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Abstract
In combating transfer pricing schemes, the determination of an arm's length price has long been a problem for enforcement agencies worldwide. It is important that these methods be clearly defined so as to prevent transfer pricing abuses and facilitate certainty for the taxpayer. This comment will compare the United States and Australian approaches to this problem, focusing particularly on the method of arm's length price determination and its effectiveness in each jurisdiction.

Keywords
transfer pricing, taxation, United States, Australia

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TRANSFER PRICING: AUSTRALIAN AND AMERICAN REACTIONS

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In combating transfer pricing schemes, the determination of an arm's length price has long been a problem for enforcement agencies worldwide. It is important that these methods be clearly defined so as to prevent transfer pricing abuses and facilitate certainty for the taxpayer. This comment will compare the United States and Australian approaches to this problem, focusing particularly on the method of arm's length price determination and its effectiveness in each jurisdiction.

Transfer pricing has been defined as "a method of reducing a corporation's total tax liability through the manipulation of prices between countries with differing tax rates and legislation so as to realise the largest proportion of the profit in the country with the most favourable tax regime".[1] In spite of legislating against it from early on,[2] transfer pricing has been, and continues to be, a major problem for the revenue authorities of both Australia and the United States of America ("the US").

The full extent of the problem is demonstrated by the discrepancy between the gross income and the tax liability of foreign-owned businesses in the US. During 1986 foreign-owned businesses in the US had a gross income of $500 billion while reporting aggregate tax liability of negative $1 billion.[3] Apart from the physical problems of investigating off-shore schemes to discover the existence of transfer pricing, authorities in both countries have struggled to formulate a method of adequately determining an arm's length price in such transactions. This note discusses the approaches to pricing taken by the two countries and considers the implications thereof.

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1 See the Auditor General, *Efficiency Audit Report, Australian Taxation Office: International Profit Shifting* (Canberra: AGPS, 1987), 5, para 2.10.

2 Transfer pricing legislation first appeared in Australia in the Income Tax Assessment Act 1915, s 23, and was first enacted by the US in 1921 as s 482 of the Internal Revenue Code.

3 See Kaplan, "International Tax Enforcement and the Special Challenge of Transfer Pricing" (1989) 6 Australian Tax Forum 423. The figures are attributed to remarks by Rep Rostenkowski, 136 Cong Rec H928 (20 March 1990).

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Treatment of transfer pricing in the United States

Before 1921 transfer pricing arrangements by companies subject to US tax could only be fought by questioning the legitimacy, or bona fides, of the subsidiary corporation to see if it was a sham; ie, looking to the substance rather than form. However, this judge-made standard was largely inefficient due to the ease with which corporations could establish economic substance sufficient to be more than a mere sham.[4] Ultimately, an anti-transfer pricing provision, in the form of s 482, was introduced into the Internal Revenue Code to combat such arrangements.[5] Section 482 applies very broadly. It permits revenue authorities to make a determination of true taxable income in any case in which it appears that the taxpayer's income is incorrectly reported by virtue of a non-arm's length transaction.[6] It is not limited to cases of improper accounting, fraudulent, colourful or sham transactions, or other tax minimisation devices. The section is complemented by regulations which define the key terms used and outline methods for calculation of the arm's length transfer price. Like the section itself, the principal key terms of "organization", "trade or business" and "controlled" are defined very broadly.[7]

Three principal methods are provided in the regulations for calculating the arm's length price of the goods: the comparable uncontrolled price method, the resale price method, and the cost plus method.[8]

The comparable uncontrolled price method looks to "the price paid in comparable uncontrolled sales".[9] This method should be used where products are substantially similar, or in circumstances where the price paid reflects the supply and demand conditions of the market for that product.[10] The calculation is subject to adjustments for differences in the compared products where those differences have a definite and reasonably ascertainable effect on the price.[11]

The regulations provide a number of examples to illustrate the types of situations to which this method would apply. Where a corporation sells

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4 *E I Du Pont de Nemours & Co v United States* 608 F 2d 44 (1979); cert den 445 US 962 (1980). A wholly-owned Swiss subsidiary of a US parent sold only its parent's products to yield fully 75 percent of the total profit realised upon their sale. The subsidiary's internal memoranda were replete with references to the transfer pricing benefits. However, the court found that although these benefits were an important consideration in the subsidiary's creation and operation, the subsidiary performed substantial commercial functions and as such could not be considered a sham operation. (The government ultimately "won" the Du Pont case through legislation, albeit twenty years after the breach occurred.)

5 Above n 2.

6 Income Tax reg 1.482-1(c).

7 See reg 1.482-1(a).

8 These are the methods advocated by the OECD and, as will be seen below, are also used in Australia.

9 Reg 1.482-2(e)(2).

10 In *Ciba-Geigy Corporation v Commissioner of Internal Revenue* 85 TC 172 (US Tax Court, 1985) it was held that an *exclusive* licence to manufacture, formulate and sell herbicide could not be regarded as sufficiently similar to a *non-exclusive* licence for the same.

11 Reg 1.482-2(e)(2)(ii).

products to both uncontrolled and controlled entities this method will be used as a direct comparison can be made with an arm's length transaction. In this case, however, the differences between the uncontrolled and the controlled transaction must be quantifiable for the unrelated to be reasonably comparable.[12]

Where it is not possible to identify a comparable uncontrolled price, the resale price method should be used.[13] This method attempts to determine the arm's length price by ascertaining the sale price to an unrelated third party and discounting it by an appropriate profit margin expressed as a percentage of sales. It is ". . . designed primarily for transfers of products to subsidiaries that sell the products to unrelated customers without adding more than an insubstantial amount of value to the products".[14]

The regulations prescribed criteria for determining the comparability of a resale price. These include the type of property, functions performed by the reseller with respect to the property,[15] intangible property used by the reseller (if any) and the geographic market in which the functions are performed by the seller.[16]

On the other side of the coin is the cost plus method, which establishes arm's length price by determining the related vendor's costs and increasing them by an appropriate gross profit percentage.[17] This method has been described as being applicable:

> . . . [P]rimarily to exports of components or unfinished goods that will have substantial value added to them by the controlled purchaser. The gross profit mark-up is determined in substantially the same manner as under the Resale Price Method.[18]

Normally, the cost plus method is appropriate in post-sale manufacturing situations and it generally applies where the cost and profit factors associated with the activities performed by the related-party seller (which have an effect on the price of the property) are easier to evaluate or approximate than those associated with the buyer/reseller's activities.

Under the cost plus method the vendor's cost of production must be calculated in accordance with sound accounting practices which neither favour nor burden controlled sales in comparison with uncontrolled sales.[19]

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12 Reg 1.482-2(e)(2)(ii) provides quantifiable adjustments can be made for differences in product quality, terms of sale, use of intangible property, time of sale, geographic market, market share and level of trade.

13 Reg 1.482-2(e)(3)(ii)(a) provides, *inter alia*, that the resale price method must be used to compute an arm's length price of a controlled sale if there are no comparable uncontrolled sales, as defined in subparagraph (2) of that regulation.

14 Ziegler, "Transfer Pricing: a Problem Seeking Solution" (1989) 6 Australian Tax Forum 455, 463. Comments are attributed to Levey and Ruchelman, "Section 482 – the Super Royalty Provisions Adopt the Commensurate Standard" (1988) 41 Tax Lawyer 611, 618.

15 Eg, packaging, labelling, maintenance of inventory, minor assembly, advertising, selling at wholesale or retail, billing, maintenance of accounts receivable and servicing.

16 Reg 1.482-2(e)(3)(vi).

17 Reg 1.482-2(e)(4).

18 Zeigler, above n 14.

19 Reg 1.482-2(e)(4)(ii).

The criteria for determining compatibility of transactions is the same used for the resale price method. If similar sales are not available, the regulations provide the prevailing gross profit percentages in the particular industry may be appropriate.[20]

If the product which is the subject of transfer pricing is freely available from many different manufacturers, "arm's length comparisons" are relatively easy to ascertain. However, where the product is of a proprietary nature, as in the *Du Pont* case,[21] or of an intangible nature, with no realistic comparable product, the method of pricing becomes vastly more difficult.[22]

The regulations for s 482 recognise the difficulties of identifying comparable transactions and allow a "fourth method", an appropriate method of pricing other than those described above, to be used where necessary.[23] The courts have generally recognised this fourth method as the "reasonable profit split approach". This approach involves identifying the reasonableness of the profit split on intercompany transactions between related companies. This type of profit analysis is usually done by employing a "functional analysis". A functional analysis measures the reasonableness of the profit split between the two companies according to the economic functions performed and the risks undertaken by each company for the development, manufacture and sale of the product.

The difficulties in assessing the value of intangible property are demonstrated in *Bausch & Lomb Inc and consolidated subsidiaries v Commissioner of Internal Revenue.*[24] Here the court considered whether a non-exclusive licence agreement with a wholly-owned subsidiary in Ireland for a 5 percent royalty was an arm's length agreement and whether the sale of the goods manufactured under licence back to the parent was at an arm's length price.

Regarding the price of the sale to the parent, the company argued that the price was comparable and, in some cases, even below that of its competitors. The IRS argued that because Bausch & Lomb's patented manufacturing process had been licensed out to the subsidiary, they could in fact produce the goods at substantially lower rates than its competitors.[25] The court found for Bausch & Lomb, holding that the market price for any product will be

20 Reg 1.482-2(e)(4)(iv).

21 Above n 4.

22 An internal company memorandum submitted in evidence in the *Du Pont* case (above n 4) clearly shows the corporate attitude to the legislation and the difficulties encountered in ascertaining comparable prices: "It would seem to be desirable to bill the tax haven subsidiary at less than an arm's length price because: (1) the pricing might not be challenged by the revenue agent; (2) if the pricing is challenged, we might sustain such transfer prices; (3) if we cannot sustain the prices used, a transfer price will be negotiated which should not be more than an arm's length price and might well be less; thus we would be no worse off than we would have been had we billed at the higher price".

23 Reg 1.482-2(e)(1)(iii). Note, however, that the regulations do not offer any guidance in developing or applying such a fourth method.

24 92 TC 525 (US Tax Court, 1989), affirmed 933 F 2d 1084 (1991).

25 Obviously the company was using a comparable price valuation and the IRS was using a cost plus method.

equal to the price at which the least efficient producer, whose production was necessary to satisfy demand, is willing to sell. The court accepted that the competitors, although using substantially different manufacturing techniques, were distributing comparable products.

The question of royalty payments went in favour of the IRS, although the court-determined arm's length price was less than that argued for by the IRS. To estimate prospective profits, the court used the estimations of start-up costs and capital investment made when setting up the subsidiary rather than the actual results over the relevant period of time.[26]

To aid in determining an appropriate price for intangible property, s 482 was amended in 1986 to include the following:

> In the case of any transfer (or licence) of intangible property (within the meaning of s 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

In the Treasury's White Paper the discussion of this amendment recognised that transfers of intangibles between related parties do not involve the same risks as they do for unrelated parties. It was felt that to overcome the difficulties in determining the arm's length value, the actual income attributable to the intangible should be commensurate with the payments made on the transfers.[27] This is essentially a change from arm's length price to arm's length return.[28]

The objective is to ensure that the income of the US parent and its foreign subsidiary "reasonably reflects the relative economic activities undertaken by each."[29] This departure from international standards is radical in its explicit rejection of industry norms or other party transactions as a defence. Hence the colloquial name "super royalties" as the price found will often be greater than the industry average.

This super royalty provision is likely to give rise to an increase in international disputes over the right of the primary taxing jurisdiction to tax the income. Further, the method of calculation, as one of hindsight, seems unduly onerous on the taxpayer, who may act bona fide and without negligence in forecasting potential gains under a licensing arrangement, only to later find the actual results to be otherwise and a potential tax liability looming.

The Australian legislation

The current Australian transfer pricing provisions are set out in Division 13 of the Income Tax Assessment Act 1936 ("the ITAA"), ss 136AA-136AG inclusive.

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26 Under the new provisions, discussed below, the actual profits would have been considered.

27 Staff of the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (1987) 1015-1016.

28 This type of calculation would have foiled the taxpayer in the *Bausch & Lomb* case (above n 24) where the court used the taxpayer's calculation of the uncontrolled price method instead of the IRS's suggested cost plus method.

29 Above n 27 at 1016.

There are four essential ingredients in order for Division 13 to operate:

- the existence of an international agreement;[30]
- between parties who are not dealing at arm's length;[31]
- for the supply[32] of property[33] for either less or more than arm's length consideration,[34] or for no consideration[35]; and
- the Commissioner has determined to apply the provision.[36]

The Commissioner is authorised to re-allocate income arising from an "international agreement" where there is no consideration (or insufficient consideration) for the agreement, and he is satisfied that the parties were not dealing at arm's length and the consideration was not arm's length. The re-allocation involves applying a substitute consideration calculated according to arm's length standards or, failing that, on an arbitrary basis. The Commissioner can impute or create income where this is necessary to give effect to the arm's length principle.

Arm's length consideration is defined in the ITAA as the consideration which the Commissioner objectively decides might reasonably be expected to have been received or given had the deal occurred between independent parties dealing at arm's length.[37] The explanatory memorandum specifically mentions the comparable uncontrolled price method, the resale price method and the cost plus method as possible methods to be used. Further, the OECD report[38] suggests various tests based on rate of return rather than determining a comparable price. In *Case N69*[39] the Board of Review recognised the comparable uncontrolled price method as probably the best starting point. The Board also mentioned, in the context of a discussion of the means of constructing a hypothetical price where there were no comparable market prices, that the cost-plus method may have to be resorted to at times. However, due to limited judicial consideration it is difficult to determine the court's attitude in Australia to the different methods and their likely use.

Like the US position, the Commissioner has the power to make correlative adjustments where the income has been included or a deduction disallowed pursuant to the re-allocation power in s 136AD of the ITAA.[40]

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30 ITAA, s 136AC. Section 136AA(1) broadly defines agreement to cover all types of formal or informal arrangements or understanding, whether enforceable or not.

31 ITAA, s 136AD.

32 The words "supply" and "acquire" are defined, in the ITAA, s 136AA(1) to cover most methods of providing or obtaining, or agreeing to provide or obtain, property, whether under or in connection with an agreement.

33 "Property" is given an extended meaning in the ITAA, s 136AA(1), to cover all types of rights to, interests in and power over, property of every kind including choses in action, rights to receive income and services.

34 ITAA, s 136AD(1)(c) and (3)(c).

35 ITAA, s 136AD(2)(c).

36 ITAA, s 136AD(1)(d), (2)(d) and (3)(d).

37 ITAA, s 136AA(1).

38 See OECD Committee of Fiscal Affairs, *Transfer Pricing and Multinational Enterprises* (1979).

39 (1963) 13 TBRD 270.

40 ITAA, s 136AF.

Comparison of the two jurisdictions

The scope of s 482 appears to be wider than Division 13. This is evident from the fact that s 482 is not limited to the supply of property under an international agreement as is the case for Division 13 in Australia. Arguably, purely domestic transactions can be brought within the scope of the provisions in the US, something which could never happen in Australia. Unlike Australia, however, there is a distinct need for this in Territories of the US, such as Puerto Rico, which provides a 100 percent tax credit to US corporations operating there. Under the Australian Division 13, trade with these territories would not be under an international agreement and transfer pricing would go unchecked.

Another area of difference between the US and Australia is in the concept of control. There must be common ownership or control of the transferor and the transferee before the US provision can apply; the decisive factor is the reality of control and not its form. Nonetheless, a presumption of control will arise if income or deductions are considered by the IRS to have been arbitrarily shifted.[41]

By contrast, Division 13 merely provides that the Commissioner needs to be satisfied that two or more parties were not dealing at arm's length "having regard to any connection between . . . the parties . . . or to any other relevant circumstances".[42]

The purpose of s 482 is to "place a controlled taxpayer on a parity with an uncontrolled taxpayer by determining according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of the controlled taxpayer".[43] The standard to be applied in every case is that of an uncontrolled taxpayer dealing at "arm's length". As such, the amount charged in independent transactions with unrelated parties under the same or similar circumstances is the amount to be taxed. Unlike the Australian provisions, the US regulations provide a basis upon which to determine whether an arm's length price has been paid. Further, the US regulations deal specifically with five different types of transactions to guide in computation of non arm's length transactions; loans and advances, services, use of tangible property, transfer or use of intangible property, and sales of tangible property. They also provide an order of preference for the different methods dependant upon the nature of the transaction.[44]

Division 13, on the other hand, simply applies to property, broadly defined to include any chose in action, estate, service, etc. Further, it relies on the explanatory memorandum and the few decided cases to determine arm's length value. This creates the problem of uncertainty to the taxpayer as to how its transfer pricing is likely to be assessed.

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41 Reg 1.482-1(a)(3).
42 ITAA, s 136AD.
43 Reg 1.482-1(b)(1).
44 Unless the taxpayer can establish an alternative approach that is clearly more appropriate in the circumstances.

As stated above, the US has specifically dealt with the complex subject of determining the arm's length pricing of intangible property. The method used is one of a charged transfer price of the income attributable to the property. This creates a problem in that theoretically s 482 would require parties to increase the charged transfer price in the event that income attributable to the intangible property increases over time. At the time of printing no material was available to this writer indicating how the US authorities will deal with this problem. It is hoped that common sense prevails so that the initial pricing arrangement accepted by the revenue authorities remains static, irrespective of future changes to income attributable to intangible property.

The certainty of determination of arm's length consideration, provided for in the US legislation and regulations, is a stark contrast to Division 13. Australia's infancy in the field of international tax enforcement means we will have to wait many years for considerable judicial review or some guidance from the Commissioner, by way of ruling, to reach the same level of certainty.