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TRANSFER PRICING AND TAXATION OF INTERNATIONAL INCOME IN DEVELOPING COUNTRIES*

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INTRODUCTION

1. Intercompany transfer prices are prices charged among members of affiliated companies for goods, services and loans transferred on an intercompany 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, for example, a distributor overpays its foreign manufacturing affiliate or a manufacturer undercharges its foreign distributor.

2. For example if a United States parent 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 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 similar rules for determining appropriate transfer prices as the IRS. It then further depends on whether the foreign country’s tax authorities agree with the IRS as a factual matter based on all the relevant data.

3. 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 this example would be indifferent whether the transfer price is $1,200 or, for example, $800, for 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 fairly similar and have tended to converge in the past 10 years. From a tax point of view, the multinational is often merely a stakeholder between the tax authorities of the two countries. Obviously, as between the two countries, where the tax is paid matters very much.

4. 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.

5. 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 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

6. 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, this becomes a more and more important question. With the encouragement of the United States, the world community has largely adopted a so-called "arm's length" standard. It sets transfer prices based on prices charged in transactions between unrelated parties. This is the theoretically correct pricing rule. The problem is that it is usually difficult to find such a transaction from which to derive an arm's length price. As a result, the United States has tried to find alternative rules, involving functional analysis, comparative rates of return, and profit splitting. These approaches, while theoretically flawed, may be practical supplements to the arm's length standard.

A. The arm's length standard

1. In favour of the arm's length standard

7. 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 Organisation for Economic Cooperation and Development.

8. The arm's length standard was first implemented by the United States in its 1935 regulations interpreting Section 482 of the Internal Revenue Code. These regulations simply stated 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".

9. 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 formulas in regulations.

10. IRS regulations were issued under Section 482 that governed transfer pricing practices for United States taxpayers from 1968 until last year, 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 intercompany 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.

11. The arm's length standard uses real transactions that occur in the marketplace as the standard for allocating income between countries. This 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 marketplace really operates.

12. 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 departs 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

13. 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.

14. 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. Even small changes in transfer prices can result in huge increases in tax liability.

15. Uncertainty also provides room for abuse by taxpayers. Transfers within multinational corporations often involve intangible property and non-standardized products. There are usually no comparable transactions involving third parties to judge the reasonableness of the multinational's transfer price.

16. 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 these economies of scale into account.

17. Moreover, contrary to what the IRS 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 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 business would otherwise operate.

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

1. IRS attempts to move away from the standard

18. The 1968 regulations stood the test of time quite well, but, by the 1980s, they were showing signs of strain, caused by several factors. In the 1986 tax legislation, the 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 status of the United States as a major capital exporter.

19. In response, the IRS issued its 1988 White Paper on transfer pricing. The White Paper was received with extreme hostility because it appeared to constitute a wholesale rejection of the arm's length standard. Instead, the IRS proposed applying arm's length rates of return in circumstances where taxpayers had little hope of being able to gather adequate comparison data (which would often have to come from competitors or unreliable or unavailable industry statistics).

20. 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. These 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. This 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.

21. Finally, in July 1994, the IRS issued final transfer pricing regulations. These regulations reaffirm the use of the arm's length standard and require the taxpayer to determine arm's length using the "best method" available. The comparable profits test is no longer required but may be used as a method for determining transfer prices if there are no comparable transactions. These regulations represent an extraordinary good-faith effort by the United States to make the arm's length standard work in a complex world.

22. The question still at issue, however, is how much importance should be placed on comparable profits of competitors. Foreign tax authorities have asserted that any method keyed to comparable profits is impossible to reconcile with the arm's length standard. But if comparables 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 legislation

23. The United States Congress has introduced several bills in recent years which would require a minimum amount of taxable income to be reported by certain foreign-owned (that is, 25 per cent) 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 H.R. 5270, the taxpayer's taxable income from any category of business would be no less than 75 per cent of the amount determined by applying the applicable profit percentage to the taxpayer's gross receipts from that business category.

24. This formulary apportionment is similar to the manner in which income among States is allocated and apportioned, as if the multinational were a unitary world-wide business. Most States use a three-factor apportionment formula of sales, property and payroll, with each factor equally weighted. A "unitary" formulary apportionment formula combines the income of the entire affiliated group and then applies the three-factor formula to that larger income base.

25. The IRS will continue to object to formulary apportionment, citing the need for international conformity, 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, and the intense international resistance to moving away from the arm's length standard.

3. Enforcing the arm's length standard

26. The 1986 tax legislation permitted the IRS to shift its attention away from tax shelters, which have 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 is pending in federal courts). Audits of foreign corporations increased over 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. The history of its efforts are discussed below.

27. Initially, the IRS experienced difficulty 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 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 delays in negotiating with the foreign Government over what information is accessible.

28. Although the IRS had authority to impose the general 20 per cent accuracy-related penalty in transfer-pricing cases even before the 1990 legislation discussed below and periodically did so, there were no known cases where the taxpayer actually paid the penalties. A 20 per cent penalty based on negligence or a substantial understatement was a possibility only in the flagrant case, because there are usually reasonable points of view on both sides. Application of the 20 per cent penalty based on grounds other than negligence, such as a substantial understatement of tax, was also difficult.

29. United States tax law requires every person 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 this requirement. Courts have held that the IRS may not use this 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, this requirement does not apply to foreign parents that are not themselves liable for United States tax.

30. Section 982 (1982) provides that 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 document request, the taxpayer will be precluded from later introducing any foreign-based documentation covered by that document in court. 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.

31. 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, Congress completely reworked Section 6038A (enacted in 1982) in a manner that will virtually eliminate the difficulties the IRS has experienced in obtaining foreign-based documents in the custody of foreign multinationals. First, because of expanded reporting requirements, many new foreign parties and transactions are now brought under

IRS scrutiny. Secondly, the United States taxpayer must maintain records that are sufficient to establish the correctness of his United States tax returns with respect to transactions with foreign related parties. Thirdly, 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. Fourthly, a $10,000 civil penalty may be imposed on reporting corporations for non-compliance with either the annual information reporting and record-keeping requirements, with an additional penalty of $10,000 for each 30-day period of continuing noncompliance after the taxpayer has been notified by the IRS.

32. Fifthly, and most important, the IRS has been granted sweeping new powers to impose the "non-compliance penalty" if a foreign related party fails to designate the reporting corporation in the United States as its agent for service of process or if 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 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.

33. During his presidential campaign, then 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 down to $3.8 billion (from $45 billion) over five years. The President's proposal was enacted in 1993. His 1994 budget also proposed additional funding to double the audit rates on the United States subsidiaries of foreign multinationals.

34. In 1993 Congress enacted new penalties equal to 20 per cent, or as high as 40 per cent, of the tax underpayment attributable to a transfer pricing adjustment. To avoid these 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.

35. These 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 taxpayer behaviour by forcing taxpayers to prepare contemporaneous documentation of their transfer pricing methods and to provide such documentation to the IRS upon request. These penalty rules are the culmination of years of IRS' complaints that taxpayers wait until the audit stage to justify their related party transactions. Such delay resulted in delays in (or denial of) IRS access to taxpayer's transfer pricing information, and therefore caused more

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controversy between the IRS and the taxpayer. Contemporaneous documents are more probative since they do not allow a taxpayer to delay stating its reasoning.

C. Transfer pricing practices in other industrial countries

36. A task force of nine OECD member countries prepared part I of a draft of a report on transfer pricing on 8 July 1994, under a mandate from the OECD Committee of Fiscal Affairs, and released part II of the draft on 8 March 1995. The complete report, which is a revision of another OECD report from 1979, will reflect and update the views of OECD members 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.

37. OECD believes that each enterprise within a multinational's world-wide 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 these 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 and thereby avoid the creation of any tax advantages or disadvantages attributable to operating as either a multinational or an independent.

38. 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 none the less 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. This understanding should continue to be streamlined so as to improve the administration of the arm's length principle.

39. OECD believes that the most direct and reliable way to determine arm's length prices is by use of the comparable uncontrolled price method, resale price method and cost plus method. Substantial concern is expressed over the use of a comparable profits method or a profit split method.

40. 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. Effectively to avoid double taxation, one would need world consensus 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. Exchange rate movements would skew the formula's application. Compliance costs and data requirements for an application of a

global formulary apportionment would generally be more burdensome than those under the separate entity approach of the arm’s length standard.

II. CONSTRAINTS ON THE ABILITY OF DEVELOPING COUNTRIES TO TAX MULTINATIONALS EFFECTIVELY

A. Dependence on the corporate income tax

41. Developing countries have long relied on corporate income taxes as a principal means of revenue. These taxes account for up to a third of revenue in some developing countries.

42. It may seem at first unusual that a levy as complex as the corporate income tax would be so prominent in developing countries, where 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. No credit is given to the multinational in its home country for sales taxes or gross receipts taxes paid abroad. Obviously, to attract foreign investors, developing countries need to preserve as much as possible the investors’ foreign tax credit.

43. 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 the economy is mostly agricultural and the population is geographically dispersed. Moreover, much of the population may fall below even 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.

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

45. 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. These 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 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 has adopted a new VAT to begin in 1996. The bottom line, though, is that each country needs to do what is

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administrable - there is no single type of VAT or sales tax that is most appropriate in all cases.

B. Administrative constraints

46. The transfer pricing arena, perhaps better than any other area of the 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 this area. This problem, however, is world wide.

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

48. There are also differences among the developing countries. It may be that some of these 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.

49. 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 paralleled the trends that have been noted in the United States and other developed countries.

50. In recent years countries in Latin America and elsewhere have abandoned their highly progressive income tax rate structures. This shift in tax policy has in large part resulted from the conclusion in those countries that they 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 the VAT as a central part of their tax systems. Once again, 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.

51. Another common strand in most of these reforms of the income tax or the VAT is the enactment of relatively broad exclusions for low-income taxpayers (in the case of the income tax) or broad groups of small merchants (in the case of the VAT). In several countries the movement away from highly progressive income taxes and towards broad-based consumption taxes has been accompanied by the elimination of a variety of less productive taxes that they have 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 administration.

52. This experience suggests that in developing a more productive tax system, one should realistically assess the country's ability to administer particular taxes and tax rules and its ability to improve those administrative capacities. One cannot make dramatic improvements in the tax administration in the short run. Numerous administrative constraints must be taken into account in developing tax policy.

III. RECENT ATTEMPTS BY DEVELOPING COUNTRIES TO COMBAT TRANSFER PRICING ABUSE

53. 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 40,000 pages 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 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 none the less cruder, ways of taxing multinationals.

54. Many developing countries have no laws on their books regarding intercompany pricing. Examples are Indonesia, the Philippines and Thailand, to name a few. Some of these 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 differences. However, there is rarely coordination between Customs and the tax administration with respect to income taxes.

55. 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 as to how they will be determined. Chile, for example, empowers its Internal Revenue Service to question the prices or values in which intercompany transactions are carried out, when those prices differ from those ordinarily obtained in the domestic or foreign market. In Malaysia, when a Malaysia 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 intercompany transactions by reference to contemporary market value and, where no such reference is available, to determine the arm's length value using its own discretion.

56. Some developing countries are slightly more specific in their provisions designed to counter tax avoidance through transfer pricing. In Argentina, for example, when exports 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

57. Mexico has made great strides in recent years in its regulation of transfer pricing. Effective as of 1 January 1994, Mexico amended its transfer pricing provisions to increase the authority of the Ministry of Finance pertaining to transfer pricing and to recognize four transfer pricing methods of determining arm's length prices: comparable uncontrolled price; resale price; cost plus; and profit split. Mexico's signing of the North American Free Trade Agreement, tax treaties with the United States and Canada, and its admission to the OECD have no doubt accelerated Mexico's increased interest in transfer pricing. Mexico began international audits of firms on transfer pricing issues in the last several years and collected its first transfer pricing adjustment in 1994. Mexico has been assisted by the IRS in training international examiners. Mexican tax authorities have said they will apply international transfer pricing principles. They have no current plans to issue transfer pricing regulations.

58. Effective as of 1 January 1995, the Mexican tax authorities will require that maquiladora companies comply with the arm's length principle. (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 to resell the finished goods outside of Mexico). These corporations typically are wholly owned by a United States parent corporation that repurchases the goods. While they were technically subject to arm's length principles under prior law, there was no enforcement. Thus, most maquiladoras did not incur significant income taxes and paid the minimum assets tax instead. With these 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. According to the Government of Mexico, to date the Mexican tax authorities have received at least eight requests for advance pricing agreements from maquiladora companies and have released an APA ruling procedure modelled after the United States advance pricing agreement programme.

B. Republic of Korea

59. With OECD membership on the horizon in 1996, the Republic of Korea has recently repealed several controversial rules relating to taxation of multinationals and has adopted in their place rules more or less conforming with international norms. First, the Republic of Korea's definition of "dependent agent" has been revised to follow the OECD Model Treaty definition. The National Tax Authority had been taking an aggressive position on this issue, treating some independent agents as dependent agents, which resulted in several controversial cases subjecting foreign companies to Korean tax.

60. Secondly, the Republic of Korea repealed a 1990 ruling that required formulary apportionment in determining the Korean income of a foreign corporation's permanent establishment. That ruling resulted in about 40 per cent of a foreign manufacturer's profits from Korean sales being attributed to the Republic of Korea and 100 per cent of a non-manufacturer's profits from Korean sales being attributed to the Republic of Korea. The country had the authority to apply these formulas when the world-wide profit rate of the foreign corporation was "substantially lower" than the profit rate of domestic corporations engaging in the same business. Recognizing that this rule violated OECD principles, the Republic of Korea will now apply four transfer pricing methods - uncontrolled price method, resale price method, cost-plus method, and other reasonable method - in computing Korean-source income attributable to a foreign corporation's permanent establishment.

61. Thirdly, the Republic of Korea repealed a 1988 guideline under which Korean-source income attributable to an industrial plant construction project was determined under an apportionment formula. The National Tax Authority announced that the guideline was not in accordance with the internationally accepted method of allocating income. The new guideline applies arm's length principles by comparing what a comparable, third-party enterprise would earn if it performed the same or similar functions as those performed by the permanent establishment in light of the functions performed and risks borne by the permanent establishment. The National Tax Authority intends to ask for accounting records and other relevant evidence located outside the Republic of Korea, either from the foreign contractor or from the tax authorities of the contractor's home country.

IV. OTHER APPROACHES TO DEVELOPING AN EFFECTIVE TAX ON THE INCOME OF MULTINATIONALS

62. One approach for overcoming 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 one would ideally like to impose. Several presumptive approaches have been used in countries where the tax administration is not equipped to enforce an income tax properly. Over time, certain countries, have replaced these approaches with taxes based on actual income, as tax collection and enforcement have developed. Another approach is 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

63. 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. Even colonial America once had a presumptive tax based on the number of windows in a taxpayer's house.

64. 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, these 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.

65. 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 is more favourable, then taxpayers will attempt to shift income artificially to that sector.

66. 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.

67. In Colombia, 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

68. Many countries also employ rebuttable presumptions in enforcing their income taxes. These 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 as to 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.

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

70. Even in some relatively developed countries, the vast 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 to work well should also have sufficient resources to enforce some variant of a more conventional income tax.

71. Such collection devices must be distinguished from what have been referred to above as 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. Secondly, 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 foreign presumptive tax on a tax base other than net income.

C. Minimum taxes on assets

72. In recent years several countries have supplemented their conventional income tax on business activities with a minimum business assets tax of general application which is based on an assumption that taxpayers realize a minimum net return from assets that they employ in such activities. These 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.

73. 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 Mexico's progress in achieving voluntary compliance. Other Latin American countries, including Venezuela, Peru and Ecuador, have since adopted various forms of a business tax.

74. The imposition of taxes on imputed business income results from the difficulties these countries have faced in enforcing their income taxes, in both the domestic and international sectors of the economy. Because an income tax is based on accounting for a taxpayer's costs and deductions, it is hard 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 cuts through both of these problems because it is not based on a direct measurement of a taxpayer's net income.

75. 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 these difficulties against the extra revenue that they can obtain from the tax.

76. The minimum assets tax is based on the theory that capital should 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 1-2 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

77. If a tax authority structures a tax such as a minimum tax within his income tax system, he should be careful not to do so in a way that discourages investment in his country by a foreign company. (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 his country will typically not be economically attractive for such a company if foreign tax credit is not available for income taxes paid to his country. Such a foreign tax credit is generally available only for foreign income tax liability.

78. 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 his 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 he enacts to back-stop his income tax. This is because of the so-called multiple-levies rule under IRS regulations. It 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 his assets tax as an alternative minimum tax, the authority allows 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. Thus, if the income tax liability is 30 and the assets tax liability is 20, the 30 of income tax should be paid first, with 20 of it acting as a credit against the assets tax; if the 20 of assets tax is paid first, as a credit towards the 30 of income tax, only the excess 10 of income tax will be creditable.

2. Assets tax in selected Latin American countries

79. Mexico imposes a 2 per cent tax on the average value of gross assets owned by all companies and individuals engaged in business in Mexico, including the permanent establishments of non-residents. The assets tax operates as a minimum tax. It 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. This 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 back-stopping the income tax for taxpayers who would otherwise evade it.

80. The Mexico 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. This takes into account the possibility that a taxpayer will realize a below-market rate of return on its assets during such start-up phase.

81. 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 only imposed to the extent that a taxpayer's tentative liability for such tax exceeds its 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. This ensures that the income tax paid in the subsequent year is fully creditable for foreign tax credit purposes.

82. In Venezuela, the assets tax is 1 per cent of gross assets. Unlike Mexico, however, 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 which 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.

83. In Peru, the assets tax is 2 per cent of gross assets. Unlike Mexico and Venezuela, there is no ability to reduce payments of income tax for payments of excess tax in prior years. There is also a question of whether the income tax is creditable in the United States, because the tax law provides that the income tax is not to be less than 2 per cent of gross assets. This contrasts with Mexico and Venezuela where the income tax liability is determined separately from the assets tax.

84. Bolivia has a 3 per cent tax on net assets which applies in lieu of income tax. No portion of this tax is creditable in the United States.

3. Use of an assets tax to combat transfer pricing abuse

85. The assets tax not only will ease the problems that developing countries experience in their attempts to assess tax on multinationals but also will 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

86. 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.

87. Moreover, a 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.

88. Every tax expert can appreciate just how difficult it is to get Governments to focus on the priorities of good tax administration and choice of 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. It is a struggle to obtain the resources needed to administer the law and regulations properly. 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 figure out what taxes and what rules will really work well under a country's own unique circumstances.

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

B. Penalty structures

90. 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. This 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. This requires the imposition of appropriate penalties, the allocation of sufficient resources to enforcement activities, and the efficient use of those resources.

91. The 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 can be easily understood. The penalties must 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, are low.

C. Targeting enforcement activities

92. No matter how successful the tax authorities are in expanding their enforcement budget, however, they will undoubtedly be operating with limited resources. Therefore, it will also be essential for them to target their enforcement activities effectively. This means identifying groups of taxpayers whose compliance is low and then allocating resources effectively among the enforcement efforts directed at those groups.

93. There are obvious political limitations on such a targeting process. Often it will mean directing increased enforcement activity against politically important groups. This is 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.

94. Apart from such political considerations, the main tension in this targeting process will arise from balancing the conflicting needs to focus on both 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 towards the tax controversies with the most at stake.

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

D. Obtaining qualified personnel

96. The key to sound tax administration is good people - finding them, then training them, keeping them and protecting their integrity. Hard choices must be made on how best to utilize the 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. It is advisable,

however, also to assign some of the best people to tax analysis units. Their job should be to identify problems in administration and enforcement, to analyse the causes of those problems and to identify solutions. Clearly it will also be helpful 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

97. In many countries the question of targeting 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 problems with the way tax officials are compensated.

98. Many developing countries employ financial incentives based on revenue "targets", or quotas, in financing their tax administration. Apparently those countries believe their resources are insufficient to pay their officials an adequate salary, and they must use incentive compensation as an alternative. Every developing country must consider whether it is more economical in the long run to pay salaries that will attract competent and well-motivated employees or to economize and substitute incentive compensation schemes that undermine the tax collection system. Agents will always respond to incentives, but sometimes in perverse ways. If a developing country must rely on incentive compensation, it is important that it adjust the incentives to ensure that they encourage administrative effort and permit the central authorities to exercise the necessary oversight.

VI. CONSIDERATIONS WHEN MAKING CHANGES IN TAX LAWS

99. The recent tax reform efforts in developing countries reflect a new pragmatism in their approach 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 certain economic or social objectives. This has parallelled similar pragmatic trends in the more developed countries. Many new techniques are being tried, and it remains to be seen which will work.

100. 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. Developing countries, like developed countries, 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, one must consider whether there is a substitute or a backup tax or rule that will work better, even if this means a fundamental change in the tax system.

101. The tax authorities should also continually reexamine whether they have overcome administrative constraints that they have 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 of us would agree, however, that a developing country should work to shift its reliance away from trade taxes as soon as possible.

102. There are more than merely practical reasons both to favour taxes that work and to adopt the best rules that will work well. If one cannot administer a tax effectively, it will not be applied equally to different 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.

103. Every country must also evaluate its tax system in 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 the main tasks must be to evaluate the many potential barriers and to distinguish the real constraints from the problems that can be overcome.

104. It is important to be wary 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, the tax authority must 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 put off because one cannot get the "best" system. Modest reforms introduced early may give the best results in the long run.

VII. INTERNATIONAL COOPERATION

A. Bilateral cooperation in taxing international transactions and capital flows

105. 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.

106. In the past some developing countries have hesitated to formalize such cooperation. They may have thought that in this 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. This requires bilateral cooperation with the countries in which those enterprises are based. An important part of such cooperation is the cooperation in tax enforcement.

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

107. Just as important as bilateral cooperation in tax enforcement is increased cooperation among the developing countries in addressing their common problems of tax administration. Thirty years ago one of the first regional organizations of this kind, the Inter-American Center of Tax Administrators (CIAT) was formed.

108. 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.

109. CIAT also served as a model for similar organizations, such as 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 (CESTO) has held an annual meeting. The meetings have provided a useful forum for world-wide exchange of information and for expanding cooperation in addressing basic questions of tax administration.

110. There are many areas in which the developing countries could benefit by 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 joint development of appropriate computer software. Others are 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. Another area where joint efforts might be useful is in the study of methods for training and compensating tax administration employees.

111. Such cooperation would not eliminate the need to base reforms squarely on the country's individual situation. Nevertheless, there would be several clear benefits from closer cooperation on these 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, a country should be able to accelerate its progress towards improving its tax administrations and developing simpler and more stable tax systems.

112. A less obvious but equally important benefit from such cooperation would be the encouragement that it could provide to increased foreign investment. 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 various tax systems. The proliferation of approaches to tax administration in the developing countries increases those costs and discourages such investment.

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

VIII. RECOMMENDATION FOR A NEW INTERNATIONAL TAX INITIATIVE

114. Some countries do not have the capacity to ensure that sophisticated international corporations pay their fair share of taxes for their business activities within the countries' territory. The arm's length standard, which 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 follow the profits from the ultimate sale back along the chain of commerce. Several legislators in the United States wish to go to some formulary system, but it only gives the appearance of simplicity.

115. I would like to propose a new initiative. It would require a good deal of international cooperation but would not require large staffs, nor would it increase complexity. What I want to do is to put tax and administrative staffs on a level playing field with the corporate world.

116. In the United States many of the states realized a number of years ago that they had a problem similar to the one being discussed with regard to developing countries. That is, the smaller states lacked the capacity to audit large national corporations, which operated across many state boundaries. They therefore organized what is called the Multi-State Tax Commission. This is a group to which each state pays dues in accordance to its size and use of the Commission's services: really, a fee for service. The Multi-State Commission then audits the activities of the large corporations in various states and makes a fair and uniform allocation of the corporation's income among the states in which it operates.

117. My suggestion is that either the United Nations or some regional body or CIAT-like organization take over a similar function. That body would develop a set of uniform principles or model statute - like Section 482 of the Internal Revenue Code - which would be adopted by all of the countries participating. Thus, they would all agree to use the same principles in allocating income in multinational transactions. This may sound like a large step, but it is really rather minor; most of the rules are similar now. On top of that, many countries have strict and arbitrary rules which are not really enforced or, if they are, there are no transactions against which to apply them.

118. Thus, a group of international experts would draft a code. They would also draft implementing regulations or forms. Thus, a corporation doing business in four or five countries which are members of the new alliance would prepare one form for that allocation.

119. The next step is to have a group of experts at the call of this international group. Retired professionals in many countries could be used as a corps of experts in law, accounting, auditing, economics etc. to be on call to provide advice and to assist in the resolution of disputes. This would lead to an in terrorem effect: returns would be better and more forthrightly prepared if the corporate world knows that the authority has the capacity to meet them with equal intellectual force. A fairer system would yield better international commerce and fairer allocation of prices.

120. I know that what I suggest sounds revolutionary. But when an organization like CIAT was first proposed in the United States in 1966, many people were sceptical. Now, almost 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. I hope the United Nations can act as a catalyst in working on this and other ideas to help Governments do their job better; and, most importantly, to help countries receive their fair share of the income produced by international activities.

121. I am hopeful that a working group will be appointed by the United Nations or some similar organization to work out the details of this proposal. From my experience I have learned that the tax systems of the world have more similarities than differences. I believe that we can find a mutually acceptable method of fair taxation both for the countries involved and for international businesses.