ensuring the elimination of double taxation.

50. Initially, many multinationals received the advance pricing agreement programmes with skepticism. Now, however, many multinationals have come to view advance pricing agreements favourably, citing certainty regarding the tax consequences of inter-company transactions, the elimination of exposure to transfer pricing penalties and limiting record-keeping responsibilities to specified items. Consequently, multinationals indicate that they believe that the use of advanced pricing agreements will continue to grow, although enthusiasm is less strong in such countries as Germany and France, partially due to the reluctance of their taxing authorities to enter into such agreements. From the viewpoint of tax authorities, advance pricing agreements appear to be a more efficient use of resources. The IRS estimates that the budget for its entire advance pricing agreement programme is about the same as the cost of bringing one transfer pricing case to trial. Notably, the OECD transfer pricing guidelines endorse the use of advance pricing agreements, and the Committee on Fiscal Affairs is expected to issue guidelines on carrying out such agreements.

II. Constraints on developing countries' ability to effectively tax multinationals

A. Dependence on the corporate income tax

51. Developing countries have long relied on the corporate income tax as a principal means of revenue. Those taxes account for up to one third of revenue in some developing countries.

52. It may seem at first unusual that a levy as complex as the corporate income tax would be so prominent in developing countries, in which the number of tax experts is relatively low. One reason is that many of the tax systems of developing countries that are former colonies can be traced to the tax systems of their colonizing countries, and the corporate income tax is a principal means of taxation in industrial countries. Another reason is the foreign tax credit granted to taxpayers in industrial countries. The foreign tax credit gives credit only for income taxes paid abroad. However, no credit is given to the multinational in its home country for sales taxes or gross receipts taxes paid abroad. Obviously, as an aid to attracting foreign investors, developing countries need to preserve as much as possible the investors' foreign tax credit.

53. Corporate income taxes are important for another reason: they are relatively easier to collect than other types of taxes. Personal income taxes, for example, are difficult to collect when an economy is mostly agricultural and a population is geographically dispersed. Moreover, much of the population may fall below the low personal exemption levels. In practice the individual income tax typically becomes a tax on employees who work in large firms that withhold taxes from wages.

54. Property taxes are only a minor revenue source in most developing countries, for several reasons. Many properties are too small to be readily assessed. Self-valuation does not work well. Assessors are often subject to political influence.

55. The majority of tax revenues in developing countries comes from taxes, on commodities, which include value added taxes, sales taxes and excise taxes on imports and exports. Sales taxes come in various forms, but the least desirable form is the turnover tax, which has been quite common in developing countries. The turnover tax is imposed at every stage of the production-distribution chain. Those taxes distort decisions at the production level, and cause a cascading of tax liabilities as each transaction accumulates more tax. The pure form of value added tax (VAT) — that is, one that allows the tax paid by a firm on its purchases or inputs to be credited against or subtracted from the tax that the firm charges on its output or sales — generally has less distortive effects. Many developing countries have difficulty administering a pure form of VAT. However, in recent years several developing countries have implemented a pure VAT with success. India is a good example. Uganda adopted a new VAT that began in 1996. The bottom line, though, is that each country needs to do what is administrable — there is no single type of VAT or sales tax that is most appropriate in all cases.

B. Administrative constraints

56. The most important additional constraints that developing countries face are the relative lack of sophisticated record-keeping in many of the local business enterprises and the limited resources available to tax authorities for tax enforcement. Those are barriers to implementing broad-based taxes, such as income taxes and VAT. The key to overcoming those barriers is to modify those taxes and the rules applied in collecting them so that the taxes are enforceable using the available business records and the limited resources available to the tax authorities.

57. There are also differences among developing countries. It may be that some of those differences arise more or less by accident, or from the peculiarities of the taxes that those countries have imposed. Or they may in part reflect cultural and historical differences in the willingness of some peoples to voluntarily submit to the income tax.

58. One could also point to numerous similar examples in which developing countries have responded to administrative realities in choosing their tax policies. In many respects, those developments have parallelled the trends noted in the United States and other developed countries.

59. In recent years, countries in Latin America and elsewhere have abandoned their highly progressive income tax rate structures. That shift in tax policy has in large part resulted from the conclusion in those countries that tax authorities cannot effectively administer such highly progressive taxes. At the same time that developing countries have been reducing the progressivity of their income taxes, they have been adopting VAT as a central part of their tax systems. Once again, a relatively simple broad-based tax has proved the most effective. Difficulties have arisen when they have employed a variety of rates or a complicated scheme of exemptions from the tax.

60. Another common strand in most of the recent reforms of income tax or VAT is the enactment of relatively broad exclusions for low-income taxpayers (in the case of income tax) or broad groups of small merchants (in the case of VAT). In several countries, the movement away from highly progressive income taxes and toward broad-based consumption taxes has been accompanied by the elimination of a variety of less productive taxes that they had previously imposed. In other developing countries, reforms have been unsuccessful when they have been too complex or have otherwise failed to take sufficient account of the realistic limits of the country's tax authority.

61. That experience suggests that in developing a more productive tax system, developing countries should realistically assess their ability to administer particular taxes and tax rules, as well as their ability to improve those administrative capacities. Most developing countries will probably conclude that they cannot count on making dramatic improvements in their tax administration in the short run. Most developing countries will also be able to identify numerous administrative constraints that they must take into account in developing tax policy.

62. If a developing country keeps those considerations in mind, its emphasis in developing a tax system will probably be on keeping it as simple and as stable as possible. That focus on simplicity and stability should lead developing countries to consider ways of simplifying their current tax systems. Most likely, it will also lead them to adopt rules or taxes that may be only rough approximations of preferred taxes or preferred rules, but that are more effective because they are more administrable.

63. The transfer pricing arena, perhaps better than any other area of international tax law, illustrates how taxpayers can often gain the upper hand through their access to highly qualified tax professionals. Even the IRS, with all its resources, has a fairly dismal record of successfully challenging taxpayers in that area. The sustention rate with regard to the IRS examiner's proposed transfer pricing adjustments has generally been less than 30 per cent in the past five years. That problem, however, is worldwide, and steps are being taken to correct it. The United Kingdom's Department of Inland Revenue, which has only litigated one transfer pricing case to date, recently announced that it plans to increase enforcement of laws intended to prohibit transfer pricing abuse. Among developing countries, Brazil's tax authority recently announced that it is creating a special unit, consisting of senior audit personnel, accountants, economists and lawyers, to handle transfer pricing cases exclusively.

III. Recent attempts by developing countries to combat transfer pricing abuse

64. To understand how multinationals should be taxed by the various countries in which they operate is a daunting task for even the most experienced tax practitioner, much less the staff of a developing country's tax administration. They must see the above-mentioned 40,000 words of regulations under section 482 and shake their heads, possibly with awe but more likely with disgust and frustration. In the United States, the rules for taxing foreign operations have reached a level of complexity that threatens to result in a breakdown of the system for taxing and auditing multinational taxpayers. In many instances, even the most sophisticated taxpayers find it difficult to determine their tax liability. IRS officials freely admit that they are unable to enforce the rules effectively. It is no wonder that developing countries conclude that their tax administrations are incapable of administering such a complex system of taxation, and resort to simpler but nonetheless cruder ways of taxing multinationals.

65. Many developing countries, such as the Philippines and Thailand, have no laws on their books regarding inter-company pricing. Some of those countries implement controls through their Customs divisions for import and export

transactions. Declared prices are compared with standard prices compiled by Customs, and the duty base can be increased for any difference. However, there is rarely coordination between Customs and the tax administration with respect to income taxes.

66. Other developing countries have general statements in their law regarding transfer pricing, often providing broad authority to their tax administrators to determine transfer prices but without any specific rules regarding how they will be determined. Chile, for example, empowers its tax authority to question the prices or values in which inter-company transactions are carried out when those prices differ from those ordinarily obtained in the domestic or foreign market. In Malaysia, when a Malaysian company derives less profit than would normally arise from a trading transaction with a commonly controlled non-resident, the Director General can tax the non-resident on a fair percentage of the profits from trading in Malaysia. A similar rule exists in Singapore. In Papua New Guinea, the Commissioner General of Internal Revenue is authorized to ascertain the arm's length value of inter-company transactions by reference to contemporary market value, and where no such reference is available to determine the arm's length value using his own discretion.

67. Some developing countries are slightly more specific in their provisions designed to counter tax avoidance through transfer pricing. In Argentina, for example, when exports from Argentina are priced below the wholesale market price of the goods in the importing country, the Tax Board is authorized to assess the exporter's profits on the basis of the wholesale market price in the importing country. Conversely, when the price of imports into Argentina is above the wholesale market price in the exporting country, plus shipping and insurance expenses, the Tax Board may adjust the importer's costs of goods downwards and treat the difference as Argentine source income of the importer.

A. Mexico

68. Mexico, in particular, has made great strides in recent years in its regulation of transfer pricing. Mexico's admission to the OECD and its signing of the North American Free Trade Agreement and tax treaties with the United States and Canada have no doubt accelerated Mexico's increased interest in transfer pricing. Mexico has been assisted by the IRS in training international examiners.

69. Effective 1 January 1997, Mexico amended its transfer pricing provisions to recognize six transfer pricing methods of determining arm's length prices: comparable uncontrolled price, resale price, cost plus, contribution profit split, residual profit split and transaction operating margin method. Those methods are intended to be in harmony with the OECD guidelines. Mexico's new transfer pricing provisions also include extensive documentation requirements and special penalties for underpayments of tax due to transfer pricing. Like those in other North American countries, Mexico's tax authority continues to actively pursue resolution of transfer pricing compliance issues through advance pricing agreements.

70. Interestingly, the new Mexican transfer pricing laws specially discourage transactions with low-tax jurisdictions, or tax havens, by establishing a presumption that such transactions are not at arm's length prices and granting the tax authority broad authority to determine the proper price unless the taxpayer can prove through properly prepared documentation that the prices are arm's length.

71. Since 1 January 1995, the Mexican tax authorities have expressly required that *maquiladora* companies comply with the arm's length principle, though a special safe harbour provision for those corporations is available. *Maquiladoras* are Mexican corporations that operate assembly plants, generally along the United States-Mexico border, to assemble or further manufacture component parts to take advantage of lower labour costs and then resell the finished goods outside Mexico. Those corporations typically are wholly owned by a United States parent corporation that repurchases the goods. While those corporations were technically subject to arm's length principles under prior law, there was no enforcement. Thus, most *maquiladoras* did not report significant income taxes, and paid the minimum Mexican assets tax instead. With those new requirements to report profits on an arm's length basis, there is evidence that the *maquiladoras* are paying more attention to Mexican income taxes.

B. Republic of Korea

72. In accordance with its recent initiation into OECD membership, the Republic of Korea passed legislation in 1995 that marked an unequivocal departure from the former formulary apportionment transfer pricing regime to a regime with the arm's length principle as its foundation. The new legislation adopts the OECD pricing methods as acceptable methods, and provides for advance pricing agreements between multinationals and the Republic of Korea's National Tax Administration.

73. A recent National Tax Administration notice, effective 1 January 1997, requires particularly extensive contemporaneous documentation. In addition to specifying a supporting transfer pricing methodology, the notice requires that the taxpayer provide "segmented" income statements

showing the gross profit from numerous types of transactions. Although the documentation rules do not set forth specific transfer pricing penalties, failure to file the documentation can subject the taxpayer to fines and increase the likelihood that it will be selected for audit.

C. Brazil

74. In the past, Brazil's tax authority attempted to enforce arm's length pricing under a law that provided for adjustments to taxable income in cases in which the transfer price charged was "notoriously" higher or lower than the fair market value. Obviously, the term "notoriously" gave taxpayers a considerable degree of latitude.

75. Effective 1 January 1997, new legislation in Brazil provides for more sophisticated transfer pricing rules. In May 1997, Brazil's tax authority issued transfer pricing regulations providing for use of the comparable uncontrolled price, resale price and cost plus methods. Commentators generally agree that Brazil's move towards those types of rules and more vigorous enforcement is reflective of its desire to become a member of OECD.

IV. Other approaches that developing countries take to effectively enforce taxes on income

76. One approach for developing countries to overcome administrative constraints is to adopt taxes or tax rules that are simpler to administer, even if they are only approximations of the taxes or rules that the countries would ideally like to impose. Several presumptive approaches that have been used in countries where the tax administration is not equipped to properly enforce an income tax are considered below. Over time, certain countries have replaced those approaches with taxes based on actual income tax as their collection and enforcement capabilities have developed. Accordingly, the discussion proceeds to focus on the use of a minimum tax on imputed income from business assets as a means to overcome the difficulties that developing countries face in administering their income tax systems.

A. Taxes on "presumptive" net income

77. The idea of taxing imputed income is not new. Several of the countries of sub-Saharan Africa have long imposed such a presumptive tax as a percentage of a taxpayer's gross revenue. Colonial America once had a presumptive tax based on the number of windows in a taxpayer's house.

78. Presumptive taxes have more recently been used by developing countries to overcome the difficulties of administering an income tax. Of course, such presumptions are often very imperfect measures of net income. Nevertheless, those taxes have the advantage of simplicity in sectors of a developing economy where it may be unrealistic to try to enforce a tax on net income in a purer form.

79. The use of such presumptive taxes can lead to distortions and tax evasion, especially if different presumptive taxes are applied in different sectors of the economy. If one sector is more favourable, then taxpayers will attempt to shift income artificially to that sector.

80. In Argentina, there is a presumed net taxable income for certain types of activities of non-residents, including international transportation, international news agencies, insurance and reinsurance operations, and distributors of foreign films. For example, a non-Argentine company that ships goods in containers within Argentina or from Argentina abroad is deemed, as an irrebuttable presumption, to have net income from Argentine sources equal to 20 per cent of the gross amount collected from those activities.

81. In Columbia, on the other hand, there is a broad-based presumptive income tax applicable to all corporations. The taxpayer's net income is presumed to be at least equal to 4 per cent of its total net assets as of the last day of the preceding fiscal period. The 30 per cent corporate income tax is paid on the basis of the higher of presumptive income or ordinary taxable income. The taxpayer may rebut the presumptive income amount only in very limited circumstances. Since 1990, taxpayers who pay corporate taxes on the basis of presumptive income may deduct in the following two years the excess of taxes paid on presumptive income over taxes that would have been paid on an ordinary taxable income.

B. Rebuttable presumptions under the income tax

82. Many countries also employ rebuttable presumptions in enforcing their income taxes. Those are basically collection devices, which impose tax based on indicators of income rather than true income. They can be either withholding taxes based on gross wages, or presumptions of net income based on a taxpayer's professional experience or lifestyle. The French *forfait* system, which is widely employed in West Africa, uses a practice of determining income tax assessments through a process of negotiation with the individual taxpayer,

starting with rebuttable presumptions developed for classes of taxpayers based on indicators other than conventional records of income and deductions. Such systems are subject to corruption because the tax collectors typically do not have the information needed to negotiate an objective assessment.

83. Other countries, such as the Republic of Korea, have attempted to apply a variant of the tahshiv system first developed in Israel. Under that system, the tax administration attempts to estimate taxpayers' incomes based on more objective factors, including detailed studies of samples of businesses in various sectors.

84. Even in some relatively developed countries, the majority of taxpayers are taxed on the basis of such rebuttable presumptions. Such systems may result in improved enforcement for some countries. It seems likely, however, that a country that has sufficient resources and sophistication to develop the information needed for such a system to work well should also have sufficient resources to enforce some variant of a more conventional income tax.

85. It is necessary to distinguish collection devices from taxes on presumptive net income. First of all, the taxpayer can overcome a rebuttable presumption by showing his true net income, though as a practical matter rebuttable presumptions often result in a final determination of tax for many taxpayers. Second, use of such rebuttable presumptions generally should not prevent a foreign taxpayer doing business in the developing country from receiving a foreign tax credit for the developing country's income tax against the taxpayer's income tax liability in his home country. By contrast, the United States and other countries generally do not allow such a foreign tax credit for a foreign presumptive tax on a tax base other than net income.

C. Minimum taxes on assets

86. In recent years, several countries have supplemented their conventional income tax on business activities with a minimum business assets tax of general application that is based on an assumption that taxpayers realize a minimum net return from assets that they employ in such activities. Those new business assets taxes are more sophisticated than a tax on gross revenue or on the number of windows in a taxpayer's house. They are also more limited than some other presumptive taxes in that they only apply to assets employed in business activities.

87. A business tax is based on the value of the assets employed in a taxpayer's business, at a rate intended to be the equivalent of such an imputed income tax. The assets can be valued on either a gross or net basis. Mexico's assets tax, adopted in 1989, has contributed to its progress in achieving voluntary compliance. Other Latin American countries, including Venezuela, have since adopted various forms of a business assets tax.

88. The imposition of taxes on imputed business income results from the difficulties that those countries have faced in enforcing their income taxes in both the domestic and international sectors of their economies. Because an income tax is based on accounting for a taxpayer's costs and deductions it is difficult to enforce an income tax against domestic taxpayers whose accounting systems are not well developed. Furthermore, because developing countries have limited resources for enforcing their income taxes they are vulnerable to taxpayer efforts to conceal their gross income. Obviously, it is more difficult to conceal physical assets. Also, because each year's calculation is based on the prior year's calculation the tax authorities are in a better position to detect fraud by comparing different years. In the international sector, multinational companies have the necessary accounting systems but they are often able to avoid a developing country's income tax through manipulation of transfer prices in transactions with related foreign parties. An imputed income tax or assets tax eliminates both those problems because it is not based on a direct measurement of a taxpayer's net income.

89. Of course, such a tax is not a panacea because it requires continuous revaluation of the taxpayer's business assets. If the tax is imposed on net assets, it is also open to abuse by taxpayers who fraudulently reduce their net assets with fraudulent debt. Mexico's assets tax eliminates the potential of abuse from artificial debt by imposing its assets tax on a taxpayer's gross assets. Thus, a country considering such a tax must weigh those difficulties against the extra revenue that they can obtain from the tax.

90. The minimum assets tax is based on the theory that no one would invest capital unless it can produce a minimum return. Presumably, the taxpayer would put the capital to a more productive use if a minimum return were not being met. The rate used is generally 1 per cent to 2 per cent on gross assets, and as high as 3 per cent on the basis of net assets.

1. Preserving the United States foreign tax credit

91. If a developing country were to structure such a tax as a minimum tax within its income tax system, it should be careful not to do so in a way that discourages investment by foreign companies. The United States and other developed countries generally avoid double taxation on foreign income by allowing their taxpayers a credit for foreign income taxes

paid on foreign source income. An investment in a developing country will typically not be economically attractive for such a company if such foreign tax credit is not available for taxes paid to the country. Such a foreign tax credit is generally available only for foreign income tax liability.

92. Peculiarities of the rules governing the United States foreign tax credit cause the credit to be based on the amount of foreign income tax that is actually paid under the law of the foreign country. A business assets tax is not creditable in the United States. Further, a taxpayer's tentative liability for a country's income tax will not be eligible for a United States foreign tax credit to the extent that it is offset by a credit for an assets tax or other presumptive tax that is enacted as an alternative minimum tax. That is because of the so-called multiple levies rule under IRS regulations, which provides that if two taxes overlap, the tax imposed first is the tax that must qualify for the foreign tax credit. It is important that in structuring an assets tax as an alternative minimum tax, a developing country allow a credit for a taxpayer's income tax liability against the assets tax that it would otherwise owe, rather than structuring the offset as a credit of assets tax against tentative income tax liability. That was the technique employed in assisting the Government of Mexico with the design of its assets tax. Thus, if the income tax liability is 30 units and the assets tax liability is 20 units, the 30 units of income tax should be paid first, with 20 units of that amount acting as a credit against the assets tax; if the 20 units of assets tax is paid first as a credit towards the 30 units of income tax, only the excess 10 units of income tax will be creditable.

2. Assets tax in selected Latin American countries

(a) Mexico

93. Mexico imposes a 1.8 per cent tax on the average value of gross assets owned by all companies and individuals engaged in business in Mexico, including permanent establishments of non-residents. The assets tax operates as a minimum tax, and is payable only to the extent that it exceeds the taxpayer's income tax liability. A taxpayer may credit any income tax liability for a tax year against its tentative assets tax liability. That helps to mitigate the inflation problem, which is the biggest systematic threat to the integrity of an assets tax. Mexico does employ a system of indexing values for inflation throughout its tax system. Such indexing is important because of inflation. But even if the valuation of a taxpayer's assets is imperfect, the assets tax still serves a useful function of backstopping the income tax for taxpayers who would otherwise evade it.

94. The Mexican law has a number of features designed to cause the assets tax to be a reasonable estimate of the taxpayer's net income. Assets so employed are not included in the assets tax base until two years after they are first placed in use in the business. That takes into account the possibility that a taxpayer will realize a below-market rate of return on his assets during the start-up phase.

95. The Mexico assets tax is also structured to take into account the fact that a taxpayer's actual return on business assets will fluctuate over time. As mentioned above, the assets tax is imposed only to the extent that a taxpayer's tentative liability for such tax exceeds his current income tax liability. If the taxpayer pays assets tax in one year because it exceeds the income tax but pays income tax in a subsequent year, the taxpayer is entitled to a refund of the "excess" assets tax in the prior year up to the amount by which the income tax in the subsequent year exceeds the assets tax. The taxpayer may recover "excess" assets taxes for up to 10 previous years. It should be noted that income tax in the subsequent year must be paid even though a refund of the prior year's excess assets tax is due; that is, the tax and the refund are not netted. That ensures that the income tax paid in the subsequent year is fully creditable for foreign tax credit purposes.

(b) Venezuela

96. Venezuela's assets tax is 1 per cent of gross assets. It differs from the assets tax in Mexico, however, in that the excess assets tax is not separately refunded but rather is offset against the following three years of income tax liability, if any. Thus, it is uncertain whether the portion of income tax liability that is offset by prior payments of excess assets tax will be creditable in the United States — it is possible that only the net payment of income tax will be creditable.

(c) Peru

97. Peru's assets tax is now 1.5 per cent of gross assets, recently reduced from 2 per cent. It differs from the assets tax in Mexico and Venezuela, however, in that there is no ability to reduce payments of income tax for payments of excess tax in prior years. It is now established that the income tax is creditable in the United States.

3. Use of assets tax to combat transfer pricing abuse

98. The assets tax will not only ease the problems that developing countries experience in their attempts to assess tax on multinationals but also reduce the incentives of multinationals to manipulate transfer prices when the multinationals know that they must pay at least some tax in

the local jurisdiction. Indeed, the multinational will want to ensure that its income tax liability is higher than the assets tax so that the taxes paid are creditable in its home country. Tax administration would be simplified by substituting a simple tax calculation for the complexity involved in auditing transfer prices.

V. Improving the collection and enforcement of taxes on the income of multinationals

A. Effective administration

99. Effective administration is the key to creating a productive tax system. The best designed tax system will not work if it is poorly administered. Even a poorly designed tax system, on the other hand, can work reasonably well if it is well administered.

100. It is also important for a developing country to work smarter, as well as harder. Any country's efforts to establish a productive tax system will be more likely to succeed if its taxes and major tax rules are appropriate for its own needs and circumstances.

101. The problem is that it is difficult to get Governments to focus on those priorities of good tax administration and to choose appropriate tax rules. Questions of administration are seldom glamorous. It is always easier to assume that enacting a law or issuing a regulation solves the problem. Obtaining the resources needed to administer the law and regulations properly is a struggle. And in choosing taxes and major tax rules, it is often easy to resort to gimmicks, to argue about what is the ideal tax regime or to borrow rules directly from another country. It is always harder to calculate what taxes and what rules will really work well under a country's own unique circumstances.

102. Whatever the other goals for a country's tax system, however, that system will not be productive unless it is well administered and is designed to take a country's economic and social circumstances into account. Because those are basically pragmatic considerations, they are equally important whether the prevailing philosophy is market-oriented, State-run or anything in between.

B. Penalty structures

103. To the extent that a developing country cannot collect its taxes through withholding and other automatic collection mechanisms, it must rely on enforcement activities directed at individual taxpayers. The goal of such individual enforcement activities must be to promote what is generally known as "voluntary" compliance, which is compliance that does not require direct enforcement activity against the taxpayer in question. The key to such quasi-voluntary compliance is to increase the probability that a taxpayer who evades the law will pay significant penalties. That requires the imposition of appropriate penalties, the allocation of sufficient resources to enforcement activities and the efficient use of those resources.

104. A penalty structure need not be elaborate. In fact, as with so many other issues there is a great advantage in having a system of penalties that is simple enough that it can be easily understood. It is important, however, that the penalties for willful non-compliance be severe enough to be effective but not so severe that they are unlikely to be imposed at all in practice. An effective penalty structure also requires an effective administrative structure for adjudicating tax disputes and imposing appropriate penalties fairly and predictably. No penalty structure will be useful if the probability of detection and likelihood of being penalized if detected remain low.

C. Targeting enforcement activities

105. No matter how successful a developing country is in expanding its enforcement budget, however, it will undoubtedly be operating with limited resources. Therefore, it will also be essential that it effectively target its enforcement activities. That means identifying groups of taxpayers whose compliance is low and then allocating resources effectively among the enforcement efforts directed at those groups.

106. There are obvious political limitations on such a targeting process. Often, it will mean directing increased enforcement activity against politically important groups, particularly true in countries in which elite groups have not paid their fair share of tax in the past. Thus, the targeting process requires a great deal of political sophistication and restraint. It is doubtful, however, that a developing country can develop a productive tax system unless it gives the tax authorities a great deal of latitude in targeting the domestic taxpayers with the greatest potential for increased collections.

107. Apart from such political considerations, the main tension in the targeting process will arise from balancing the conflicting needs to focus both on the largest taxpayers and on the groups with the largest collective tax avoidance. In most countries, the most obvious targets for enforcement activity are the largest firms operating in the country. The

IRS, for example, has in recent years made a point of shifting its ablest people and its primary resources toward the tax controversies with the greatest tax dollars at stake.

108. It is equally important, however, to achieve at least a minimum level of enforcement in the broader sectors of the economy, in which the total amount of tax avoidance may be greatest — usually the agricultural and small business sectors. Assuming that the taxes imposed on such taxpayers are reasonably enforceable, it is probably wise to target those groups with enough enforcement to move them to a higher level of voluntary compliance.

D. Obtaining qualified personnel

109. It is well known that the key to sound tax administration is people — finding good people and then training them, keeping them and protecting their integrity. That is just as true in the United States as it is anywhere else. Concerning the recent budgetary problems in the United States, it has been revealed that the IRS finds it very difficult to attract and keep the best people because its pay scales have declined relative to those in the private sector. Of course, the budgetary crisis in the United States is partly real and partly manufactured. Nevertheless, its situation illustrates just how universal is the problem of finding and keeping good people in the tax administration.

110. It is important that tax authorities in developing countries make hard choices on how best to utilize their best people. Some of them clearly must be assigned to the critical tasks of drafting regulations, devising forms and internal manuals, and organizing enforcement activities. However, tax authorities also assign some of their best people to tax analysis units to identify problems in administration and enforcement, analyse the causes of those problems and identify solutions. Clearly, it will also be useful for those people to be in touch with their counterparts in other countries and to make use of the resources available from regional and international organizations.

E. Incentives for tax personnel

111. In many countries, the question of targetting particular groups for enforcement activities will be related to the question of motivating the country's tax collectors. Many tax reforms have floundered and the enforcement of many existing taxes has lagged because countries have been unable to mobilize their tax collectors to enforce the law. Sometimes, the problem has resulted from the way that tax officials are compensated.

112. Many developing countries employ financial incentives based on revenue "targets" or quotas in financing their tax administration. Apparently, those countries believe that their resources are insufficient to pay their tax officials an adequate salary, and they must use incentive compensation as an alternative. Like the United States, however, any developing country must consider whether it is more economical in the long run to pay salaries that will attract competent and well-motivated employees than to economize and substitute incentive compensation schemes that undermine the integrity of the tax collection system. Agents will always respond to incentives but sometimes in perverse ways. Although incentive compensation plans are not recommended, if a developing country must rely on incentive compensation it is important that it adjust those incentives to ensure that they encourage administrative effort and permit the central authorities to exercise the necessary oversight.

VI. Considerations when making changes to a country's tax laws

113. The recent tax reform efforts in developing countries reflect a new pragmatism in their approaches to taxation. In a wide variety of countries, there has been movement towards tax systems that are more effective in raising revenue, and away from tax systems designed primarily to promote narrow economic or social objectives. That has parallel similar pragmatic trends in the more developed countries. Many new techniques are being tried, and it remains to be seen which will work.

114. Among the most important considerations that any country must take into account in designing its tax system are the administrative requirements for enforcing particular taxes, and the limitations on the ability of its tax administration to implement certain taxes or tax rules. A developing country, like any other country, must be realistic and creative in choosing taxes and tax rules that will take such administrative realities into account, with minimum sacrifice of tax equity or economic efficiency. If it will not be possible to administer a particular tax or tax rule effectively for the foreseeable future, it must consider whether there is a substitute or a back-up tax or rule that will work better, even if that means a fundamental change in the tax system.

115. A developing country should also continually re-examine whether it has overcome administrative constraints that it has tried to accommodate in the past. For example, trade taxes have been widely accepted as a necessary evil for many low-income countries that have not developed the capacity to impose more broadly based consumption or income taxes. Most commentators would agree, however, that a developing country should work to shift its reliance away from trade taxes as soon as possible.

116. There are more than merely practical reasons both to favour taxes that work and to adopt the best rules that will work well. If a developing country cannot administer a tax effectively, it will not be applied evenly to all taxpayers; that is the most fundamental kind of inequity in a tax system. Moreover, if a tax is widely evaded, that will tend to destroy taxpayers' sense of the equity of the tax system and ultimately their willingness to cooperate with the system. Conversely, rules designed solely to accommodate administrative constraints almost always do so at the cost of equity or economic efficiency in the tax system. Thus, developing countries should move towards more equitable or efficient rules as soon as it is administratively feasible.

117. Any country must also evaluate its tax system in the light of its particular social environment. There are many social, political and economic factors that are cited as limitations on the ability of developing countries to employ certain taxes or to develop a productive tax system. One of a developing country's main tasks must be to evaluate the many potential barriers and to distinguish the real constraints from the problems that it can overcome.

118. It is important in that regard to beware of fads and to avoid adopting particular taxes or rules because everyone else is doing so. In developing a tax system that is appropriate for a country, it is important to keep in mind that the idea of the best possible tax system is the enemy of actually developing a better tax system. Small improvements should not be delayed because the "best" system cannot be obtained. More modest reforms introduced earlier may give the best results in the long run.

VII. International cooperation

119. In conclusion, the authors wish to commend the United Nations for convening the current meeting. They also wish to suggest that the meeting be followed up with further cooperation in the field of tax administration.

A. Bilateral cooperation in taxing international transactions and capital flows

120. The most direct kind of cooperation, of course, is in the area of tax enforcement itself. Informal cooperation in tax administration between developing and developed countries has become much more common over the past 30 years. It is important, however, to go beyond informal cooperation. Only formal public agreements can provide both the framework needed for systematic cooperation and a clear incentive to taxpayers to comply with the law.

121. In the past, some developing countries have hesitated before formalizing such cooperation. They may have thought that in that way they could attract investment from those foreigners seeking to avoid taxes in their home countries. It is increasingly clear, however, that attracting such "hot" money is far less important to most developing countries in the long run than creating the kind of environment that will enable them to attract stable investment from legitimate multinational enterprises. That requires bilateral cooperation with the countries in which those enterprises are based, and an important part of such cooperation is cooperation in tax enforcement.

B. Multilateral cooperation in analysing administrative problems and developing administrative capacity

122. Just as important as bilateral cooperation in tax enforcement is increased cooperation among developing countries in addressing their common problems of tax administration. Over 30 years ago, one of the first regional organizations dedicated to such cooperation was formed: the Inter-American Center of Tax Administrators (CIAT).

123. CIAT has developed into a useful forum for the exchange of ideas. Its annual conferences have produced a wealth of informal contacts and useful technical papers. Through its own publications and its central library, it has increased its members' access to useful materials on tax administration. Its professional staff has coordinated technical assistance projects in the hemisphere, and has published a handbook on tax administration that has had a major impact on improving tax administration in its member countries.

124. CIAT has also served as a model for similar organizations that have sprung up since that time, including the African Association of Tax Administrators, the Commonwealth Association of Tax Administrators, the Study Group on Asian Tax Administration and Research, and the Caribbean Organization of Tax Administrators. Since 1985, the Council of Executive Secretaries of Tax Organizations has held an annual meeting. Those meetings have provided a useful forum for worldwide exchange of information and for expanding cooperation in addressing basic questions of tax administration. Developing countries may wish to consider expanding their cooperation with each other, on their own, through their regional organizations, and through such international bodies as the United Nations Secretariat, the International Monetary Fund and the World Bank.

125. There are many areas in which developing countries could benefit from the pooling of resources to study common problems and to develop practical programmes for increasing the productivity of their tax systems. One particularly promising possibility is in the joint development of appropriate computer software. Another is the joint study of methods for estimating the public and private compliance costs of existing taxes and tax reform proposals, including the transitional costs of changes in the law. A third area where joint efforts might be useful is in the study of methods for training and compensating tax administration employees.

126. Such cooperation would not eliminate the need mentioned above to base reforms squarely on each country's individual situation. Nevertheless, there would be several clear benefits from closer cooperation on those and other issues. Perhaps the most obvious benefit would be the savings that could result from avoiding unnecessary duplication of effort in studying problems and developing solutions. Through such a pooling of resources, developing countries should be able to accelerate their progress towards improving their tax administration and developing simpler and more stable tax systems.

127. A less obvious but equally important benefit from such cooperation would be the encouragement that it could provide to increased foreign investment in developing countries. One of the big costs for a multinational company investing in the developing world is the need to cope with the ambiguities and peculiarities of the developing countries' tax systems: the proliferation of approaches to tax administration in the developing countries increases those costs and discourages such investment.

128. Cooperation in developing common approaches to common problems can provide a big boost to developing countries' efforts to achieve full participation in the world economy if it helps to reduce the uncertainties facing multinational companies doing business in the developing world.

VIII. Recommendation for new international tax initiative

129. The authors wish to suggest a new initiative in the international tax field that they believe would enhance cooperation in and just enforcement of international tax laws. Some of the nations represented at the meeting may not have the capacity to ensure that sophisticated international corporations pay their fair share of taxes for their business activities within that nation's territory. After all, even the very large and developed countries are having a difficult time ensuring that those large diversified corporations pay their fair share of taxes. The arm's-length standard that seems now to be the norm in the developed countries is not easily administered. It requires a staff of well-trained lawyers, accountants, economists, business planners etc. to insure the capacity to follow the profits from the ultimate sale back along the chain of commerce. There is some desire on the part of several legislators in the United States to go to some formulary system; not that such a system would be easily applied but it gives the appearance of simplicity.

130. The authors' suggestion would require a good deal of international cooperation but would not require large staffs nor would it increase complexity: their goal is to put tax and

administrative staffs worldwide on an equal playing field with the corporate world.

131. In the United States, many states realized a number of years ago that they had a similar problem to that under discussion. The smaller states lacked the capacity to audit large national corporations, which operated across many states' boundaries. They organized the Multi-State Tax Commission, a group to which each state pays dues in accordance to its size and use of the Commission's services — a fee-for-service system. The Multi-State Commission then audits the large corporations' activities in various states, and makes a fair and uniform allocation of the corporation's income among the states in which it operates.

132. The authors suggest that either the United Nations, a regional body or an organization such as CIAT take over a similar function to that provided by the Multi-State Commission. That body would develop a set of uniform principles or a model statute — along the lines of section 482 of the United States Internal Revenue Code — that would be adopted by all the countries participating. Thus, they would all agree to use the same principles in allocating income in multinational transactions. That might sound like a large step, but it is really rather minor; most of those rules are rather similar now. In addition, many countries have strict and arbitrary rules that are not enforced in practice.

133. Thus, a group of international experts would draft a code, like those now devised in the treaty area. They would also draft implementing regulations or forms. Thus, a corporation doing business in four or five countries that are members of such a new alliance would prepare one form for that allocation.

134. The next step is to have a group of experts at the disposal of that international group. The retired professionals of many countries could be used as a corps of experts in law, accounting, auditing, economics etc., to be on call for their advice, to check results with and to assist in resolving disputes.

135. The idea is to achieve a level playing field on which all parties come well prepared. That would lead to an in terrorem effect: tax returns would be better prepared and more forthrightly stated if the corporate world knew that countries had the capacity to meet them with equal intellectual force. A fairer system would yield better international commerce, and fairer allocation of prices.

136. Such suggestions may sound revolutionary, but when CIAT was first suggested in 1996 many people thought it was unrealistic. Now, more than 30 years later, CIAT is a real force in the tax world and has produced a number of offspring in other parts of the world. The authors hope the United Nations can act as a catalyst in working on that and other ideas to help all developing countries do their jobs better; and most importantly, to help such countries to receive their fair share of the income produced by international activities.

137. The authors are hopeful that a working group will be appointed by the United Nations or some similar organization to work out the details of their proposal. From their experience, they have learned that the tax systems of the world have more similarities than differences. They believe that it is possible to find a mutually acceptable method of fair taxation for both the countries involved and the international business community.