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– A Comparison of Three
Jurisdictions

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Summary

*It's a game. We [tax lawyers] teach the rich how to play it so they can stay rich -- and the IRS keeps changing the rules so we can keep getting rich teaching them.
--John Grisham (The Firm)*

One way of describing the international dealings with taxes is to picture them as moves in an “international tax game”. And in this on-going international tax game transfer pricing constitutes a double-edged tool that allows for both profitable challenges as well as disastrous risks for involved interested parties. Interested parties consist of states and MNEs (taxpayers) among others. One of the aims in the international tax game is to maximize profits, although some restraining factors do exist in various forms. For the states this means to maximize tax revenue without angering other states or scaring away investments by applying too acquisitive rules. For MNEs this means to lower tax burdens without risking harsh penalties and bad reputation. Through the OECD Model Convention and OECD Guidelines efforts have been made to harmonise the rules of the international tax game with regard to transfer pricing. The OECD Model Convention is today widely used in bilateral tax treaties between both member and non-member countries. Central to modern transfer pricing theory are the separate entity approach and the arm’s length principle, both adopted into most states’ domestic tax laws in one way or another.

As part of the international tax game, states complain about tax gaps due to international tax evasion schemes, while MNEs complain about objectively uncertain tax laws. However, no laws can possibly cover every conceivable situation and transfer pricing, in itself, is not an exact science. Even the OECD Guidelines argue for allowing a legal transfer pricing *range*, rather than one correct transfer price. As a matter of fact, the uncertain nature of transfer pricing may be exactly what makes it a desirable tool for both states and MNEs.

To illustrate the on-going international tax game this thesis looks into the transfer pricing implementation in three jurisdictions: Sweden, the People’s Republic of China (China), and the United States of America (the USA). The statutory rules on transfer pricing adopted by Congress or Parliament are, in all three jurisdictions, vague and supplementary rules are called for. Despite differences in legal history, legislative and political systems, and in culture, there are a number of similar features in the transfer pricing situations between China and the USA. Most likely, these similarities do not owe to OECD harmonisation efforts. Sweden, on the other hand, seems to be on its way to follow general American transfer pricing tax law solutions, while retaining certain features of its own. The OECD harmonisation efforts are called for, but far from always respected in the international tax game, where participating actors have interests of their own. This far, the OECD Guidelines, although widely spread and frequently referred to, have not effectively served to lower international legal uncertainty.

Preface

I have been supported in many ways throughout the process of gathering material for and writing this thesis.

On an individual level, I above all want to most warmly thank my supervisor and tutor at Juridicum, Christina Moëll. Without her constant encouragement and support, the difficulties I encountered in China would have been unbearable. I also wish to thank Birgitta Edebalk for her kind support.

On an institutional level, I firstly want to thank Lund University and the Faculty of Law, Juridicum, for awarding me the one-year scholarship for studies at Peking University, which provided me with an institutional base for carrying out my studies in China. I also wish to thank the Faculty of Law for inviting me to PKU-UMICH Tax Law Forum 2007. In Wanzhou, I want to thank the leaders and judges at Wanzhou People's Intermediate Court for their hospitality.

Many scholars, judges, lawyers and other tax law practitioners in China, Sweden and from the USA have willingly discussed my work with me. Their views and opinions have been very helpful.

Abbreviations

APA	Advanced Pricing Agreement
EUTPD	European Union Transfer Pricing Documentation
FIE	Foreign Invested Enterprise
IRS	Internal Revenue Service
MNE	Multinational Enterprise
OECD	Organisation for Economic and Cooperative Development
PRC	People's Republic of China
RMB	RenMinBi, 人民币
SEK	Swedish Krona
UN	United Nations
USD	US Dollar

1 Introduction

The right to impose both taxes and penalties is often claimed to be an entirely internal matter for the sovereign state. There are, however, conflicting interests between parties involved in inter-company transfer issues, which inevitably turn these country-internal affairs into international affairs. One main reason for this is that although internal law usually applies for taxation in each country and although there is no supranational authority to supervise the design and interpretation of internal tax law, internal tax law still affects the global distribution of profits and has, as such, become a matter of international concern.

Inter-company transfers may include transfers of both tangible and intangible assets. Provision of services and finance as well as rentals and leasing arrangements are further examples of common inter-company transfers.

There are many reasons for advance planning of transfer pricing activities for an MNE, and reaching desired effects of direct taxation and customs valuations merely constitute one reason. Streamlining inter-company-group management and communication is another important reason. It is sometimes claimed that transfer pricing is one of the most exploited ways of reallocating profits within a company group. It is however important to remember that diffuse rules about what is the correct transfer price may confuse practices and perhaps even induce revenue authorities to challenge a larger number of companies. In any case there is usually a lot of money at stake.

The parties involved in an inter-company transaction can be several, among others:

- the state or province from which untaxed profits are transferred out;
- the state or province to which too high profits are allocated;
- the concerned tax authorities in both states;
- the customs authorities in both states;
- the multinational company group as a whole;
- the individual company belonging to the multinational company group.

However, depending on the power structure in a particular country there may be other parties taking an interest in an inter-company transaction. Furthermore both the national community and the international community take an interest in how principles for international taxation are preserved and obeyed in the dealings between countries. Thus, taxation may be an internal affair, but internal tax law clearly affects the development of tax law worldwide (especially tax law of powerful states) and has a large influence on international trade, and allocation of investments and funds. We could even say that internal tax law actually affect the lives and living of many people both inside and outside of the state in question.

One of many effects of disproportionate transfer pricing is juridical double taxation, defined by the OECD as the imposition of comparable taxes in two (or more) States on the same taxpayer with respect to the same subject matter and for identical periods.¹ This may happen when all countries persist in using their own pricing methods for international transactions. The occurrence of these situations is of course very harmful to international trade and economic development as well as relations between countries.

In the same way transfer pricing compliance practices are of significance for the global distribution of tax revenue. Overly harsh procedural rules and documentation requirements may result in un-fair shift of tax revenue. The burden of proof can be of major importance. This is especially the case when the burden of proof is guiding behaviour and can be misused by both tax authorities and taxpayers for making unverifiable assertions about transfer pricing.

Thus, since internal transfer pricing rules have a clearly international dimension considerable international effort has been made to find universally acceptable regulations and common principles for transfer pricing. Both the OECD and the UN have functioned as conduits for the discussions and contributed with efforts to unify transfer pricing rules.

These efforts resulted in the OECD and UN Guidelines, which are merely recommendations for participating countries. The basis of the recommendations lies with the arm's length principle, a principle today recognised as international standard by both member and non-member countries. The principle is defined in Article 9 of the OECD Model Tax Convention, and forms the basis for bilateral tax treaties between both OECD Member Countries and non-member countries. However, the principle simply says that compensation for any inter-company transaction shall be the same as it would have been between unrelated parties, which means that it remains unclear how the principle is to be followed in practice. Transfer pricing is not an exact science because of the complexity of the facts in individual cases, which results in difficulties in interpreting and evaluating circumstances. Divergence in transfer pricing is thus likely to occur even if all parties would try hard to follow the guidelines.² Furthermore both examination practices as well as burden of proof and penalty rules vary between countries, making it possible for one and the same transaction to be viewed as compliant with the arm's length principle by one state's tax authorities while being non-compliant in the view of another state's tax authorities. And from here the divergence in implementation of the principle emerges throughout the world.

The transfer pricing rules in various countries seem to present a range of dissimilarities. From a state's point of view, agreeing on a vague

¹ OECD, Introduction to Model Convention 2005, p1.

² Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2001, IV1- IV3.

international principle may be preferred to agreeing on using a stricter rule. A principle, by its nature, usually leaves enough leeway for local implementation and application that fits into the already present legal system. However, the question of uncertainty that is connected to using a principle must be solved somehow, since uncertainties in tax law may lead to higher administrative costs and even to many undetected tax evasions. From the company groups' and the individual company's point of view these dissimilarities may easily lead to confusion and even require very different transfer pricing policies in different jurisdictions. How the question of uncertainty is solved in a particular state is also of paramount importance for the taxpayer. With these unanswered questions about possible reasons for dissimilarities, potential uncertainties and conflicting interests the starting point for this study is thus set.

2 Purpose and Aim

The purpose of this study is to, from an “uncertain tax law”-perspective, describe and analyse the implementation and application of the arm’s length principle in three jurisdictions. The three jurisdictions are Sweden, The People’s Republic of China and the USA. The comparative aim has been chosen since transfer pricing rules exist in an international environment, which means that multiple-country approaches are likely to be more profitable. The study of the Chinese transfer pricing situation has been the main challenge and received most attention.

The basis for the study is the more or less universally accepted arm’s length principle defined in Article 9 of the OECD Model Tax Convention 2005. The implementation, interpretation and application of the principle in the three jurisdictions will then be scrutinized. As mentioned in the introduction the principle itself is quite diffuse and leaves room for many different interpretations and ways of application. The focus of this study will be on how these three countries have chosen to deal with the uncertainty problem that follows from the fact that the arm’s length principle is rather diffuse. The question of uncertainty is closely related to issues such as taxpayers’ compliance with the law, administrative costs and burden of proof. An attendant question is whether the OECD harmonisation efforts have resulted in any visible effects.

The study will essentially consist of three sections: a more theoretical analysis of uncertainty in tax law (chapter 4), a descriptive study of the OECD guidelines and the corresponding legislation and practice in the three jurisdictions (chapters 5-8) and a country-specific analysis, and lastly a comparative overall analysis of the results (chapter 9). The tax law “grey zones“ will be depicted with regard to judicial independence, transparency, and accountability. An explanation to the dissimilarities between the jurisdictions will be attempted.

3 Methodology and Materials

The study of rules and practice with regard to transfer pricing in three jurisdictions has mainly been carried out using comparative methods as described by Michael Bogdan in *Komparativ Rättskunskap* (2003)³. In addition traditional legal dogmatics has served as a starting point for describing practical legal realities, where statutory legislation (including tax treaties), preparatory acts, case law and doctrine have been considered. With regard to China “case law” has been provided through interviews with practitioners and representatives from foreign invested enterprises in China, since litigation in tax cases is rare if not non-existent and the material on the few existing cases is not public. Furthermore, for scrutinizing and explaining conducts in relation to for example uncertainty in tax laws I have included a legal methodology based on micro-economical theory and the concept of *homo economicus*.

According to Bogdan, understanding of rules in a foreign legal system should be sought through both communication with skilled practitioners and through self-studies. Bogdan thinks that one of the most severe mistakes one can make is to assume that methods of interpretation, judicial terminology and hierarchy of legal bodies have the same meaning or scope of importance as in one’s own legal system.⁴

According to Bogdan, firstly a general legal understanding should be obtained by studying secondary information from for instance university schoolbooks written by domestic practitioners. Also literature by foreign practitioners describing the legal system from a foreigner’s perspective may be very helpful. Secondly, accurate and up to date information and knowledge of the intended legal issue should be achieved through the study of original and primary sources. The real purport of the rules should be sought instead of an inaccurate translation. Bogdan stresses the importance of interpreting foreign legal acts as they are interpreted in the particular legal system in question. The importance of legal acts may often only be achieved through studying the practical use of the rules during a longer period, since academic literature does not always ascribe the legal acts their actual importance or influence.⁵

The author was physically present in China from the beginning of the project, and parts of the Chinese rules and above all the Chinese legal reality were studied together with some of the Swedish material. The participation of the author in the third Tax Law Forum co-organised by Peking University and University of Michigan in June 2007 provided a good base for starting a study of the American rules. The author has tried to achieve a general understanding of the Chinese legal system and above all the Chinese tax

³ Bogdan, *Komparativ Rättskunskap*, p 39ff, 49-50.

⁴ Bogdan, p 39ff.

⁵ Bogdan, p 41-46.

system through both Chinese and foreign literature. The author has also during her one-year stay in China tried to venture into as many legal situations as possible where law has been practiced or discussed. For example the author frequently visited Beijing courts (mostly Haidian People's Court); stayed as an intern at one of the 400 People's Intermediate Courts in China, namely the one in Wanzhou (万州); took one tax law class at Peking University; and frequently met with Chinese lawyers and other practitioners of Chinese law. The continuous dialogues and dealings with practitioners would not have been possible without a proficiency in Mandarin and plenty of patience.

Bogdan warns for the dangerous mistake of studying only a legal detail. Since the foreign country's systematic legal division may differ from the one in one's own country it is always necessary to view the detailed rules in an overall legal context. For example the foreign legislator may also have chosen other means of solving a certain societal issue than what one is used to in one's own country. To understand the real purpose and practical effects of the rules one must also take into account environmental elements such as economical, political, ethical, religious and cultural factors and how these factors function in the society of one's study.⁶

According to Bogdan it is important to be aware of how one defines "existing law". The influence of moral rules and unwritten customary rules may be much more important than in Sweden. Some behavioural rules may have developed *praeter legem* but still function as legal rules, for example the practice of executive bodies such as public prosecution offices or tax authorities.⁷ With regard to the actual comparison the aim is to compare comparable elements in the different legal systems and distinguish similarities and differences. A meaningful comparison should be one between objects that share common characteristics, i.e. rules that address the same situations or problems that should be compared.⁸

Consequently, the author started the project with the working hypothesis that the Swedish, American and Chinese rules, which are rather similar to article 9 in the OECD model convention, are addressing the same situations and problems and thus are comparable. The basis for the study is thus the OECD guidelines and aims.

A comparative study inevitably leads to the finding of similarities and differences. The following elements are, according to Bogdan, the ones most referred to by researchers doing comparative studies for explaining variations between legal systems: the economical system, the political system and ideology, religion, history and geography, demographical variations, interplay between governance through law and through other mechanisms, and accidental and unknown factors.⁹

⁶ Bogdan, p 44-46, 52-55.

⁷ Bogdan, p 50-52.

⁸ Bogdan, p 56-59.

⁹ Bogdan, p 64-72.

4 Uncertainty and Non-compliance

4.1 Tax Gaps

Before analysing each country's tax laws in more detail it is interesting to observe that the tax authorities in Sweden, China and the USA all claim that owing to tax evasion through transfer pricing schemes tax revenues received are much less than they would have been if taxpayers had paid what they actually owed, i.e. the existence of so called tax gaps. Thus, the Swedish tax authority reports an estimated annual tax gap amounting to at most 8 billions SEK (of totally approximately 90 billions SEK) in 2002¹⁰, while the Chinese tax authority claim an annual shortfall of at least 30 billion RMB in 2005¹¹ due to transfer pricing schemes. The US tax authority reported an annual gross tax gap within the corporate income tax sector amounting to 32 billions US dollars in 2001 (of a total of 345 billions US dollars). It is however unclear how much is connected to transfer pricing circumstances.¹² The estimated transfer pricing tax gaps amount to 0.33% (Sweden), 0.18% (China), and 0.26% (the USA) of respective country's GDP.^{13 14}

From the tax authorities' point of view a tax gap is apparently connected to some kind of non-compliance with tax laws. However, no matter how detailed and precise tax laws are they cannot possibly cover every conceivable situation (which of course applies to any law and not only tax laws). This is especially true for complicated company transactions. And in the case of transfer pricing a correct pricing is not an exact science. So a relevant counterquestion is thus: what is non-compliance? And to answer this question it is firstly necessary to discuss the concept of uncertain tax

¹⁰ Report from the Swedish Tax Authorities: Skatteverkets rapport 2002:2, p 32.

¹¹ This figure is used by several local SAT tax bureaus as well as newspapers and seems to originally stem from a statement made orally by one of the heads of the central SAT. However, I have not found the original central SAT statement, but the figure would not appear in so many different public contexts without a supporting report from the central SAT. Sources using this figure are among others: Beijing local tax bureau (北京市地方税务局): http://shewai.tax861.gov.cn/ssxwz/ssxwz_display.asp?more_id=815350, as viewed on 2007-08-07; Puning local tax bureau (普宁市地方税务局): <http://gdgn-tax.gov.cn/news/list.asp?id=1678>, as viewed on 2007-08-07; Xinhuanet news: http://news.xinhuanet.com/fortune/2005-05/20/content_2979121.htm, as viewed on 2007-08-07; The People's Net (人民网) <http://finance.people.com.cn/GB/1038/3710018.html>

¹² Report from the American Tax Authorities: Internal Revenue Services, Reducing the Federal Tax Gap, p 10.

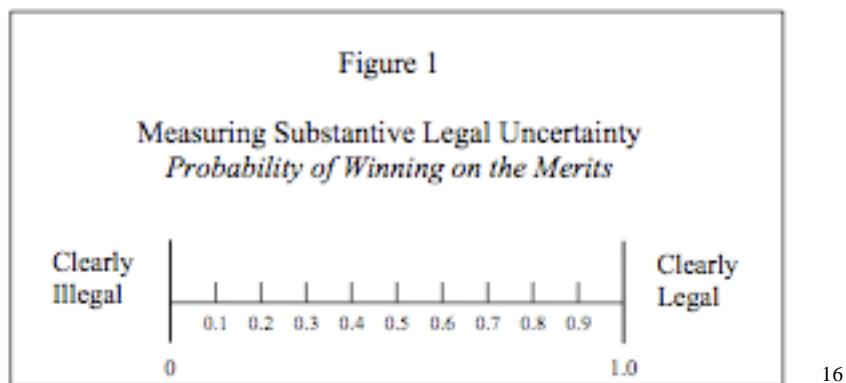
¹³ The World Bank's Key Data and Statistics Webpage: <http://web.worldbank.org/WBSITE/EXTERNAL/DATASTATISTICS/0,,contentMDK:20535285~menuPK:1192694~pagePK:64133150~piPK:64133175~theSitePK:239419,00.html>, as viewed on 2007-09-10.

¹⁴ For the calculations (1.18/357.7, 3.98/2234.3 billions of US dollars, 32/12416.5 billions of US dollars) currency rates from www.x-rates.com were used, as viewed on 2007-09-10.

laws, i.e. what uncertain tax law is and how the uncertainty is related to non-compliance.

4.2 Probabilistic Tax Law

One way to conceptualize the term “uncertain tax law” is to array the possible range of tax positions along a continuum according to their probability of success on the merits if reviewed by court. This is called the Tax Compliance Continuum. On one extreme end (to the left) lie tax positions that are indisputably illegal, and on the other extreme end (to the right) lie tax positions that are clearly legal. Indisputably illegal means the probability that the tax authorities and the courts would support that tax position is zero, while clearly legal means that the probability that the tax authorities and the courts would sustain the position is equal to one. Thus, in between these two extremes there is a continuum of probabilities of success on the merits for a certain tax position.¹⁵



Uncertain tax law can furthermore be divided into what is objectively uncertain and what is subjectively uncertain. Objective uncertainty stems from the statutes or rules, while subjective uncertainty arises from the taxpayer’s point of view. Although subjective uncertainty may often be a consequence of objective uncertainty, it is still usually necessary for a taxpayer to prove that an objective uncertainty exists in order to sustain his case.¹⁷

There are several possible sources of tax law uncertainty. Vague provisions, gaps and loopholes (intended or unintended) could be one source. Another source could be complexity of tax rules, for example that the number of documents to be consulted is large and their relationship to each other not easily comprehended. When the filling up of gaps is left to tax authorities or courts the uncertainty may depend on the administrative or judging tradition practiced. A relevant circumstance may for example be if similar tax positions are treated in the same way, i.e. if one uncertain position resolved

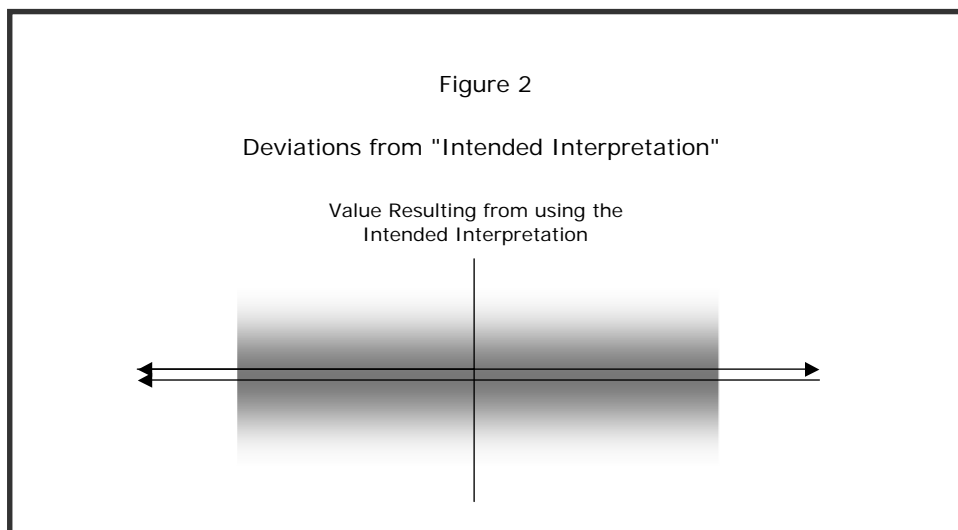
¹⁵ Logue, *Optimal Compliance and Penalties When the Law Is Uncertain*, p 13-14.

¹⁶ Logue, *Optimal Compliance and Penalties When the Law is Uncertain*, p 14.

¹⁷ Vasconcellos, *Vague Concepts and Uncertainty in Tax Law*, p 32.

by either the tax authorities or the courts has effect on how similar cases will be resolved in the future. Another example of a relevant circumstance may be the incentives guiding the work of the tax authorities and the courts (see section 7.4.3).

Another interesting aspect of uncertain tax laws is how much a legal interpretation may deviate from the specific wording in the statutory rules or from the intention of the statutory rules. This kind of deviation is however hard to quantify, since it is dubious if one can ever talk about a “true interpretation” and thus deviations from this “true interpretation”. After all, whose interpretation should be picked to represent this “true interpretation” is definitely not indisputable. However, provided there is an “intended interpretation” and that this “intended interpretation” yields a certain value (for example a certain taxable income) then the deviations from this “intended interpretation” could be depicted as a grey zone. What is inside a certain range would then also be within some kind of “legal range” or “legal grey zone”.



Lastly, a few words should be mentioned about the rules/principles dichotomy. Dworkin made a distinction between rules and principles, where rules are said to require an “all or nothing” approach while principles require a more flexible approach due to their nature.¹⁸ Harding contends that the “all or nothing” approach nature of statutory rules contributes to uncertainty by allowing loopholes which in turn results in an expansion of the number of rules and exceptions, making the law confusing.¹⁹ Whereas principles give the interpreter a certain flexibility to adjustment depending on the case in question, there may be a risk that the liberty is used for changing the original meaning and scope of the statute.²⁰

¹⁸ Dworkin, *The Model of Rules*, 35 *University of Chicago Law Review* 23-29 (1967).

¹⁹ Harding, *Comparative Reasoning and Judicial Review*, 28 *Yale Journal of International Law* 455, 456 (2003).

²⁰ Vasconcellos, p 24.

4.3 Non-compliance and Rational Behaviourism

The difference between tax avoidance and tax evasion is the thickness of a prison wall.
--Denis Healey

Sandmo prefers to explain non-compliance by making a conceptual distinction between tax evasion and tax avoidance. Tax evasion is when a taxpayer purposely engages in illegal tax activities and only is worried about being detected, while tax avoidance consists of exploiting legal loopholes and the taxpayer has no reason to worry about possible detection.²¹ Although this distinction may serve as a moral starting point, it does not really help answering the question about what non-compliance and uncertain laws are. Furthermore, there should perhaps also be a third category consisting of taxpayers who unknowingly and unintentionally indulge in non-compliance due to objectively uncertain tax laws.

That taking indisputably illegal tax positions is equivalent to non-compliance is of no doubt. The question is if and where on the tax compliance continuum a tax position will be considered legal ex post. The probability for every tax position on the tax compliance continuum is an estimation of the probability of success on the merits ex post. In other words, one interesting question is if there is a relation between how aggressive your tax position was (how close to zero) and the result of the judicial review ex post. The answer of course depends on the legislation or maybe more probable on the interpretation of rules and on court practice in every jurisdiction.

Another question concerns the “aggressiveness” of taxpayers to pursue tax positions close to zero on the tax compliance continuum. To answer this question I have in the following used the ideas of Logue (Optimal Tax Compliance and Penalties When the Law is Uncertain, 2006) but modified his example slightly to better illustrate a transfer pricing situation.²² Thus, let us assume the common taxpayer is a multinational enterprise (as is the case in transfer pricing cases) and that the enterprise is a rational *homo economicus* that only seeks to optimize its monetary profitability. Factors that are likely to influence a transfer pricing decision involving uncertain tax positions are then among others the following: the amount of the potential tax cost or tax savings of the pre-tax profit expected from the transaction, the amount and the certainty of the pre-tax profit expected from the decision, the probability of detection, the ex post penalty risked, and the taxpayer’s disposition to risk. However, not only formal sanctions may influence an enterprise’s behaviour, but also informal sanctions in the form of conscience (internal) or reputation (external).²³ At least the latter can be

²¹ Sandmo, *The Theory of Tax Evasion: A Retrospective View*, p 4.

²² Logue, p 22-30.

²³ Logue, p 32.

seen as part of optimizing the profitability of the enterprise, since bad reputation may have long-term influence on business.

This far this study has only discussed non-compliance from the taxpayer's perspective, but the definition of non-compliance also depends on the aims of the state and the tax authority. Are the state and the tax authority mainly opting for maximizing tax revenue and minimizing costs related to taxation or are there other principles guiding their way of work? To understand the aims and conducts of the tax authority it may be necessary to devote some attention to which interested parties that are to be found within the organisations and which internal conflicts that may exist. The conduct and traditions of tax authorities may be attributable to so called principal agent problems not very dissimilar to those in a firm.

Furthermore, are the judges willing to prioritise the state's profit maximizing arguments in their judgments above other principles? The answer to these questions may differ depending on which country one is studying and seem to be closely related to which aim one contributes to the existence of tax law. Logue argues that tax law is primarily about raising revenue to spend on public goods and allocating tax burden in order to obtain some kind of distributive fairness, which would make the collection of penalties important to compensate for illegal tax gaps and tax administration expenses.²⁴ Vasconcellos instead prefers to promote fulfilling societal visions by arguing from the taxpayers' point of view. Since uncertainty of tax law is thought to have harmful effects on taxpayers' business as well as on the growth of the overall economy it is suggested that, in case of doubt, the taxpayer should be exempted from payment.²⁵ And when the uncertainty problem is serious enough to prevent a taxpayer from planning his business life in advance the taxpayer should be exempted from any penalty whether it is proven that he had good or bad intentions.²⁶

4.4 Optimal Penalties?

In no legal system is the probability of detection equal to one, but usually much less. According to Logue, a well known tendency is that, providing all other factors are equal, the lower the rates of detection, the larger the incentive for taxpayers to take aggressive tax positions.²⁷ In criminal law contexts a classical theory connects the probability of detection, and the magnitude of the penalty with the optimal level of deterrence.²⁸ This theory applied to tax law gives the simplified conclusion, that the optimal fine for tax underpayments is the amount of tax underpayment divided by the probability of detection. The A-S model, as introduced by Allingham and Sandmo in 1972, also implies that a higher penalty rate or a higher

²⁴ Logue, p 61.

²⁵ Vasconcellos, p 13-16.

²⁶ Vasconcellos, p 32.

²⁷ Logue, p 30.

²⁸ Becker, Crime and Punishment: An Economic Approach, 76 J. Pol Econ. 169 (1968).

probability of detection always reduces tax evasion.²⁹ Thus, dividing the harm (the taxes not paid plus interest) by the probability of detection produces the optimal fine (in this simplified model) required to induce potential perpetrators to act as if the probability of detection were one. However, this conclusion may only hold under certain assumptions, among others that the taxpayers act as a *homo economicus* and have sufficient assets at risk; and that the amount of the harm and the probability of detection can be calculated in advance and made known to taxpayers.³⁰ The taxpayer is also assumed to be risk averse.³¹ The method also results in disproportionality and unfairness problems, since with a low probability of detection a few taxpayers will have to pay extremely high penalties. Another problem concerns under- and over-deterrence. Logue points out, that a taxpayer without many assets may ignore the threat of penalties and take aggressive tax positions, while taxpayers with sufficient assets may be deterred from making investments through taking even slightly uncertain tax positions.³² On the other hand, Sandmo believes it to be reasonable to assume a relation between higher gross income and an increase in tax evasion, since richer people become more willing to engage in risky activities.³³

If ex post a taxpayer is found to owe more taxes than he has paid there are two evident penalty alternatives, either the taxpayer is strictly liable or a fault-based approach (negligence penalty) is used. Under a fault-based regime the reasonableness of the taxpayer's conduct, "due care", would be scrutinized.³⁴

4.5 Concluding Remarks

All three jurisdictions claim to suffer from tax gaps due to transfer pricing schemes. Although the estimated annual tax gaps amount to less than 1% of the GDPs the sums are not negligible. After all, 8 billions SEK would cover the annual costs for running the Swedish government³⁵, 30 billions RMB would cover the basic living costs for 35 million Chinese people in the rural areas for a whole year³⁶, and 32 billions US dollars would pay the annual tuition, room and board costs at a public institution for 2.5 millions students in America.³⁷

²⁹ Allingham, Sandmo, Income Tax Evasion: A Theoretical Analysis, p 323-338.

³⁰ Logue, p 33-36.

³¹ Allingham, Sandmo, p 323-338.

³² Logue, p 33-36.

³³ Sandmo, p 7.

³⁴ Logue, p 49-51.

³⁵ Webpage of Swedish Government: <http://www.regeringen.se/sb/d/8969/a/79783>, as viewed on 2007-09-13.

³⁶ Calculation based on information on average basic living costs in Chinese rural areas on the webpage of Xinhua: <http://english.peopledaily.com.cn/90001/90776/6246047.html>, as viewed on 2007-09-13.

³⁷ Calculation based on information published by USAToday: http://www.usatoday.com/money/perfi/college/2007-01-12-college-tuition-usat_x.htm, as viewed on 2007-09-13.

Naturally, one would like to know how much of these estimated tax gaps arise from tax evasion, tax avoidance or perhaps even from rather “innocent” behaviour resulting from uncertain tax laws. As accounted for, the probability for taxpayers to pursue tax positions close to zero on the tax compliance continuum seems to rely on several, sometimes interdependent, factors. In fact, in order to be able to justly compare the uncertainty of transfer pricing regulations in the three jurisdictions we would need to look into factors that may influence the behaviour of **all** different interested parties (compare to chapter 1). It is necessary to find out who is responsible for or de facto filling out vague provisions or law gaps in the jurisdictions. The nature and results of the uncertainty remedies (if they exist) need to be studied. Also, the penalty systems deserve special attention as incentive-sparking or restraining mechanisms. From the theoretical exposition above, one may at least deduce that there is a relation between the penalty rate, the probability of detection and the probability of tax evasion. At least these factors should therefore be studied in all three jurisdictions. It also seems unclear which assumptions would best describe a taxpayer and which factors are most likely to influence his behaviour. Apart from incentives or restraints caused by rules and administrative systems as mentioned under section 4.4, one may assume that more general societal factors may also affect the behaviour of interested parties and in particular a taxpayer’s inclinations. The question of whether taxpayers are risk averse, risk neutral or willing to engage in risky business may be very different depending on market conditions in a specific country. For example tempting business opportunities on a developing market may induce MNEs to take higher risks during a short-term attempt to gain market shares. Perhaps it is not possible to generalize taxpayer’s behaviour all over the world with an accurate result.

5 OECD Guidelines

5.1 The Organisation for Economic Co-operation and Development

5.1.1 Introduction

The Organisation for Economic Co-operation and Development (OECD) was created in 1961 as an outgrowth of the former Organisation for European Economic Co-operation, which had served the purpose to coordinate the reconstruction of Europe after World War II with funding from the USA and Canada. In the OECD Convention (1960) the OECD has taken on as its overall aim to support its member states in achieving the highest sustainable economic growth and employment, and a rising standard of living, while maintaining financial stability, and thus contribute to the development of the world economy. Furthermore, the OECD aims to promote contribution to sound economic expansion in member states as well as non-member states. In addition, the OECD shall promote contribution to the expansion of world trade on a multilateral, non-discriminatory basis in accordance with international obligations. The support from the OECD to member states is provided through several means and non-member states as well as non-government organisations have increasingly been invited to participate and comment on the work of the OECD. For one thing the OECD provides a forum for governments to compare experiences, seek answers to common problems, identify good practices, and work to coordinate policies with regard to economic, social and environmental challenges of globalisation. Both Sweden and the USA are members of the OECD, while the People's Republic of China belongs to one of 25 non-member states that participate regularly as observers in the work of the OECD.^{38 39 40 41}

Discussions at the OECD may lead to many different outcomes: among others formal agreements, standards and models or recommendations and guidelines. Discussions and exchange of information are conducted in specialised committees, while decision-making power lies with the OECD Council. There are altogether about 200 specialised committees, working groups and expert groups. The OECD Council consists of one representative from each member state and decisions are taken by consensus. In the Paris

³⁸ Convention on Organisation for Cooperation and Development, Paris 14th December 1960, Article 1.

³⁹ OECD Model Tax Convention 2005, p 2.

⁴⁰ The OECD 2006, p 8-10.

⁴¹ http://www.oecd.org/pages/0,2966,en_36335986_36336523_1_1_1_1.00.html, as viewed on 2007-05-14.

headquarters the OECD secretariat with its researchers and expert analysts supplies the committees and council with relevant materials.⁴²

5.1.2 Transfer Pricing issues within the OECD

The OECD's taxation work covers many areas, work on tax treaties and transfer pricing being just two of those.⁴³ Among others the Centre for Tax Policy and Administration of the OECD secretariat provides research and reports for discussions in the Committee on Fiscal Affairs.

In the 1960's and 1970's the OECD member states started to pay attention to transfer pricing issues and consequently saw a need for international guidelines in order to avoid damaging effects that threatened to emerge from disharmonious rules and practices.

China is one of 6 countries with observer status in the Committee for Fiscal Affairs. The other non-member observers are Argentina, Chile, India, Russian Federation and South Africa. The same non-member states including China are also regular observers in related working groups within the OECD such as for example the Working Party No. 1 on Tax Conventions and Related Questions, the Working Party No. 2 on Tax Policy Analysis and Tax Statistics and the Working Party No. 3 on the Taxation of Multinational Enterprises.

5.2 OECD Transfer Pricing Guidelines

The OECD Transfer Pricing Guidelines (2001) are a revision and compilation of among others the OECD reports on *Transfer Pricing and Multinational Enterprises* (1979), *Transfer Pricing and Multinational Enterprises – Three Taxation Issues* (1984), and *Thin Capitalization* (1987). The Guidelines were approved by the OECD Council in 1995 and have since then been continuously reviewed and revised. A new version is expected in 2008. The Guidelines are intended to assist both tax administrations of both OECD Member countries and non-member countries as well as multinational enterprises to find mutually satisfactory transfer pricing solutions.^{44 45}

5.2.1 OECD Taxation Principles and Aims

The OECD member states have declared the separate entity approach to be the most reasonable way for achieving equitable results and minimising risk of juridical double taxation. The separate entity approach means that each individual enterprise within a multinational company group is treated as a

⁴² The OECD 2006, p 11-13.

⁴³ http://www.oecd.org/topic/0,2686,en_2649_37427_1_1_1_1_37427,00.html, as viewed on 2007-05-14.

⁴⁴ The OECD Transfer Pricing Guidelines, iii.

⁴⁵ The OECD Transfer Pricing Guidelines, P-4.

separate entity for tax purposes and thus is merely subject to tax on the income arising within it. To ensure correct observance of the separate entity approach the arm's length principle has been adopted by the OECD member states.

The arm's length principle is set forth in article 9 of the OECD Model Tax Convention as follows: "*...conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly*".

The arm's length principle builds on the belief that market forces on an open and free market naturally will result in sound market prices and competition on equal footing between associated and independent enterprises on the world market. Thus, when transfer pricing does not reflect market forces and the arm's length principle, distortion of the allocation of tax revenues may result and consequently appropriate adjustments may be necessary. The goal is however to induce all enterprises to act in their relationships with each other as if they were on arm's length and thereby simulating an open market. The OECD does however acknowledge difficulties in simulating an open market. For one thing associated enterprises tend to engage in transactions that independent enterprises never would. Furthermore merely upholding the arm's length principle may result in extra costs and burdens for the associated companies that the independent companies do not have. Although the arm's length principle provides several difficulties with regard to evaluation and obtaining of information it is still considered to provide the best existing approximation of the workings of an open market.⁴⁶⁴⁷

The principle of equality between domestic and foreign persons (as long as they are Contracting Parties) is set forth in article 24, which declares non-tolerance of discrimination.

The above-mentioned principles are incorporated in the OECD Model Tax Convention and have been chosen in order to achieve an appropriate allocation of tax base to each jurisdiction as well as to prevent double taxation.

5.2.2 Transfer Pricing Definitions

The articles in the OECD Model Tax Convention deals with all different kinds of tax issues that may arise from mobility of physical persons, enterprises, capital, and tangible and intangible property between countries. Some articles in the Model Tax Convention are more related to transfer pricing than others and will therefore be described in the following.

⁴⁶ OECD Transfer Pricing Guidelines, I1-I3.

⁴⁷ OECD Transfer Pricing Guidelines, I4-I6.

In article 4.1 of the OECD Model Tax Convention the term "resident of a Contracting State" is defined as meaning *"any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof"*.

Article 5.1 defines the term "permanent establishment" as a fixed place of business through which the business of an enterprise is wholly or partly carried on. In article 5.2 typical permanent establishments are enumerated.

Article 7.1 encodes the separate entity approach: "The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment."

Article 9 deals directly with taxation of profits of associated enterprises and how to apply the arm's length principle. Two enterprises may be considered to be associated in two different situations. One situation is when *"an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State"*. The second situation is when *"the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State"*. The term "person" is defined in article 1.1.a as *"an individual, a company and any other body of persons"*. If between such associated enterprises *"conditions are made or imposed ... in their commercial or financial relations which differ from those which would be made between independent enterprises"* then the taxation authorities of a Contracting State may for the purpose of calculating tax liabilities re-write the accounts for the enterprises. Such an adjustment of tax liability in one Contracting State shall however be followed with a corresponding adjustment in the other Contracting State in order to avoid juridical double taxation.

Articles 10, 11 and 12 deal with the fiscal treatment of cross-border dividends, interest and royalties. Article 13 deals with taxation of capital gains.

As mentioned above, in article 24 the rule of non-discrimination is laid down and the principle of equality is declared. Article 24.3 and 24.5 say that ownership structures (for example with direct or indirect ownership or control by citizens or residents from another State) shall not have any influence on taxation or any requirements connected therewith. Thus all enterprises or permanent establishments shall with regard to burdens from taxation and other connected requirements be treated as enterprises of the State in question that are carrying out the same activities.

From article 25 one may learn, that an enterprise, which finds itself unjustly taxed with regard to the provisions of the Convention, may, irrespective of the domestic laws in either Contracting country, present its case to the competent authority of the Contracting State where it is resident within three years. If the competent authority does not agree with the enterprise a resolution shall be sought by mutual agreement with the competent authority of the other Contracting State. In fact any difficulties or doubts arising from the interpretation or application of the Convention shall be resolved through a mutual agreement procedure.

According to article 26, as far as is foreseeable the competent authorities of both Contracting States shall exchange all relevant information necessary for following the provisions of the Convention. The same disclosure rules shall apply as for information obtained under domestic laws. The information shall only be disclosed to persons and authorities (including courts and administrative bodies) concerned with the case.

5.2.3 Comparison of Conditions

Application of the arm's length principle in general requires a comparison between the conditions in transactions between associated enterprises and conditions in transactions between unrelated enterprises. The wording in article 9 of the Model Convention itself implies that a comparison of conditions should be made. In the OECD Transfer Pricing Guidelines independent enterprises are assumed to make all their decisions in accordance with microeconomic theory, i.e. always opting for the alternative that will maximize their profit. Since not all characteristics of the controlled and uncontrolled transactions are comparable adjustments must always be made to compensate for differences. Consequently, the degree of comparability must be established and necessary adjustments made before an arm's length price may be derived.

For the determination of comparability certain factors are considered of particular importance; characteristics of property or services, functions performed by the parties with regard to the structure and organisation of the company group (taking into account assets used and risks assumed), the contractual terms, the economic circumstances of the parties (for example geographic location and competition situation on the markets), and the business strategies pursued by the parties.

Although comparison transaction-by-transaction is considered to approximate fair market value most accurately the OECD acknowledges that there may be situations where transactions cannot be evaluated separately. This for example applies to package deals, where a number of benefits are packaged as a single transaction with a single price.⁴⁸

⁴⁸ OECD Transfer Pricing Guidelines, I17-I18.

Government intervention and policies are as a general rule to be treated as market conditions in the particular country in question. In the OECD Transfer Pricing Guidelines a non-complete enumeration (since the wording “such as” is used) names the following possible government interventions: price controls, interest rate controls, controls over payments for services or management fees, controls over the payment of royalties, subsidies to particular sectors, exchange control, anti-dumping duties, or exchange rate policy. The circumstance that independent enterprises might not engage in transactions that are subject to government interventions is mentioned.⁴⁹

5.2.4 Transfer Pricing Methods

Controlled transactions need to be tested against the arm’s length principle. The OECD Transfer Pricing Guidelines describes and comments on several methods for analysis, but does not require either the taxpayer or the tax examiner to perform analyses with more than one method. In general, only one method is needed for estimation of the arm’s length method, but various methods may be used in conjunction in complicated cases.⁵⁰

The transfer pricing methods authorised by the OECD Transfer Pricing Guidelines can be divided into two categories: traditional transaction methods (the comparable uncontrolled price method, the resale price method, and the cost plus method) and transactional profit methods (the profit-split method and the transaction split margin method). The traditional transaction methods use direct means for testing the arm’s length character for controlled transactions, but require an uncontrolled comparable transaction as well as available and reliable data about the transactions to be applied. Without suitable comparables or reliable data profit-based methods may be used instead, which examine profits arising from particular controlled transactions. Traditional transaction methods are however preferred over profit-based methods, which should be used in cases of last resort.⁵¹

A non-arm’s length method is the global formulary apportionment, which however is not accepted by the OECD Member Countries as a realistic alternative to the arm’s length method. The method in short means that the global profits of a multinational enterprise group would be determined on a consolidated basis and then allocated to every taxable unit through a fixed formula based on costs, assets, payroll and sales.⁵²

5.2.5 Burden of Proof

The OECD Transfer Pricing Guidelines pay attention to the divergence in rules on burden of proof between Member countries and the potential serious problems that may arise therefrom. The burden of proof for tax cases

⁴⁹ OECD Transfer Pricing Guidelines, I22-I24.

⁵⁰ OECD Transfer Pricing Guidelines, I27.

⁵¹ OECD Transfer Pricing Guidelines, III16-III17.

⁵² OECD Transfer Pricing Guidelines, III19-21.

varies between OECD Member countries, although it is most common that the tax administration bears the burden of proof both in internal dealings with the taxpayer (assessment and appeal) and in litigation. In some countries the burden of proof can be reversed if the taxpayer has not acted in good faith, for example by not complying with certain documentation requirements. If the burden of proof is reversed the tax administration may be given the authority to estimate the taxpayer's income and assume facts based on experience. A reversed burden of proof may in some jurisdictions be shifted back again if the taxpayer presents arguments and evidence indicating pricing on arm's length.⁵³

Although there is no OECD consensus on how the rules on burden of proof should look like, some strong suggestions are still given in the Guidelines on what is considered to be appropriate conduct in applying rules on burden of proof. These suggestions all aim at preventing misuse of the burden of proof by the taxpayer or by the tax administrations in either state.

In case of corresponding adjustments in accordance with article 9.2 of the OECD Model Convention the State that has proposed an adjustment bears the burden to prove to the other State that the adjustment "is justified both in principle and as regards the amount". The Guidelines however stresses that both authorities are nevertheless expected to take a cooperative approach.⁵⁴⁵⁵

In cases where taxpayers are involved tax administrations should not impose an unreasonable level of cooperation on taxpayers even if cooperation is required by law. Regardless of where the burden of proof lies both the tax administration and the taxpayer should be prepared to make a good faith showing that their determination of transfer pricing or transfer pricing is consistent with the arm's length principle.⁵⁶

The Guidelines especially warns about situations, where harshly applied rules on burden of proof may establish irresponsible behaviour that may lead to conflict between tax administrations in different states as well as double taxation. One situation could be when the burden of proof is on the taxpayer in one jurisdiction and on the tax administration in a second jurisdiction. If the tax administration in the first state makes an unsubstantiated assertion about the pricing of a controlled transfer and the taxpayer accepts the assertion, the tax administration in the second jurisdiction will have to disprove both the taxpayer and the first tax administration. This may however be very difficult if neither the tax administration in the first state nor the taxpayer is interested in cooperating.⁵⁷

⁵³ OECD Transfer Pricing Guidelines, IV4-5.

⁵⁴ OECD Commentary on OECD Model Convention, p117.

⁵⁵ OECD Transfer Pricing Guidelines, IV6-7.

⁵⁶ OECD Transfer Pricing Guidelines, IV6.

⁵⁷ OECD Transfer Pricing Guidelines, IV5-6.

5.2.6 Penalties

The OECD Committee on Fiscal Affairs is of the meaning that the primary objective of civil tax penalties should be to promote compliance.⁵⁸ Although penalties cannot be evaluated without considering the whole tax and judicial system of a country, the OECD still has agreed on a couple of notable guidelines concerning tax penalties.

First of all, the OECD points out that compliance within transfer pricing is in itself complicated and no exact science. An overly harsh penalty system may be onerous for the taxpayer, but also give multinational enterprises an incentive to overstate their income in one particular country while understating the income in other countries with less harsh penalty systems. The concept of fairness of a penalty system should therefore be used in reference to the proportionality of the penalties in relation to the offence.⁵⁹

The OECD thinks it is desirable to distinguish between understatements of income attributable to “good faith”, negligence, and an actual intent to avoid tax. It is considered unduly harsh to apply sizable strict liability penalties to cases of “good faith” understatements. Sizable penalties are also considered unfair to taxpayers that have made reasonable efforts in good faith to set the terms of their related party transfer pricing transactions correctly. In particular, it is considered inappropriate to impose penalties on taxpayers for failing to use data to which they do not have access or was not available to them.⁶⁰

5.2.7 Dissenting Opinions

In the OECD Commentary to the 2005 Model Convention Member States have had the possibility to make reservations and comments when they have not agreed with the majority.

No reservations on article 9 have been made by either Sweden or the USA. Neither has China as a non-member participant made any particular comments on article 9. However, China explicitly says in the introduction to the document on non-Member countries positions that “*China wishes to clarify expressly that in the course of negotiations with other countries, it will not be bound by its stated positions as they appear in this document*”. According to an official from the Chinese central tax authorities in Beijing this statement should merely be seen as an example of the traditional Chinese view on written documents, namely that written documents result in inflexibility and loss of face when one cannot comply with the inflexible promises.⁶¹

⁵⁸ OECD Transfer Pricing Guidelines, IV7.

⁵⁹ OECD Transfer Pricing Guidelines, IV8.

⁶⁰ OECD Transfer Pricing Guidelines, IV9-10.

⁶¹ Lunch discussion during PKU-UMICH Tax Law Forum June 2007.

As for the other articles described above under section 5.2.2, all three countries have made some reservations, i.e. on article 4 (USA, China), 5 (USA, China), 7 (USA), 10 (USA), 11(USA), 12 (USA, China), 13 (Sweden, USA) 24 (USA), and on article 25 (China). The reservations usually only concern parts of the articles. For example, China's reservation on article 25 merely concerns the establishment of a joint committee for enabling communication between competent authorities of Contracting States.

5.3 Customary International Law?

In view of China's statement one may wonder what kind of legal document the Model Convention is. As is implied in the Introduction to the 2005 Model Convention, the Member States are only recommended to follow the pattern and main provisions of the Model Convention.⁶² We may therefore conclude, that the reservations for one thing serve a purpose to give input to the legal discussion, and that also without reservations made a country is not confined to merely using the provisions in the Model Convention.

However, the provisions and principles of the Model Convention as well as its commentaries are today used as basic documents for reference in negotiations worldwide and the provisions are incorporated into a majority of the world's bilateral conventions.⁶³ Thus, the impact of the OECD Model Convention has extended far beyond the relatively small circle of the 30 OECD Member States.

An interesting question is whether the Model Convention and maybe even parts of the Guidelines may constitute customary international law, i.e. practice and customs of states that have evolved into binding law. State practice may consist of actual activity as well as more abstract statements. For the formation of customary international law a fairly general as well as constant and uniform *opinio juris* state practice of enough duration must prevail.⁶⁴ To find out whether the Model Convention constitutes customary international law requires an in-depth study, which is outside the scope of this thesis. It is however valuable to keep in mind that there may be more to China's statement than one might first think.

5.4 Principle or Rule?

The problem with practicing tax law is that the general rule never seems to apply to anything.

--Anonymous Tax Lawyer

The arm's length principle is called a principle, but the fact that the arm's length principle may only be applied to cross-border transactions between

⁶² OECD Model Convention 2005, B13.

⁶³ OECD Model Convention 2005, B14-15.

⁶⁴ Dixon, Textbook on International Law, p 28-34.

related companies rouses the question of whether the arm's length principle is actually a principle. For comparison one may look at a typical principle such as the principle of neutrality, which is applicable on all situations. Furthermore, according to Dworkin's way of distinction a principle should allow and require a flexible approach, while a rule requires an "all or nothing"-approach. The arm's length principle seems to, in a way, fit into both descriptions. Either the conditions for applying the arm's length principle are fulfilled or not, thereby fitting into the "all or nothing"-approach. However, the arm's length principle certainly allows for flexibility to adjustment depending on the case in question and no matter how many supplementary rules or exceptions the legislator may invent the arm's length principle will remain unclear (or flexible) due to its nature.

5.5 Concluding Remarks

The arm's length principle as set forth in the OECD Model Convention is in itself vague and allows for (and requires) a great variety of detailed implementations. In fact, without the Guidelines article 9 would be rather incomprehensible. For example the definition of associated enterprises in article 9 is far from crystal-clear. Based on article 9 many countries have designed their domestic transfer pricing tax rules, although this is not exactly required in the recommendations (the OECD Model Convention obviously serves as a model for tax treaties). However, one may assume that an increase in domestic transfer pricing rules resembling article 9 were expected as a result. Incorporated tax treaties are of course supposed to be treated as internal sources of law, but tax treaties are turned to only upon clashes between domestic laws in different jurisdictions. A country without the arm's length principle in its domestic tax laws would have very poor means to promote legal behaviour in accordance with the principle, since the contracting parties of tax treaties are merely the countries themselves. Consequently, the Guidelines aim at providing assistance to all kinds of interested parties and not only countries per se. This also means that any investigation into the degree of international harmonisation in domestic law should be conducted with article 9 and the Guidelines kept in mind.

We know that the OECD Council in consensus approved the OECD Guidelines. Although the OECD's overall aim is to support its member states, it does not necessarily follow that the member states always support even decisions approved in consensus. Both the USA and China have reserved their positions on parts of most articles that are related to transfer pricing, except for article 9. Looking merely to reservations and comments, Sweden's position is much more docile.

Whatever good intentions the OECD claims to harbour it is important to remember that its members chiefly consist of Western developed countries. One reason for allowing non-member observers to take part in the discussions is without doubt to increase the international legitimacy of the OECD documents as well as of the OECD itself. However, there is indisputably a need for harmonisation of rules and practices. The question is

rather how far-reaching the harmonisation effects instigated by the OECD actually are and whom the rules (if followed) would benefit the most. From a non-member country's point of view, active participation has become more important with the growing international recognition of OECD documents. China has, as a non-member state, taken a very active part in a large number of working groups.

According to the documents the OECD stands for a very liberal market-model, but one may question if far-reaching governmental intervention in the internal dealings of MNEs is actually in line with the ideas of a free and open market. The OECD claims it wants to simulate the effects of an open market, but never convincingly explains why related party transactions would not exist on a truly open market.

Considering the contradicting arguments in the OECD documents one may conclude that the documents are many times the result of political compromises – political compromises between mainly Western developed countries who all (among other things) want to gain as big a share as possible from the MNEs profits. This is obviously a consequence of the consensus based decision-making procedure of the OECD Council. The OECD documents may also be viewed as a way of agreeing on game rules for the global tax game. The aim is of course to maximize tax revenues without angering other countries (or at least without angering the politically and economically important countries).

Although there is no consensus on how rules on burden of proof should look like, the Guidelines are clearly biased towards the taxpayers. Concern is expressed about the taxpayer's rights against over-aggressive tax authorities, and the uncertain nature of transfer pricing is stressed. The Guidelines focus mostly on how uncertain tax law and harsh procedures may affect the taxpayers. Proportionality of the penalties in relation to the offences is strongly suggested. From this point of view the Guidelines definitely provide a different picture of the states' concerns compared to the tax gap reports mentioned in chapter 4. One may wonder how much of the concerns in the Guidelines are just empty words and a result of politics and compromises. Clearly, it remains to see how the OECD documents (Model Convention and Guidelines) actually have affected the domestic transfer pricing regulations in various jurisdictions.

6 Swedish Implementation

6.1 Introduction

A tax system of rather high rates gives a multitude of clever individuals in the private sector powerful incentives to game the system. Even the smartest drafters of legislation and regulation cannot be expected to anticipate every device.

--Stephen F. Williams

Sweden is a constitutional monarchy and has as an OECD member country signed up for the OECD Guidelines. Sweden has a long tradition of co-determination in tax issues. Already from at least the 15th century the king usually had to make decisions on taxation together with representatives from the aristocracy, ecclesiastics, burghers and farmers jointly.⁶⁵ Today all tax laws must be enacted by the Parliament, according to the Swedish Constitution (RF 1:4 and 8:4). The Swedish Tax Agency, Skatteverket, is a public authority that has as one of its several main duties to collect local and national taxes. For 2006 (2005) the funds covering expenses connected to collection of taxes for Skatteverket amounted to 6.5 billions SEK (6.1 billions SEK).⁶⁶ According to Eurostat, Sweden had the heaviest tax burden in Europe in 2005.⁶⁷

6.2 The Principle of Legality

The principle of legality, "*nullum tributum sine lege*" (no tax without law/representation), is a 19th century further development from the much older corresponding principle in criminal law (*nullum poena sine lege*).⁶⁸ The principle follows from articles in the Swedish Constitution (RF). All legislation concerning the relationship between an individual and the state, such as taxes to the state, must be enacted by the Parliament (Riksdagen), although rules on how to comply with statutory rules may be issued by the Government or a public authority (1:4 and 8:4). Rules on taxation must not be retroactive except when special circumstances are at hand and approved by the Parliament (2:10).

Lodin argues that an important consequence of the principle of legality is predictability, i.e. possibility for taxpayers to assess the legal consequences of a certain action in advance. The importance of predictability grows with the pressure of taxation, since the economical consequences of an incorrect assessment may be devastating. Furthermore, Lodin thinks that abiding by

⁶⁵ Häthén, Stat och Straff, p 44.

⁶⁶ Årsredovisning för Skatteverket och Kronofogdemyndigheten budgetåret 2006, p 10.

⁶⁷ Eurostat News Release 89/2007 on June 26th 2007:

http://epp.eurostat.ec.europa.eu/pls/portal/docs/PAGE/PGP_PRD_CAT_PREREL/PGE_C_AT_PREREL_YEAR_2007/PGE_CAT_PREREL_YEAR_2007_MONTH_06/2-26062007-EN-AP.PDF, as viewed on 2007-10-02.

⁶⁸ Hultqvist, Legalitetsprincipen vid inkomstbeskattningen, p 3.

the principle means interpretation made by the courts should be restricted to using clear statutory law and preparatory works. Predictability is also closely related to rule of law. Out of rule of law reasons, analogism should not be used when it leads to a decision that is disadvantageous for the taxpayer.⁶⁹

6.3 Transfer Pricing in Sweden

The Swedish statutory rules on transfer pricing were changed to resemble the OECD arm's length principle in 1965 (Prop 1965:126). In 1983 the burden of proof was changed and the burden shifted to Skatteverket (Prop 1982/83:73).

6.3.1 Laws and Regulations

Statutory rules concerning transfer pricing between associated enterprises are found in articles 14:19-20 of the Swedish Income Tax Law (IL). Thus, if the enterprise's revenue, as a consequence of terms of deals differing from those made between unrelated parties, is lower than it would have been (had the terms of the deals been as between unrelated parties), the income shall be adjusted to a level that eliminates the favourable effects of those deals (article 14:19 IL). However, this only applies under the following circumstances:

1. if the enterprise receiving a higher revenue, as a result of the terms of the deals, is not taxable for that income in Sweden according to provisions in the IL or because of double taxation agreements;
2. if there is probable cause for presuming the existence of common economic interest between the parties; and
3. if it does not appear from the circumstances that the dealings are a result of something apart from common economic interests.

The term common economic interest is defined to be a relation when either:

- a business person, directly or indirectly, participates in the management or supervision of another business person's enterprise or owns part of the shares in that enterprise; or
- the same persons, directly or indirectly, participate in the management or supervision of both enterprises or own part of the shares in both enterprises (article 14:20 IL).

Some small guidance on how a market-oriented price may be estimated is given in article 61:2 2 st, but otherwise there are no further articles on how to implement and apply the arm's length principle.

Swedish law does not enable negotiation of APAs, but there is instead sometimes a possibility for the taxpayer to apply for advance rulings. The system with advance ruling allows a taxpayer to ask a specific question concerning taxation that is of importance for the taxpayer or a question that

⁶⁹ Lodin, Inkomstskatt del 2, p583-584.

is of importance for achieving a uniform interpretation and application of tax laws, 5§ Lag (1998:189) om förhandsbesked i skattefrågor. The application will be treated much as a real life taxation issue and the tax authority is the opposite party in the case (11§). The question will be considered by a panel of members appointed by the Government (2§). The panel will in the advance ruling form a judgment on how the question should be treated legally (15§). After the judgment has acquired legal force the tax authority is bound by the ruling, unless the law in question is changed by parliament (16§). If the taxpayer is not satisfied with the judgment of the panel he may appeal to the Swedish Supreme Administrative Court (22§).

According to Lagen (2001:1227) om självdeklarationer och kontrolluppgifter (Act on self assessment and statements of income), an enterprise is obliged to hand in an annual specific income tax return (2:1, 2:7). Since January 2007 specific documentation requirements must be met by enterprises involved in transactions with such associated enterprises that are mentioned in 14:20 IL (19:2a). If the economic interest is merely based on direct or indirect ownership of shares, then documentation is only required if the shares owned exceed 50% in every link (19:2a). The document shall include a description of the company's organisation and activities, a description of the nature and scope of transactions undertaken by the company, a functional analysis, a description of the selected pricing method, and a comparability analysis (19:2b). The mandate to issue detailed rulings on documentation requirements is delegated to the Swedish Tax Agency, according to 19:2b and the Government's Ordinance (2001:1244) om självdeklarationer och kontrolluppgifter (12:4). This is done in the SKVFS 2007:1 Skatteverkets föreskrifter om dokumentation om prissättning mellan företag i intressegemenskap. SKVFS 2007:1 mainly contains a slightly more detailed description of the documentation requirements mentioned above. The extent of the requirements still remains rather unclear, an opinion shared by Swedish practitioners.⁷⁰ Documentation implemented in accordance with the EUTPD (EUT C 176, 28.7.2006) is considered to be in accordance with Swedish law. The documentation related to a specific financial year must be kept for ten years and shall be handed in to the Swedish Tax Agency on request (12, 14§§). Only a simplified account is required for transactions involving tangible goods amounting to a value not exceeding 630 PBB (approximately 25 millions SEK) and transactions involving other tangibles amounting to a value not exceeding 125 PBB (approximately 5 millions SEK) per single entity (10§).

Skatteverket has issued further instructions in a 45-pages circular, SKVM 2007:4. In the circular Skatteverket frequently refers to the OECD Guidelines. Skatteverket even states that deviations from the five pricing methods described in the Guidelines are only acceptable as long as they are in accordance with other conditions set out in the Guidelines for following

⁷⁰ KPMG Sweden's webpage: <http://www.kpmg.se/pages/105528.html>, as viewed on 2007-09-05.

the arm's length principle.⁷¹ Although the circular mainly summarizes important rules that follow from law, preparatory works or judgments, Skatteverket has also smoothly inserted its own opinions in many places. For example, Skatteverket asserts that the more important a certain transaction is for an enterprise's financial result the more should be required of the enterprise in demonstrating that the pricing is acceptable.⁷² This certainly sounds like furtively laying the burden of proof on the taxpayer. Since it is most doubtful whether it is within Skatteverket's mandate (from Government Ordinance 2001:1244) to alter the burden of proof, it should, at least in theory, be seen as one party's contribution to the debate. In practice, however, Skatteverket's view may have much more impact than intended.

6.3.2 Penalty and Anti-Abuse System

There are no special sanctions for non-compliance related to transfer pricing schemes, but instead the general sanctions rules for non-compliance within taxation are applicable. Thus, so called incorrect or misleading statements ("oriktig uppgift") from the taxpayer (for example in the tax return or transfer pricing documentation) may lead to additional assessment for arrears as well as additional tax, according to 4:16 and 5:1,3 Taxeringslag (1990:324), the Swedish Tax Assessment Act. Some mistakes are excused (5:14). Additional tax on income taxes is usually 40% of the tax evaded/avoided, but may be only 10% depending on availability and accessibility of check material (1:1, 5:4). 10% also applies to cases when the statement is incorrect not because of the amount, but because of attachment to the wrong year of assessment or accounting period. The validity of tax returns and other statements from the taxpayer may be controlled through audits. The Swedish Tax Agency decides which taxpayers to control, but the law stipulates no criteria for how to select audit targets (3:8-12a). A submitter of intentionally misleading tax statements may also be convicted of tax crime (skattebrott) and be sentenced to either a fine or at most 6 years prison, according to 2-4 §§ Skattebrottslag (1971:69). Misleading tax statements due to gross negligence are punished somewhat less harsh (5-6 §§).

As mentioned the Tax Agency may require the taxpayer to submit additional information such as a transfer pricing documentation. The request may be issued under penalty of a fine, according to Lagen (2001:1227) om självdeklarationer och kontrolluppgifter (17:9).

As a last resort, tax evasion schemes may be counteracted by applying Lag (1995:575) mot skatteflykt, a law designed especially to remedy tax evasion. In order to apply the law Skatteverket has to, among other things, show that outer circumstances imply that the main aim of a transaction has been to evade taxes (2§). The law is very generally held and it has been left to case law to specify and interpret the rules.

⁷¹ SKVM 2007:4, p 19.

⁷² SKVM 2007:4, p 33.

6.3.3 Preparatory Works

Preparatory works considered in this thesis consist of official reports (SOU) and government bills (Prop). Preparatory works mentioning transfer pricing problems date back to the beginning of the 20th century, although transfer pricing is more frequently discussed in works from the 1960s onwards (for example in SOU 1962:59, SOU 1964:29, Prop 1965:126). However, neither older nor newer preparatory works are of much help for applying the arm's length principle.

In 2000 Sweden enacted a new income tax law through prop 1999/00:2. The government merely relates the historical background of the transfer pricing rules and then agrees with the opinion submitted by bodies referred to for comments that the interrelation between the transfer pricing rule and other tax rules may be unclear. However, the government considered it inappropriate to solve these uncertainties in the government bill.⁷³

The Swedish legislature often uses rather pragmatic wording in preparatory works to explain legislative choices made. In SOU 2005:99 international aspects are deemed to be essential when formulating Swedish tax law, since international transactions and international company groups have increased. The importance of considering tax rule alternatives in foreign jurisdictions is stressed, since Swedish tax law exists in an international environment.⁷⁴

In Prop 2005/06:169 it is pointed out that it should not be possible to move profits from one jurisdiction to another through incorrect transfer pricing, but in the next sentence it is stressed that incorrect pricing often is a result of rather unconscious behaviour due to the complex nature of transfer pricing itself.⁷⁵ The OECD Guidelines are also praised for illustrating the transfer pricing problems in a well-balanced way. The Guidelines are even said to express internationally accepted principles and Skatteverket as well as taxpayers are encouraged to turn to the Guidelines for guidance.⁷⁶ Both the government and Skatteverket seem to have high expectations on the new documentation requirements for removing legal uncertainty. Both hope for increased fiscal efficiency. No shift of the burden of proof is intended.⁷⁷

6.4 Practical Reality

6.4.1 Judgments

Judgments by the Swedish Supreme Administrative Court on transfer pricing are not plentiful, but the few existing have been important for improving clarity. The more important ones will be accounted for below.

⁷³ Prop 1999/00:2, p 187-188.

⁷⁴ SOU 2005:99, p 79.

⁷⁵ Prop 2005/06:169, p 88.

⁷⁶ Prop 2005/05:169, p 89.

⁷⁷ Prop 2005/06:169, p 102, 124.

The case **RÅ 1990 ref 34 (Mobile Oil)** concerned a Swedish entity that had received considerable loans from its foreign mother company to sustain its activities. According to Swedish law payment of interest is a deductible cost, but was in this case challenged by Skatteverket. However, RR decided that thin capitalisation cannot be challenged by applying the arm's length principle in 14:19 IL.

The case **RÅ 1991 ref 107 (The Shell case)** concerned pricing of crude oil and freight. Because of the complexity of the case it took 8 years (from 1983 to 1991) for the case to pass through the whole administrative court system. Apparently half a division (around 5 employees) at the Administrative Court of Appeal spent 10 months full-time only on this case.⁷⁸ Skatteverket (or rather Riksskatteverket at the time) came up with several alternative models for how to price crude oil and freight, but the models were rejected by the RR due to their hypothetical nature. Because of the uncertainty range of the calculations Skatteverket's claims were considered to be insufficiently founded. Four points that follow from the RR's judgment are worth particular attention. Firstly, the Tax Agency bears a considerable initial burden of proof. Secondly, transactions from a span of years (and not only from one year) may be considered when considering whether an arm's length price has been charged. Thirdly, a transfer pricing adjustment seems to be justified only if the deviation from arm's length pricing is significant in size. Lastly, upon establishing how to estimate the arm's length prices articles in the OECD Guidelines were referred to as a highly important but non-binding supplementary source of law by the RR.

In the case **RÅ 1994 not 697 (Cerbo AB)** a Swedish mother company had on an annual basis transferred "marketing contributions" to its wholly owned Norwegian subsidiary for 6 years. The contributions more or less corresponded to the subsidiary's annual losses. The question was whether the Swedish company might deduct the "marketing contributions" as costs for its own business activities. The RR held that the relation between the enterprises (associated) was actually a necessary prerequisite for allowing the deductions. Only by contributing to an associated foreign enterprise could the costs be considered to be related to activities the contributor (the Swedish mother company) had a direct interest in. An important circumstance was the fact that the subsidiary had as its only mission to market and sell the mother company's products on the Norwegian market.

The case **RÅ 1994 ref 85 (Eka Nobel AB)** also dealt with a Swedish company's marketing contributions to, on one hand, a Finnish subsidiary (Ekaraisio) and to, on the other hand, an American subsidiary (ECI). Ekaraisio was half owned by the Swedish company and half owned by a Finnish company. Ekaraisio's main function was to market and sell products for its owner companies. During the taxation year in question the Swedish company had also refrained from invoicing the subsidiary for costs

⁷⁸ RSV:s arbets-PM från 1990 om Något om bevisreglerna vid tillämpningen av 43§ 1 mom KL, p1.

attributed to rent, leasing and royalty. The RR argued that because of the divided ownership it did not seem probable that the Swedish company would have any reasons to contribute to business activities not related to its own products. RR ruled the market contributions and the abstention of invoicing to be acceptable, and allowed corresponding deductions. As for ECI, the RR observed that the Swedish company itself had declared the American market introduction of its products to require considerable time. The construction of a local factory for local manufacture of the products had long been discussed within the company group and the plan was also carried out. The RR observed that it must have been evident to the Swedish company that income related to sale of products manufactured by the American factory would belong to the American unit owning the factory. With this background, the RR held that contributions for “management and consulting services” could not be viewed as costs related to the Swedish company’s business activities or activities it had a direct interest in.

The case **RÅ 1995 not 388** chiefly dealt with the same kind of transactions as in RÅ 1994 ref 85 and RÅ 1994 not 697, but with the principal difference that marketing contributions were transferred to sister companies instead of subsidiaries. The contributions were considered legal.

The case **RÅ 2002 ref 56** dealt with costs for research and development work conducted by the taxpayer on request from its foreign mother company. One of the outcomes of the case was that alternative methods for calculating the arm’s length range that have been approved by the OECD and been developed in the USA may be used.

The case **RÅ 2004 ref 13** dealt with deduction of costs for the taxpayer’s repurchase (phase 2) of a stock of assembly kit from the foreign mother company. The repurchase price was 13.5% higher than the previous price for sale, although the stock was untouched and all the time in the same warehouse. Furthermore, the same stock was later sold back once more to the mother company and the sales price was then 13.5% lower again. The repurchase (phase 2) had not been mentioned in the tax return. RR referred to the outcome of RÅ 1991 ref 107 and dismissed Skatteverket’s claim for additional assessment for arrears based on the statutory rules in 14:19 IL. The reason was that Skatteverket’s investigation was insufficient to prove that the arm’s length principle had not been followed.

The case **RÅ 2006 ref 37** dealt with deduction of costs for service fees to a service company belonging to the same company group as the taxpayer (the Swedish company). The service received included marketing, production, administration and personnel administration. Skatteverket did not question that services had been received by the taxpayer, but rather questioned to which extent the services had been received or been useful to the taxpayer. For clarification, Skatteverket required more specific documentation over services received. The taxpayer on the other hand claimed it to be impossible to give an account of every service received with regard to the large amount of services received. Instead the taxpayer (as well as the MNE

as a whole) used an indirect method for apportionment of costs. RR was of the following opinion: The MNE's aim of having a service company was to lower the overall costs for the services in the MNE as a whole. The taxpayer's employment and need for different services have varied over the years, but overall amount of services received is large. With regard to these facts the method for apportionment of costs used by the taxpayer was deemed acceptable.

6.5 Doctrine

Wiman asserted in 1987 that there were plenty of uncertainties related to the interpretation and application of the Swedish transfer pricing rules.⁷⁹ The same opinion was held by Pedersen in 1998.⁸⁰ Nine years later and after the introduction of the new documentation requirements and corresponding guidelines, some interested parties apart from the government and Skatteverket seem to expect the foreseeability to increase. Grive and Hammarstrand believe tax risk (for the taxpayer) will be minimised with adequate transfer pricing documentation, although the new documentation requirements will be somewhat burdensome for the taxpayer. They also believe that continuous non-compliance will result in new and stricter transfer pricing legislation.⁸¹ von Koch seems to welcome much more detailed rules from Skatteverket, although he readily points out that Skatteverket may already have overstepped its mandate.⁸² Lodin seems perfectly convinced Skatteverket has overstepped its mandate.⁸³

6.6 Concluding Remarks

The Swedish transfer pricing statutory rules are generally held and rather vague, and no detailed guidance is given in law on how to apply the arm's length principle. The preparatory works do not give much guidance either, but rather refer to the OECD Guidelines. Some issues, such as documentation requirements, have been further regulated by Skatteverket on mandate from the Government. The few court rulings over the years have served to clarify certain specific issues, but due to the complexity of transfer pricing many questions remain unsolved. However, the new rules on documentation requirements will probably increase foreseeability and clarify expectations, especially if Skatteverket continues to issue detailed regulations. The detailed rules will not in themselves clarify all conceivable situations, but the documentation requirements will most probably be followed by most taxpayers. And since documentation will require enlarged awareness as well as internal transfer pricing policies among the MNEs, the overall harmonisation and compliance will probably increase. Frequently updated SKVM-circulars from Skatteverket will also boost harmonisation

⁷⁹ Wiman, *Prissättning inom multinationella koncerner*, p 108.

⁸⁰ Pedersen, *Transfer Pricing – i international skatteretlig belysning*, p 152-155.

⁸¹ Grive, Hammarstrand, *Transfer Pricing Review 06/07*, p 96-98.

⁸² von Koch, *Balans No 5 2007*, p 39.

⁸³ Lodin, *Svensk Skattetidning No 5 2007*, p 318-319.

and compliance. One reason for this is that although Skatteverket's interpretations are challengeable many companies will probably prefer to follow the instructions and interpretations in order to avoid long-term trouble or a lawsuit. Especially since the taxpayers will know some of Skatteverket's position in advance (through the detailed rules), conflicts can actually be avoided more easily than before. With regard to the principle of legality, this may not be a satisfactory way of solving the uncertainty issue. As a matter of fact, supplementary sources of law that serve to remedy uncertainties due to too generally held statutory rules easily turn out to do more than just remedy uncertainties. After all, the difference between clarifying a rule or adding new rules and new obligations may not be that huge. With general statutory rules it is also impossible to tell when supplementary rules go outside of the framework provided by the statutory rules. On the other hand, until the documentation requirements were introduced virtually nothing was done from the legislator's side to remedy the uncertainties for decades. And as mentioned, the few court rulings were not always useful in solving all issues that may arise within the complex field of transfer pricing. As a supplementary source of law, the OECD Guidelines are held in high esteem by the legislator, Skatteverket and the Supreme Administrative court.

By introducing documentation requirements Sweden has chosen to follow a way of dealing with the vague arm's length principle that has already been adopted by most Western countries. Requiring all companies to prepare detailed documentation is indeed a burden, but will also serve to harmonise practices. The documentation scheme will probably prove most costly for small to middle-sized companies. Larger MNEs, on the other hand, have sometimes already initiated or completed transfer pricing policies and documentation within their foreign associated enterprises. The documentation requirements will also generate plenty of work for both the tax authorities as well as the auditing and tax firms.

The Swedish tax agency, Skatteverket, is an organisation with restricted resources. Over the years, Skatteverket has lost most of the principal cases brought to court. This trend may however change with the new documentation requirements and the supplementary rules, which may shift today's burden of proof back to the taxpayer – a result not intended by the government. As a consequence, the MNEs will probably demand change in legislation to allow APAs to safeguard their interests. The present possibility of advance rulings is clearly not sufficient to provide foreseeability for individual MNEs, and especially not in complicated matters as transfer pricing. As for today's burden of proof, it is undeniably much harder on the tax authorities. But this is only when a case has reached the courts. As a matter of fact, many companies do not wish to be involved in a lawsuit, and would even without documentation requirements rather choose to assist tax officials in far-reaching and time-consuming investigations, no matter how ill founded. The documentation requirements have provided Skatteverket with a powerful tool in the tax game. A tool, which may help Skatteverket play on more even ground with the larger

MNEs, but also enable Skatteverket to harm business in small- and middle-sized companies.

The sanctions connected to tax evasion are not light, but with a very low detection rate (especially with the heavy burden of proof on Skatteverket), some taxpayers have probably been induced to take “risks”. With the new documentation requirements the tax evasion detection rate will probably increase. With higher detection rates and penalty rates unchanged the probability of tax evasion should decrease. However, in a transitional period until the power of the new tool has been tested by involved parties we may see an increase in court rulings.

7 The Chinese Implementation

7.1 Introduction

*The more morals and taboos there are,
The more cruelty afflicts people;
The more guns and knives there are,
The more factions divide people;
The more arts and skills there are,
The more change obsoletes people;
The more laws and taxes there are,
The more theft corrupts people.*
--Laozi, DaoDeJing, 57th passage

Although many present laws in the People's Republic of China have in modern times been more or less "imported" from other jurisdictions, the legal history of China actually goes back at least 4000 years.⁸⁴ Throughout the many imperial dynasties, among others two schools of thoughts seem to alternately have had a dominant impact on Chinese legal development and legal discourse: the Legalist school and the Confucian school. The Legalist school stood for a society mainly governed by written law, while the Confucian school wanted to mainly rely on rites and morals to provide continuity and stability in society. Neither school however advocated that only written law or only moral codes would suffice. The issue was rather about how to balance the influence of written law and morals.⁸⁵

In the early 20th century Chinese legal development was very much influenced by German and Japanese laws, and a majority of legal scholars received their legal training in Japan, the US, the UK, or in Germany. After the Japanese occupation during the second world war and after the civil war had ended, today's People's Republic of China was founded in 1949. During the years that followed the Chinese judiciary was largely influenced by Soviet models. However, Mao Zedong's theory of contradictions gained more and more ground, leading ultimately to the abolishment of the Ministry of Justice in 1959. One of the subsequent larger political movements, the Cultural Revolution of 1966-1976, left China without any laws, legal institutions, legal scholars, lawyers, judges or legal education. After those turbulent years the judicial system had to be more or less rebuilt from scratch.⁸⁶

In 1978 the Chinese government launched the market economy reform program. The economic reforms have raised the requirements on the fiscal system. China's first income tax law was enacted in 1980, and the first

⁸⁴ Grimheden, Assessing Judicial Independence in the People's Republic of China under International Human Rights Law, p 119.

⁸⁵ Grimheden, p124-129.

⁸⁶ Grimheden, p 155-156, 167, 171-175.

transfer pricing rules appeared in 1991.⁸⁷ The rapid socio-economic changes have, among other things, led to increasing tax-competition between provinces and provincial unwillingness to surrender power to the central government. Combating local protectionism is seen by many commentators to be essential in developing judicial independence. Corruption is seen as another main problem intimately related to judicial independence. But although “rule of law” is recognised as necessary in counteracting corruption, it largely remains a concept of rhetoric.^{88 89}

In modern time comparisons made by several practitioners with knowledge of both Western and Chinese law or philosophy one oppositional relation keeps being mentioned: absolutism contra pliability/flexibility. Some choose to see the absolutism contra pliability/flexibility feature as a result of monotheistic traditions in Western countries and polytheistic traditions in China. A polytheistic tradition means less absolute values and a more flexible approach to all kinds of issues, including legal issues. This certainly would add to the legal uncertainty. Religion is however only one factor among several for explaining the different concepts of law and justice in China and Europe. Many commentators say legal uncertainty is intentional from the government’s point of view in order to preserve leeway in case of political need and in order to retain a tool for political control.⁹⁰

Wang discusses the “dilemma of administrative enforcement” out of a Chinese perspective. The dilemma is generally described as when legal rules declared by the government are met with ignorance, evasion, or even rejection in practice due to behavioural strategies of the enforcers or the individual stakeholders (or a combination of both). This dilemma is considered vast in today’s China. Wang does not think this is very surprising, considering the rapid socio-economic changes at hand, which necessarily lead to diversification of values and a widening gap between legal expressions and legal practices. The fundamental problem is, according to Wang, the disaccord between real demands of the civil society and the government’s standpoint and legal rules. By sticking to intermittent and selective enforcement methods the government fails to address the dilemma in a long-term perspective. Thus, aberrant behaviour is not discouraged, and instead all participants continue to seek to fulfil their individual demands.⁹¹

⁸⁷ Liu, *ZhuanRangDingJia*, p 167-168.

⁸⁸ Grimheden, p 247, 238, 186-187, 256.

⁸⁹ Opinions shared by a number of judges and tax law practitioners interviewed by the author.

⁹⁰ Collected opinions from discussions with Chinese and foreign lawyers, judges and scholars.

⁹¹ Wang, *Understanding the cases of dilemma of administrative enforcement in China*, p 464-466, 486-489,

7.2 The Legislative System

7.2.1 The Constitution

The constitution of the People's Republic of China (the Constitution) forms the base for all laws and division of power in China. Article 5 in the Constitution states the Constitution's character as overall precedent legislation with the following words: "*No laws or administrative or local regulations may contravene the Constitution*". In the same article a Chinese variation of the principle of equality is also laid down: "*No organization or individual is privileged to be beyond the Constitution or other laws.*"

An interesting overall feature of the Constitution is that it often states what the State IS doing, instead of using the wording "shall". For example in article 24 we find that: "*The State (...) conducts education among the people (...) in internationalism and communism and in dialectical and historical materialism, to combat capitalist, feudal and other decadent ideas.*" And from article 27 we see that: "*All State organs carry out the principle of simple and efficient administration (...)*". Despite the use of the present participle the articles are clearly meant to state aims and desired conducts. In the end of article 27 we see a principle that is often used by Chinese officials: the principle of always doing the best to serve the people, "为人民服务".

7.2.2 Legal System and Division of Power

According to article 57 of the Constitution the National People's Congress of the People's Republic of China (the Congress) is the supreme organ of state power. The Congress meets in session once a year and has a smaller permanent body, the Standing Committee of the National People's Congress (the Standing Committee), to carry out functions and powers that need attention during the whole year (articles 57-69). The legislative power of China is exercised jointly by the Congress and its Standing Committee (article 58). The power to make amendments to the Constitution is however reserved for the Congress alone (article 62.1). As for other laws, these are normally enacted and amended by the Standing Committee if it is not stated explicitly in law that they should be enacted by the Congress (article 67.2). The laws that should be enacted and amended by the Congress are "*basic laws governing criminal offences, civil affairs, the State organs and other matters*" (article 62.3).

The Standing Committee has as one of its functions to supervise the work of the State Council and the Supreme People's Court (article 67.6). Worth mentioning is that, according to the Constitution, the Standing Committee also has the expressed function and power to interpret laws (article 67.4), while the Supreme People's Court is merely the highest judicial organ and is responsible for its actions to the Congress and its Standing Committee (article 127-128).

The State Council is the executive body of the supreme organ of state power as well as the supreme organ of State administration (article 85). The State Council is composed of the Premier and Vice-Premier as well as Ministers in charge (article 86). I may be convenient to refer to the State Council as the governmental body. One of the State Council's many tasks is to adopt administrative measures and enact administrative regulations (article 89.1). Another function is to formulate tasks and responsibilities of the ministries and commissions (article 89.3).

The ministries and commissions in their turn are divided into different departments and may issue orders, directives and regulations within the jurisdiction of their respective department (article 90).

The hierarchic structure with a congress and government is duplicated on the local levels, i.e. in the provinces, municipalities directly under the Central Government, counties, cities, municipal districts, townships, nationality townships and towns (article 95). Congresses at or above the county level also establish local standing committees (article 96). On the provincial level the congresses and standing committees may adopt local regulations, which must not contravene the Constitution or other laws or administrative regulations (article 100). As on the central level, the work in the local courts is supervised by the local standing committees (article 104).

The Chinese Government has divided Chinese laws into seven types: Constitution and Constitution-related laws, civil and commercial law, administrative law, economic law, social law, criminal law, and the law on lawsuit and non-lawsuit procedures.⁹²

7.2.3 Tax Administration System and Tax Laws

Tax laws are sorted into the category economic law and are enacted by the Congress, while administrative regulations on taxation are issued by the State Council. Directly under the State Council several governmental organs are dealing with fiscal issues: the Ministry of Finance, the State Administration of Taxation (SAT), the State General Administration of Customs, and the Tariff/Tax Regulation Committee. These organs may within their mandates issue detailed rules for implementation of the administrative regulations on taxation.

The mandates of the Ministry of Finance among other things includes formulating and implementing strategies, policies and guidelines, medium-and-long-term development plan and reform programs of public finance and taxation; formulating and implementing policies regarding income distribution between the central and local governments and between the state and enterprises; laying down and implementing regulations and rules

⁹² Webpage of the National People's Congress of the PRC:
<http://www.npc.gov.cn/zgrdw/English/aboutCongress/aboutCongressDetail.jsp?id=Legal>,
as viewed on 2007-07-29.

on fiscal management; proposing tax legislation plans; reviewing proposals on tax legislation and tax collection regulations with the SAT before reporting to the State Council; proposing tax rates; formulating model tax agreements and conventions; monitoring the implementation of fiscal and tax laws and regulations; organizing fiscal training and promoting fiscal information dissemination.⁹³

The SAT is a ministry-level department and the highest tax authority in China. Its mandates include among others to formulate detailed implementation rules for tax laws and regulations; supervise the implementation of tax laws, regulations and policies; organize collection and administration for central taxes, shared taxes and contributions to state-designated funds; provide interpretation for issues concerning tax collection and administration and general tax policy issues arising from the implementation of tax laws and regulations; implement agreements on avoidance of double taxation; be responsible for administration of human resources, salary, size and expenditure of SAT local offices; appoint and supervise the work of SAT offices on the provincial level.⁹⁴

Tax organisations at and below the provincial levels are divided into state tax bureaus and local tax bureaus. Thus, under the SAT there are provincial state tax bureaus and provincial local tax bureaus, municipal state tax bureaus and municipal local tax bureaus, and county state tax bureaus and county local tax bureaus. The central SAT exerts authority over the SAT local offices. Together with the provincial governments the central SAT guides the work of the provincial local tax bureaus.⁹⁵

State tax bureaus and local tax bureaus are established separately because of the sharing of tax revenues between the central government and the local governments. Taxes are divided into central government taxes, local government taxes, and taxes shared between the central government and the local governments. Thus, customs duties and import-related VAT belong to central tax revenues, while profits from local enterprises belong to local revenues. However, some revenues are shared despite their origin: 75% of domestic VAT revenues go to the central government as well as 60% of income tax revenues. Part of the central government's tax revenue is redistributed to local governments based on the growth in local government VAT and consumption tax. Part of the central government's tax revenue is also redistributed to less developed regions.⁹⁶

⁹³ Webpage of the Ministry of Finance of the PRC: <http://www.mof.gov.cn/english/english.htm>, as viewed on 2007-07-30.

⁹⁴ Webpage of the Government (State Council) of the PRC: http://english.gov.cn//2005-10/09/content_75307.htm, as viewed on 2007-07-30.

⁹⁵ PricewaterhouseCoopers, Transfer Pricing in China, p 5-6.

⁹⁶ Webpage of Ministry of Finance of PRC: <http://www.mof.gov.cn/english/english.htm>, as viewed on 2007-07-30.

7.3 Transfer Pricing in China

On March 16th 2007 the Congress enacted a new Corporate Income Tax Law (CIT), which will take effect from January 1st 2008. In contrast to the present legislation the new one will be applicable to Chinese enterprises, foreign investment enterprises (FIEs), and foreign enterprises doing business in China. With regard to transfer pricing the new legislation brings about several changes.

Up to August 2006 579,000 FIEs have been established in China under the old (present) rules.⁹⁷ For this reason, the below description of statutory rules is chiefly based on laws and regulations in force up to December 31st 2007.

7.3.1 Laws and Regulations

Enterprises and legal entities are subject to both national and local income taxes. At present two corporate income tax laws exist, one applies to Chinese enterprises and one applies to FIEs and foreign enterprises doing business in China. The former law is the Domestic Enterprise Income Tax Law and the latter is the Income Tax Law of the People's Republic of China Applicable to Foreign Investment Enterprises and Foreign Enterprises (FIE Tax Law, 1991). Both laws contain an identical provision concerning transfer pricing. Thus, article 13 of the FIE Tax Law states that:

The payment or receipt of charges or fees in business transactions between an enterprise with foreign investment, or an establishment or place set up in China by a foreign enterprise to engage in production or business operations, and its associated enterprises shall be made in the same manner as the payment or receipt of charges of fees in business transactions between independent enterprises. Where the payment or receipt of charges or fees is not made in the same manner as in business transactions between independent enterprises and this results in a reduction of taxable income, the tax authorities shall have the right to make reasonable adjustments.

The article above is the only rule concerning transfer pricing in tax law enacted by the Congress. Relevant definitions are instead found in articles 52-58 of the Rules for Implementation of the Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises (FIE Tax Rules) issued by the State Council. According to article 52 the term "associated enterprises" relates to economic units having one of the following relationships:

1. Relationships with respect to existing direct or indirect ownership of or control over such matters as finances, business operations or purchases and sales;
2. Direct or indirect ownership of or control over it and another by a third party;

⁹⁷ Webpage of newsgd: <http://www.newsgd.com/business/laws/200612250018.htm>, as viewed on 2007-08-26.

3. *Any other relationship with respect to an association of reciprocal interests.*

To be lawful, transactions between associated enterprises must conform to business transactions carried out between unrelated enterprises on the basis of arm's length prices and common business practices (article 53 FIE Tax Rules). Enterprises have a duty to provide the local tax authorities with relevant materials on their dealings with associated enterprises (article 53 FIE Tax Rules). If the deals are deemed not to be based on dealings between unrelated enterprises the local tax authority may make tax adjustments (article 54 FIE Tax Rules).

In Guoshuifa [1998] No 59 (Transfer Pricing Circular) and Guoshuifa [2004] No 143 (Amendments to the Transfer Pricing Circular) the SAT has further specified rules on transfer pricing. Article 4 of the Transfer Pricing Circular gives a more detailed definition of "associated enterprises". Thus, if an enterprise (the Enterprise) fulfils one of eight relationships with another enterprise (the Other Enterprise) they are considered to be associated, namely if:

1. *the Other Enterprise directly or indirectly owns 25% or more of the shares of the Enterprise or vice versa;*
2. *a third party directly owns or controls at least 25% of the shares of both the Enterprise and the Other Enterprise;*
3. *debt between the Enterprise and the Other Enterprise accounts for 50% of its total capital, or 10% of an enterprise's debt is guaranteed by another enterprise;*
4. *more than half the directors, or high level management of the Enterprise such as managers, or one executive director, are/is appointed by the Other Enterprise;*
5. *the Enterprise's business operations depend on the Other Enterprise's proprietary technology;*
6. *the Other Enterprise controls the Enterprise's supply of raw materials and spare parts (including prices and transaction conditions);*
7. *the Other Enterprise controls the Enterprise's sales of products (including prices and transaction conditions); or*
8. *any other relationship that effectively controls the Enterprise's business operations and trades, including family and relatives.*

If an enterprise is related to another enterprise a special tax return must be filed within four months after the year's end (article 5 Transfer Pricing Circular). A separate return must be filed for each related party. Based on the return the tax bureau in charge will analyse the nature of the transactions made (article 8 Transfer Pricing Circular). Within two months after receiving the return the tax bureau in charge will determine whether the enterprise's business operations have been normal (article 11 Transfer Pricing Circular). The following circumstances are used for selecting audit targets among enterprises that have filed the special tax return (article 12 Transfer Pricing Circular):

1. *the enterprise is controlled by related parties in respect of management decisions for business operations;*
2. *the enterprise has significant amounts of transactions with related parties;*
3. *the enterprise has had consecutive losses (for more than two years);*
4. *the enterprise has increased its scales of operations continuously despite the fact that it has had small profits or small losses for a long time;*
5. *the enterprise has had a fluctuating pattern of profits and losses;*
6. *the enterprise has had business dealings with related parties in tax havens;*
7. *the enterprise's profit level is lower than that of other enterprises in the same industry (comparison is made against profit level obtained by similar enterprises in the same region);*
8. *the enterprise's profit margin is lower than that of other enterprises within the same group of enterprises;*
9. *the enterprise has paid various unreasonable expenses to related parties using various schemes; or*
10. *the enterprise had avoided taxes by suddenly reducing profits immediately after the expiration of tax holidays, or other tax evasion schemes.*

No less than 30% of the selected audit targets are to undergo actual investigations, and specialized audit teams carry out the examinations (articles 13-14 Transfer Pricing Circular). Before an audit the tax bureau in charge may request lots of documents from the enterprise being audited, including investment or business contracts, licenses, and feasibility studies (article 16 Transfer Pricing Circular). During the audit an enterprise may within 60 days have to provide detailed documentation regarding the types, contents, scopes, lengths, quantities and amounts of the related party transactions. As for providing the required information “the enterprise cannot refuse and cannot hide” (article 15 Transfer Pricing Circular). Generally, it will probably be in an enterprise's interest to provide information, since any decisions regarding potential adjustments will depend primarily on the information submitted by the enterprise (article 23 Transfer Pricing Circular).

Article 24 Transfer Pricing Circular puts a heavy burden on the enterprise being audited by requiring it to provide the following information to support the normality and reasonableness of its related party transactions:

1. *Purchases and sales of tangible assets – information about the extent of the reputation and popularity of the products traded between related parties, the function of each related party and its market position, seasonal fluctuations in sale prices, the extent of influence on the product by an intangible asset, the degree of quality, functions and pricing methods;*
2. *Transfers and uses of intangible assets – information about intangible assets and their transfer conditions (including geographic region and scope of rights etc), their degrees of market dominion and duration period; value of labour such as technical services and*

training provided by the transferor; the maintenance costs for the value of trade marks (including costs for advertising and quality control); costs reduced or profits predicted to arise from the use or transfer of such intangible assets, and price components and payment methods;

3. *Provision of labour – information about whether labour services provided by related parties benefit the enterprise, whether the standard of labour costs is reasonable and the level of profit and direct and indirect costs is reasonable; and*
4. *Financing – information about regular financing interest rates, the reasonableness of various financing costs.*

If the related enterprises are found not to be conducting transactions in a normal and lawful way, the tax bureau will form an initial adjustment plan and select appropriate adjustment methods (article 33 Transfer Pricing Circular). The opinion of the enterprise concerned shall be obtained either through written correspondence or through a meeting. If the enterprise disagrees with the tax bureau, it may submit evidence supporting its opinion. The tax bureau will review the evidence and make a decision within 30 days (article 35 Transfer Pricing Circular). If the enterprise disagrees with the decision on transfer pricing adjustments, it may appeal to the tax bureau at a higher level after it has paid any taxes due. If the enterprise disagrees with the decision of the tax bureau at the higher level, it may appeal to the People's court within 15 days after receiving the notice of the judgment (article 40 Transfer Pricing Circular). However, article 51 Transfer Pricing Circular states that "The State Administration of Taxation will be responsible for the interpretation of this Regulation."

APA:s were formally in 1998, but due to emergence of local variations among the different local tax authorities more detailed rules had to be released. Thus, further clarifying rules were issued by the SAT in Guoshuifa [2004] No. 118 and Guoshuifan [2005] No. 1172. Since 1998 over 180 unilateral and 4 bilateral APA:s have been concluded.⁹⁸

Further transfer pricing provisions are found in the Implementation Rules of Tax Collection and Administration Law, which deals with the implication transfer pricing adjustments may have for other taxes apart from income tax (for example for value-added tax).

7.3.2 Penalty System

Article 201 (and 211) of the Criminal Law of PRC deals specifically with income tax evasion. Tax evasion is at hand when taxpayers are "... *found guilty of forging, altering, concealing, or indiscriminately destroying accounts books, entry proofs, or making unsubstantiated expenditures, or failing to enter or enter lower income items, or failing to submit tax returns*

⁹⁸ PricewaterhouseCoopers, Transfer Pricing in China, p 7.

after being notified by the tax authorities, or submitting a false return, or failing to pay taxes or pay less, or evading taxes...” (article 201)

Both the legal entity and the responsible persons in charge or those directly at fault may be punished under the article. There are two different penalty levels depending on the amount of tax evaded.

If the amount of income taxes evaded accounts for more than 10% (without exceeding 30%) of the total amount of taxes due and exceeds 10,000 RMB (without exceeding 100,000 RMB), or if the legal entity has attempted to evade taxes despite having twice before been subject to administrative penalties due to tax evasion, the legal entity shall be fined between 1 to 5 times the amount of taxes evaded. Furthermore, the responsible persons in charge or those directly at fault shall be sentenced to fixed-term imprisonment of not more than three years or criminal detention (article 201, 211).

If the amount of income taxes evaded accounts for more than 30% of the total amounts of taxes due, or the amount exceeds more than 100,000 RMB, the legal entity shall be fined between 1 to 5 times the amount of taxes evaded. Furthermore, the responsible persons in charge or those directly at fault shall be sentenced to between three to seven years fixed-term imprisonment (article 201, 211).

7.3.3 The New Corporate Income Tax Law

The new Corporate Income Tax Law (CIT) consists of 8 chapters with altogether 60 articles, all contained within ten pages in the English translation. As an official preparatory work one may count the 10 pages Explanation on the Draft Enterprise Income Tax Law of the PRC (Explanation), signed by the Minister of Finance. In the Explanation transfer pricing is merely mentioned as a means of achieving tax avoidance for some enterprises.⁹⁹ One significant change is that the CIT transfer pricing rules will apply to both domestic companies and FIEs. The tax bureaux are given a broad authority to reallocate income with the new rules (article 41). For compensation, APA applications seem to be encouraged (article 42). Annual related-party transaction reports must henceforth be filed together with the tax return (article 43). Also, a general anti-tax avoidance clause has been included, which enables the tax bureaux to adjust the income of any enterprise that has undertaken business transactions without a reasonable business purpose (article 47).

⁹⁹ Explanation on the Draft Enterprise Income Tax Law of the PRC 2007, p 9.

7.4 Practical Reality

7.4.1 Selection for An Audit

According to PricewaterhouseCoopers in China, the tax authorities that are most frequently conducting transfer pricing audits are located in Beijing and costal regions and cities such as Dalian, Fujian Province, Guangdong Province, Jiangsu Province, Shandong Province, Shanghai, Shenzhen and Tianjin. Also, despite the formal criteria for selecting audit targets set out in Guoshuifa [1998] No. 59, some factors are more likely to trigger an audit than others. These triggering factors include if a FIE is losing money, expanding its operations and has a significant number of inter-company transactions, or pays significant royalties and service fees to overseas companies. Furthermore, FIEs in industries such as office automation, garment and shoe manufacturing, automobile, consumer electronics, white goods and chemicals, are more likely to be selected for an audit.¹⁰⁰ Also according to PricewaterhouseCoopers, the Chinese tax authorities supplement information on comparables from the open databases with tax return information filed by other countries. Such tax return information is not publicly available.¹⁰¹

7.4.2 Case Law

In China, tax cases are very rarely taken to court. As for cases concerning transfer pricing they do not exist. Furthermore, there have been no reported Chinese court decisions that contradict an SAT administrative ruling.¹⁰²

One tax manager working at one of the four major international auditing and tax firms claims she was in charge of the only transfer pricing adjustment case that almost reached the Chinese People's court. The enterprise, supported by lots of strong evidence, claimed its transactions with related parties had indeed been at arm's length. The tax firm helped its client to discuss the provided information with tax officials from the local level up to the highest level (the SAT). These negotiations took place during the SARS epidemic in 2003, during which the different deadlines were postponed, giving the enterprise more time to procure more evidence. According to the tax manager, the local tax bureau had based its adjustment decision on very shallow grounds and used a somewhat airy conduct in its dealings with the enterprise, which had induced the enterprise's managers to pursue their case no matter what the costs, treating the case as matter of principle. The adjustment itself only accounted for a few millions RMB, which was a negligible sum. The costs for pursuing the case actually amounted to much more. But despite pressure from above officials the local

¹⁰⁰ PricewaterhouseCoopers, Transfer Pricing in China, p 6.

¹⁰¹ PricewaterhouseCoopers, International Transfer Pricing 2006, p 6.

¹⁰² This is according to interviews with tax lawyers from two of the big four international auditing firms, interviews with one person from SAT and with one teacher. Furthermore, I have not found any reference to such a case in either Chinese or foreign literature.

tax bureau in charge was very reluctant to yield and finally did so only when less than 24 hours remained before the deadline for handing in the application for appeal to the People's court. So the story ended with the local tax bureau withdrawing its decision on a transfer pricing adjustment, while receiving a black mark from the SAT. According to the tax manager, an appeal to the People's court would have damaged the reputation of the enterprise as much as the reputation of the local tax bureau. Taking such an evident tax case to court would furthermore have implied the tax authority's incompetence and caused the whole SAT to lose face, which would have affected the enterprise's future dealings with all governmental bodies. The tax manager was convinced the news about the appeal would have leaked to most Chinese newspaper within hours, making all details of the case more or less public.

7.4.3 Other Experiences

From discussions with a tax manager from another international tax firm the following experiences and thoughts were collected: It is more difficult for taxpayers to plan their transfer pricing activities in China compared to most Western jurisdictions. The laws are in part drafted to be unclear, thereby rendering the authorities "control by uncertainty". As stated in law you should ask the SAT if you think the laws and regulations are unclear. A tendency has been that initially laws and regulations have been unclear on purpose. When needed, more detailed amendments or regulations have been enacted. As for inconsistent interpretations of laws, experience from clients (enterprises) in different provinces and discussion with different local tax bureaus about the same provisions have indicated that different SAT divisions indeed have different interpretations. Harmonisation of implementation and interpretation of laws between provinces is however not a pronounced goal from the authorities, but since the SAT wants to control the quality of work within the tax bureaus a central approval system has been introduced. This system has resulted in more consistent interpretations in different provinces and thereby constitutes some kind of harmonisation effort.

According to one of the tax managers at a big international auditing firm there is a bonus system for officials at the tax bureaus, which awards officials after performance. Meeting budget means good performance. However, surpassing budget may not necessarily be a good thing, since central authorities will raise budget goals for coming years. A Swedish MNE with factories in Foshan province reported that this is the reason the local tax authorities in Foshan has on occasions asked the company to "postpone" incomes for certain years.¹⁰³ Chinese law practitioners even assert that local tax officials may deem a Chinese company to have certain income (and thereby decide the amount of taxes due) even before receiving the tax return.¹⁰⁴

¹⁰³ Interviews with the financial manager at a Swedish MNE in China.

¹⁰⁴ The information is based on discussion with Chinese law practitioners.

Although the legal uncertainty is used as power leverage by authorities this does not mean there is nothing to do for taxpayers. According to practitioners thorough preparations help the negotiations considerably. It appears, the taxable income as well as the correct transfer pricing are issues of negotiation. If your arguments are well prepared and supported you may succeed in lowering the tax authorities higher bid, hopefully even lowering it to a reasonable level. The uncertainty related to transfer pricing issues has induced some of the larger MNEs to form informal lobbying groups, which meet to compare experiences and write petitions and complaint letters to the government.¹⁰⁵

According to PricewaterhouseCoopers, the Chinese tax authorities more or less support the same type of economic methods described in the OECD Guidelines and used in OECD countries. However, this does not mean that a transfer pricing policy accepted in an OECD country will be accepted in China.¹⁰⁶

Lastly, a few words will be said about Chinese views on compliance. According to several Chinese law practitioners evening classes on successful tax evasion for Chinese business managers are very common in some provinces (Guangdong and Shanghai were mentioned). Compliance with tax laws are not seen as a duty, since many Chinese do not feel they receive anything substantial in return from the state for paying taxes.¹⁰⁷

7.5 Doctrine

The Chinese tax law scholar Liu Yongwei, specialized in transfer pricing issues, severely criticizes the behaviour of FIEs in China. Liu holds FIEs responsible for harming the state's fiscal interests through transfer pricing schemes. Furthermore, the behaviour of FIEs have destroyed the implementation of the principle of fair distribution of tax revenues (between countries) as well as destroyed the principle of fair tax burden between different taxpayers. Lastly, FIEs have destroyed the economical environment of China.¹⁰⁸ Liu admits there are several uncertainties in today's income tax law with regard to transfer pricing, but her main criticism of the present rules seems to be that the rules are not harsh enough. Liu holds the American transfer pricing rules in high esteem. She points out that the burden of proof as well as other requirements are harder on the taxpayer in the USA, and still the USA is the largest recipient of foreign direct investment. Liu's main view seems to be that the Chinese transfer pricing rules need to be much stricter.¹⁰⁹

¹⁰⁵ The information is based on interviews with practitioners.

¹⁰⁶ PricewaterhouseCoopers, International Transfer Pricing 2006, p 293.

¹⁰⁷ The views are based on discussions with Chinese law practitioners.

¹⁰⁸ Liu YongWei, ZhuanRangDingJia, p 168.

¹⁰⁹ Liu YongWei, p 183-187, 194-196.

Another tax law scholar, Liu JianWen, also chooses to describe transfer pricing mainly as a means for FIEs to evade Chinese taxes. The many successful tax evasion schemes are suggested to be a result of among other things the lack of legal harmonisation in China.¹¹⁰

7.6 Concluding Remarks

The Chinese Constitution is a document full of contradictions. According to the Constitution, capitalist ideas are decadent and need to be combated. Why this is so while the country's leaders have supported the development of a so-called socialist market economy since 1978 may seem a bit inconsistent. According to the Constitution, all State organs carry out simple and efficient administration as well as do their best to serve the people. This is also clearly recognized as empty phrases by anyone who has visited China and has somehow encountered the bureaucratic system. It appears, reading and understanding the Constitution is a matter of knowing how to distinguish between empty words and valid words. Still, reading the Constitution gives an overview of how the legislative power is distributed. Although the Congress shares legislative power with the Standing Committee, the Standing Committee seems to be the driving force. Furthermore, the Standing Committee and not the Supreme Court has the expressed function and power to interpret laws. Furthermore, since some persons in the Standing Committee appear in the State Council as well, one may assume that these people are more important than others. The SAT reports directly to the State Council (which is also stressed on SAT's webpage), which suggests that SAT is probably on an even level with the Ministry of Finance. Since the areas of responsibility for the SAT and the Ministry of Finance many times overlap, one may wonder how conflicts of interests are solved. Clearly, not only the enactment but also the interpretation and implementation of laws are very political processes in China.

The transfer pricing rule in the FIE Tax Law is very general and impossible to apply without consulting more detailed rules. Detailed rules are plentiful in the circulars issued by the SAT. These rules are clearly used as law, although not enacted by the Congress or the Standing Committee. However, the detailed rules are many times far from a remedy for uncertain and vague tax law rules. For instance, China's definition of associated enterprises is very broad, although both the State Council and the SAT have issued detailed supplementary rules. Many foreign companies will probably find that they have associated enterprises, although this may not be so according to corresponding rules in other countries. Furthermore, essentially any associated enterprise may be selected for audit. And how a tax bureau determines whether an enterprise's business operations have been normal seems rather ambiguous. One thing is clear though: discussions and negotiations about what is to be considered as normal business operations should probably be conducted **before** the tax return is filed. All discussions

¹¹⁰ Liu JianWen, Introduction to Enterprise Income Tax Law of PRC, p 437, 459.

afterwards will probably prove to be laborious and probably also costly. When tax law is uncertain for taxpayers one may assume it is unclear for tax officials as well. However, without real possibilities to challenge the tax authorities in court, a taxpayer will get the worst of uncertain tax laws - especially when the burden of proof is on the taxpayer. The fact that over 180 unilateral APAs have been concluded since 1998 shows the taxpayers' need of clarifications and long-term assurances.

China is an active non-member observer in the OECD working groups, but in domestic law no official references are made to the OECD Guidelines. And although the rules in part resemble the recommendations in the Guidelines, this does not necessarily mean practices are similar to the intended practices suggested in the Guidelines.

The construction of the Chinese tax organisation system as well political system makes it necessary to add a few interested parties to the parties involved in transfer pricing issues that were listed in the Introduction-chapter (see page 4), namely:

- the province from which untaxed profits are transferred out;
- the province to which too high profits are allocated;
- the concerned state tax bureaus in both provinces;
- the concerned local tax bureaus in both provinces;
- the local Chinese tax official;
- the local leaders of the PRC.

Unfortunately, this thesis does not allow for a deep study of the incentives and restraints of all interested parties. However, a few points will be made.

From the information gathered one may conclude that there exists a tax competition between provinces. This tax competition can probably be fierce, since lots of revenue is at stake. And not only are the provinces competing about revenue, but also about MNE-related benefits such as job opportunities and central investments in infrastructure and education.

Another point is that laws are not well harmonised in China. Considering the difficulties the European Union has in harmonising legislation on VAT one may conclude that similar, but worse, difficulties apply for China. Lack of harmonisation owes to many factors. For one thing tax rules are written in very broad and general terms, which allows for many interpretations. No court rulings exist. Many times the local tax official relies on himself to interpret the law. In important cases the tax officials will probably be guided by their leaders at the tax bureau as well as their leaders from the local government. In both simple and complicated transfer pricing issues the local bureaus may also lack necessary expertise.

One conflict of interests worth mentioning is the one between state tax bureaus and local tax bureaus reflecting the power struggle between the central government and the local governments. Local governments want to keep as much as possible of collected revenues for activities locally.

On the individual level we have the tax officials. With low incomes for state officials as well as local leaders even the most law-abiding officials will need to exert their power in unintended ways in order to provide for their families. To which extent this power is exerted is up to everybody's conscience and various control mechanisms (whether formal or informal).

Lastly, a few words will be said about the taxpayers, the MNEs. Although some MNEs probably suffer from the uncertain rules and system, this does not mean that all FIEs suffer. From the information gathered it is hard to say whether the detection rate is high or low in general, and it also probably varies between provinces. If the unusually high penalty rate (100-500% of the amount of taxes evaded) has prevented the probability of tax evasion is therefore hard to tell. The wording used by Chinese scholars seems to suggest that all FIEs are bandits and the detection rate close to zero. On the other hand, the picture from practitioners at international auditing and tax law firms instead implies over-zealous and uneducated tax bureaus and local governments that make use of uncertain tax laws for local or personal gains. In any case, the many business opportunities and the race for gaining market shares may have induced many FIEs to take greater risks in China than they would have done in Western countries. Worth noting is however that the tax gap (in relation to GDP) claimed by the Chinese authorities is less than the one estimated for the USA (see page 10). This seems to suggest that the estimated 30 billion RMB figure is on the small side.

With regard to China's short modern legal history and the fact that most laws are more or less imported the progress that has taken place is quite admirable. The country is huge, and taking into account the vast difference in degree of development, traditions and economical resources between provinces it is not strange that tax law (and other laws) are not harmonised. On the contrary, it is admirable that they are not more divergent in their practice and interpretation than they are. Also, consistency in interpretation is sometimes in contrast to flexibility, and however repulsive for Western legal scholars political flexibility might actually be necessary for a large country in rapid development and with less than 30 years modern legal history. For economical growth reasons China has until now persisted in having a separate income tax law for FIE, a system clearly violating the non-discrimination and equality rules in the OECD Model Convention. Thus the burden of taxation has been lower for FIEs, while at the same time only FIEs seem to have received the tax authorities attention with regard to transfer pricing schemes. Without any proof, but relying on the consequences of Wang's dilemma of administrative enforcement and personal observations, the author believes that taxes evaded by domestic enterprises may be of a considerable amount (perhaps even accounting for amounts comparable to the tax gap figure claimed to be attributable to actions of FIEs). After all, in today's China non-compliance is a very widespread problem, and when normal people (or people running legal entities) are offered no substantial support or protection from the state they will instead try to optimize their preferences by other means.

8 American Implementation

8.1 Introduction

In America, in 1913, an income tax law was passed and the rich have been devising tax dodging rackets ever since.

--Elliot Paul

[A] society which turns so many of its best and brightest into tax lawyers may be doing something wrong.

--Hoffman F. Fuller

The United States of America is a federal union, and taxes are imposed by both the federal government and state governments (and in some cases by municipalities). Federal power of taxation needs constitutional foundation. In 1913 the 16th amendment to the Constitution was made, thereby authorizing the Congress to enact an income tax law. Title 26 of the United States Code, the Internal Revenue Code (IRC), is the American tax law issued by the American Congress. The Department of Treasury is in charge of administration and enforcement of title 26 (section 7801 IRC). The Internal Revenue Service (IRS) is an agency under the Department of Treasury with the proclaimed mission statement *"to help the large majority of compliant taxpayers with the tax law, while ensuring that the minority who are unwilling to comply pay their fair share"*. The IRS boasts about being one of the world's most efficient tax administrators with low expenditures per collected dollar.¹¹¹ With regard to transfer pricing audits, the IRS has extensive resources available and audits are far from only limited to cases where avoidance is suspected. According to PricewaterhouseCoopers, MNEs should see audits as a rule rather than exception.¹¹²

8.2 Transfer Pricing in the USA

The predecessor to today's American transfer pricing rules dates back as far as to 1917. Over the years the rules have undergone several changes. In 1979 the legislation then in force highly influenced the OECD documents, which in turn influenced the development of transfer pricing in most other Western countries. The American rules have, however, changed and developed in their own direction after 1979.¹¹³

¹¹¹ IRS webpage: <http://www.irs.gov/irs/article/0,,id=98141,00.html>, as viewed on 2007-09-16.

¹¹² PricewaterhouseCoopers, International Transfer Pricing 2006, p 118.

¹¹³ Pedersen, Transfer Pricing – i international skatteretlig belysning, p 91.

8.2.1 Laws and Regulations

In the United States we have observed that there are two Internal Revenue Codes -- one for Wall Street and one for Main Street. Wall Street can afford and often needs the services of sophisticated tax lawyers. Main Street often can't and doesn't.
-- Sheldon I. Banoff

The arm's length principle is regulated in section 482 of the United States Internal Revenue Code (IRC), which provides as follows:

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of Sec. 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

No further provisions on transfer pricing is provided in law enacted by the Congress.

A detailed “official interpretation” of several terms and an account of how to apply IRC section 482 are set out in the IRS’s Treasury regulations §1.482, which comprises 134 pages. The regulations are very complex and also include hypothetical examples. Only some extracts are described below.

First of all, it is worth noting that the IRS asserts there is a “true taxable income” and that the approximate nature of an arm's length result owes to lack of identical transactions:

In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer. A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result).

However, because identical transactions can rarely be located, whether a transaction produces an arm's length result generally will be determined by reference to the results of comparable transactions under comparable circumstances (§ 1.482-1.b).

The term “controlled taxpayer” in IRC Sec. 482 is further defined as follows:

Controlled includes any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised, including control resulting from the actions of two or more taxpayers acting in concert of with a common goal or purpose. It is the reality of the control that is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted. (§ 1.482-1(i)(4))

Arm's length ranges are acceptable: (...) application of a method may produce a number of results from which a range of reliable results may be derived. A taxpayer will not be subject to adjustments if its results fall within such range (arm's length range). (§ 1.482-1.e)

If the IRS finds that a controlled taxpayer has not reported its true taxable income the IRS is authorized to make reallocations between or among the members of a controlled group (§ 1.482-1.a.2). Once the IRS has decided to reallocate income between or among members of a controlled group this constitutes a presumption of correctness.

The IRS regulations also require the taxpayer to select a so-called "best method" in order to attain *the most reliable measure of an arm's length result*. No strict priority of methods is recommended, but in determining which of two or several methods is the most suitable "*the two primary factors to take into account are the degree of comparability between the controlled transaction (or taxpayer) and any uncontrolled comparables, and the quality of the data and assumptions used in the analysis*" (§ 1.482-1(c)(1-2)).

On request, the taxpayer must within 30 days provide documentation to the IRS on his selection and application of a method that is the most reliable measure of an arm's length result (§ 1.6662-6(d)(2)(iii)). With regard to the amount of data that is required the taxpayer needs to have made a thorough documentation beforehand.

APAs are allowed under the Revenue Procedure 2006-9, 2006-2 IRB. The APA program is a voluntary process and aims at "*giving taxpayers greater certainty regarding their transfer pricing methods, and promotes the principled resolution of these issues by allowing for their discussion and resolution in advance*" (section 2.01). An appropriate APA term is determined for each case, but in general at least five year terms are required (section 4.07(1)). As long as the taxpayer complies with his part of the agreement, the IRS will not contest the transfer pricing methods applied to the transactions covered by the APA (section 10.02). Only during the year of 2006 82 APAs were executed and 109 APA applications filed.¹¹⁴

¹¹⁴ IRS's webpage: <http://www.irs.gov/pub/irs-apa/a-07-31.pdf>, as viewed on 2007-10-09.

8.2.2 Penalty System

The penalty regulations are found in IRC §6662. In case of a *substantial valuation misstatement* amounting to a pricing that is 200 per cent or more (or 50 per cent or less) than the correct arm's length price, a 20 per cent non-deductible transactional penalty is imposed on the tax underpayment (§6662(a) and §6662(e)(1)(B)(i)). A 20 per cent net adjustment penalty is also imposed on the tax underpayment if the net transfer pricing adjustment exceeds the lesser of 5 millions USD or 10 per cent of gross receipts (§6662(a) and §6662(e)(1)(B)(ii)).

In case of a *gross valuation misstatement*, amounting to a pricing that is 400 per cent or more (or 25 per cent or less) than the correct arm's length price, a 40 per cent non-deductible transactional penalty is imposed on the tax underpayment (§6662(e)(1) and §6662(e)(2)(A)(i-ii)). A 40 per cent net adjustment penalty is also imposed on the tax underpayment, if the net transfer pricing adjustment exceeds the lesser of 20 millions USD or 20 per cent of gross receipts (§6662(e)(1) and §6662(e)(2)(A)(iii)).

Even if the thresholds are exceeded, penalties can be avoided by passing *the reasonableness test*. A taxpayer must then show that he had reasonable basis for believing his transfer pricing to constitute an arm's length result (§6662(d)(2)(B)(ii)(II)). The tax position also has to be disclosed to the IRS. The term 'reasonable basis' is expounded in the Treasury regulations §1.6662-3(b)(3). According to Logue, a reasonable basis is understood to mean about 20 percent chance of prevailing on the merits (or on and above the 0.2 line on the tax compliance continuum).¹¹⁵ From the practical side, the taxpayer has to show that he selected and applied a transfer pricing method that was reasonable, applied the Best Method Rule and made a reasonable effort to evaluate the potential application of other specified pricing methods.¹¹⁶

Another way to avoid penalties is to show that the tax position in question has or had *substantial authority* (§6662(d)(2)(B)(i)). The term 'substantial authority' is expounded in the Treasury regulations §1.6662-4(d)(2-3): "*The substantial authority standard is less stringent than the more likely than not standard (the standard that is met when there is a greater than 50-percent likelihood of the position being upheld), but more stringent than the reasonable basis standard...*" and "*There is substantial authority for the tax treatment of an item only if the weight of authority supporting such treatment is substantial with respect to the weight of authority supporting contrary treatment.*" According to Logue, practitioners and commentators interpret the rules to mean that tax positions on or above the 0.4 line on the tax compliance continuum constitute uncertain tax positions with substantial authority.¹¹⁷ Furthermore, the taxpayer has to show that he reasonably

¹¹⁵ Logue, p 17-19.

¹¹⁶ PricewaterhouseCoopers, International Transfer Pricing 2006, p 125.

¹¹⁷ Logue, p 17-18.

believed the tax position in question “*was more likely than not the proper treatment*” (IRC §6664(d)(2)(C)).

8.2.3 Judicial Anti-Abuse Doctrines

The *Economic Substance Doctrine* was founded through the decisions in **Gregory v. Helvering, 293 U.S. 465 (1935)**. This common law doctrine is frequently applied by courts and requires that a transaction must result in a meaningful change to the taxpayer’s economic situation to be used for a tax benefit. The doctrine may even prevent tax benefits in situations where the taxpayer has exposed himself to risk of loss and when there is profit potential if the risks and potentials are insignificant compared to the tax benefits.¹¹⁸

The *Business Purpose Doctrine* is often used in combination with the Economic Substance Doctrine for determining whether a transaction should hold for tax purposes. The Business Purpose Doctrine is applied to test the subjective motives behind the transaction and whether the transaction serves some useful non-tax purpose.¹¹⁹

Also, the *Sham Transaction Doctrine* may be used for snaring taxpayers using fictitious or ‘façade’ transactions to obtain tax benefits.¹²⁰

8.3 Challenging the IRS

8.3.1 Generally about Tax Disputes

We [Judges of the U.S. Tax Court] have from time-to-time complained about the complexity of our revenue laws and the almost impossible challenge they present to taxpayers or their representatives who have not been initiated into the mysteries of the convoluted, complex provisions affecting the particular corner of the law involved. . . . Our complaints have obviously fallen upon deaf ears.
-- Arnold Raum

Many federal tax disputes fall under the jurisdiction of the US Tax Court, a federal court established under article 1 of the Constitution. The court has prescribed rules for its proceedings in its Rules of Practice and Procedure. Thus, anyone who has received a note of deficiency or note of determination from the IRS can file a petition to the US Tax Court (Rule 13). When the IRS determines a true taxable income of a controlled taxpayer under section 482 it is a note of determination.

A taxpayer may also contest an imposition of a tax by bringing the case to a United States District Court or the United States Court of Federal Claims. But unlike cases brought before the US Tax Court the taxes have to be paid

¹¹⁸ Laro, PKU-UMICH Tax Law Forum Compendium, p 7.

¹¹⁹ Laro, p 8.

¹²⁰ Laro, p 6-7.

before such lawsuits, according to the ruling **FLORA v. United States**, 362 U.S. 145 (1960).

8.3.2 About Transfer Pricing Disputes

The burden of proof in transfer pricing disputes was expounded in the ruling **I.E. du Pont de Nemours & Col v. United States**, 608 F.2d 445, 453 (Ct. Cl 1979). A taxpayer challenging a reallocation made by the IRS under section 482 has to show that the IRS has acted arbitrarily, capriciously, or unreasonably. The IRS reallocation enjoys a presumption of correctness that has to be overthrown by the taxpayer.

The reasonableness of the IRS's determination depends on the reasonableness of the result and not on details of the methodology used, according to **Sundstrand Corporation v. Commissioner**, 96 T.C. 226, 354 (1991).

Apart from showing that the IRS has acted arbitrarily, capriciously, or unreasonably, the taxpayer must also prove the correct amount of tax, according to **Eli Lilly & Company v. United States**, 372 F.2d 990, 997 (Ct. Cl. 1967).

According to **Seagate Technology Inc v. Commissioner**, 102 T.C. 149 (1994), if the taxpayer succeeds in showing that the IRS has acted arbitrarily, capriciously, or unreasonably, but fails to prove the correct tax, the court will determine the correct allocation instead.

8.3.3 Judgments

There have been plenty of transfer pricing judgments throughout the years. The IRS has succeeded in several complicated and tedious cases against mighty opponents. The **GlaxoKlineSmith (GSK) case** was the largest dispute in history of the IRS, which ended with a settlement agreement (September 2006) after pending in the US Tax Court. The dispute dated back to the 1980s and included issues related to tax years from 1989 through 2000. At issue were the rate charged to the UK parent company for marketing services by the GSK US affiliate. The inter-company pricing had taken into account product intangibles developed by and trademarks owned by the UK parent company. However, the IRS claimed much of the US market entrant was successful primarily because of the marketing services provided by the US affiliate and therefore asserted the rate charged was too low. By signing the settlement agreement, GSK committed itself to pay the IRS approximately 3.4 billion USD and to abandon its claim for refund of overpaid income taxes amounting to 1.8 billion USD.^{121 122}

¹²¹ IRS webpage: <http://www.irs.gov/newsroom/article/0,,id=162359,00.html>, as viewed on 2007-09-25.

¹²² PricewaterhouseCoopers, International Transfer Pricing 2006, p 122.

Although the taxpayer's burden of proof is high, the IRS has lost some transfer pricing cases throughout the years. In the case **Xilinx Inc. & Subsidiaries v. Commissioner, 125 T.C. 37 (2005)**, the issue was about whether stock options issued to employees for performing research and development should have been included as research and development costs. The issue involved transfer pricing, since the US affiliate had a cost-sharing agreement to develop intangibles with its foreign subsidiary. The IRS determined the costs associated with the US affiliate to be too low and made a corresponding reallocation. The US Tax Court, however, held the reallocations to be arbitrary and capricious, since the original allocations of costs had been at arm's length considering the regulations that were in force for the tax years in question.

8.4 Doctrine

In 1987 Wiman made a comparative study of the US and Swedish transfer pricing rules. Already at that time, Wiman asserted the US rules and regulations were much more refined and explicit than the Swedish counterparts, giving guidance on many complicated issues.¹²³ In 1998 Pedersen calls the IRC Sec. 483 the most thoroughly gone through and most frequently used and tried provision on transfer pricing in the world. However, Pedersen also asserted that the detailed regulations had resulted in a situation where even competent tax lawyers had difficulties to apply or understand the required economic models for obtaining an arm's length price. With the IRS's increased power to reallocate income, Pedersen found the transfer pricing legal situation very unsatisfactory from a rule of law perspective.¹²⁴ PricewaterhouseCoopers claims the US transfer pricing rules are the toughest and most comprehensive in the world.¹²⁵ Laro, on the other hand, sees the taxpayer's high burden of proof as a necessary tool for the authorities in the on-going "cat and mouse game", where taxpayers constantly pay sophisticated advisors to help them exploit loopholes in tax law.¹²⁶

8.5 Concluding Remarks

The American transfer pricing rules have developed into their present form over almost a century's time. Over the years, the American rules have influenced the transfer pricing legal development in numerous countries.

The American statutory provisions are too vague to apply without further instructions. Through the IRC Sect. 482, the Congress gives the IRS (the Secretary) a broad leeway to allocate income and deductions to prevent tax evasion or to clearly reflect income. The vagueness of the statutory provisions is remedied by extensive and detailed IRS regulations. As seen

¹²³ Wiman, Prissättning inom multinationella koncerner, p 371-372.

¹²⁴ Pedersen, Transfer Pricing – i international skatteretlig belysning, p 91.

¹²⁵ PricewaterhouseCoopers, International Transfer Pricing, p 116.

¹²⁶ Laro, PKU-UMICH Tax Law Forum Compendium, p 1, 3, 21.

above, not all commentators regard the complexity as a remedy for uncertain tax law. The complexity of the regulations and the taxpayer's burden of proof are probably two factors that have contributed to making tax consulting into a lucrative profession. Furthermore, the comprehensive documentation that may be requested by the IRS must definitely be prepared beforehand and with the assistance of tax experts. With this background the frequent use of the APA program does not seem very strange.

The IRS is an organisation with extensive resources backed up by advantageous burden of proof rules. Although sophisticated tax schemes surely exist, it may still not be too bold to assume a rather high detection rate. The penalty rates are high, but perhaps not disproportionately high. The greedier the tax evasion scheme the higher the penalty seems to be the logic. All in all, with moderately high penalty rates and rather high detection rates the probability of tax evasion should be low. Commentators' remarks seem to indicate a respect if not fear for the IRS, which would in turn indicate that the IRS is well in control of the on-going tax game.

Although initially a prototype for the OECD documents on transfer pricing, the USA has over the past 25 years developed its own practices. The concern for taxpayers' difficulties, as stressed in the OECD Guidelines, is not discernible in the present American system.

9 Overall Analysis

9.1 The Arm's Length Principle

*"I think there is something desperately wrong with the system when there is only a small subset of people who understand how it works."
--Todd McCracken*

The arm's length principle/rule, as enacted by Congress or Parliament, is reasonably similar in all three jurisdictions, and a common feature is that the principle is rather vague and in need of supplementary sources of law for application. As discussed under chapter 5 the principle cannot be but vague and will always require clarifying supplementary sources of law.

In China and the USA, the tax agencies are in laws enacted by Congress given a broad authority to both interpret and expand uncertain transfer pricing rules (according to the new Chinese rules). In comparison, in Sweden the tax agency has been seen as merely one commentator among others, although this may change in the near future due to the effects of the documentation requirements. The future of the principle of legality seems rather insecure.

The American rules cover a broad variety of situations by allowing for reallocation of income of not only incorporated entities, but also organizations, trades and businesses. The Chinese rules, too, cover all kinds of "economic entities". In both the USA and China the rules apply to all legal entities (according to the new Chinese rules), and not only to foreign-invested enterprises. The Swedish rules only allow adjustment of income in enterprises.

The American definition of associated enterprises is in statutory law merely defined by the words "owned or controlled directly or indirectly by the same interests". The Swedish and Chinese definitions of associated enterprises are defined more thoroughly in law (enacted by the Parliament and by the State Council respectively). The Swedish definition is much more delimiting than the Chinese definition. In Swedish law associated enterprises under the arm's length principle are enterprises that share a common economic interest. Common economic interest may exist both directly and indirectly through ownership or through eligibility to management and supervision. Under Chinese law, a large variety of relationships may be considered to relate to the term "associated enterprises".

Summing things up, the entities covered by the rules as well as the definitions of control vary between the jurisdictions. However, the definition of the actions (transactions not at arm's length) as well as the remedies (adjustment) are more or less the same.

9.1.1 Supplementary Sources

In Sweden supplementary sources of law mainly consist of preparatory works, Skatteverket's rules, court judgments, and doctrine. The court judgements on transfer pricing are scarce, but some important principles can be extracted from the ones that exist. The supplementary sources of law do not help much in explaining how to actually apply the arm's length principle. More helpful are the guidelines in the recent Skatteverket's circular, although the principle of legality prevents some of the guidelines from being more than comments (although they might very well be treated as law in practice). The OECD Guidelines, however, are held in high esteem and are in principle used as an important supplementary source of law by all interested parties.

In China supplementary sources of law consist mainly of circulars and rulings issued by the SAT. Good knowledge of the Chinese rules as well as of OECD and US guidelines may probably serve as valuable arguments in discussions and negotiations with the local tax bureaux and with the SAT. However, a large supply of arguments always needs to be combined with close contacts with the tax authorities and politicians. Good understanding of the Chinese political and administrative system together with powerful contacts may actually be the best remedy against uncertain statutory rules.

In the USA supplementary sources of law consist of preparatory works, comprehensive IRS rules, court judgments, and doctrine. Among these, IRS rules and court judgments are decisive. In court rulings, the Treasury Regulations many times seem to enjoy the same weight as statutory rules. Recommendations in the OECD Guidelines will probably not count much in court compared to the far more detailed IRS rules.

9.1.2 Tax Authorities

In Sweden the tax authorities is a service-minded organisation with limited resources (at least compared to the larger MNEs). Had Skatteverket had more economical resources the taxpayer would have had a much worse situation with regard to uncertain tax laws. As has been the case, Skatteverket has instead struggled with limited resources and disadvantageous burden of proof. Consequently, the estimated tax gap in relation to GDP is much higher for Sweden than for the USA and for China. This may however change with the documentation requirements and Skatteverket's aim to focus more on international transactions. This, in turn, will probably lead to taxpayers (mainly larger MNEs) demanding a change in legislation that will allow APAs to save time and money.

The tax authorities in China and the USA are both powerful but in different ways. The IRS has strong legal back-up and sufficient resources (both knowledge and economical resources). The SAT and its local branches do probably not have enough resources and definitely not enough knowledge – but exerts power through the legal uncertainty. For the taxpayer in the USA

challenging the IRS means an uneven fight against interpretation of loopholes and complex rules. However, challenging the SAT or the tax bureaux in China means a fight against both the tax organisation and the political system. Both situations are tough, but according to practitioners the IRS is still the toughest opponent in the international tax game. Why China is considered less tough with regard to transfer pricing may perhaps be explained by the lack of knowledge among Chinese tax officials and the possibility for MNEs to use the particular circumstances of the opposite parties (low salary among officials, tax competition between provinces, co-operativeness with “postponing” income etc) in their negotiations with the authorities. With increasing knowledge and professionalism among Chinese tax officials, and with reduced corruption, China will most probably evolve into a burdensome transfer pricing challenge. In addition to the possibility of APA applications, a real possibility to challenge the SAT in court may then be absolutely necessary in order to balance tax game rules.

The USA and China have both chosen to lay the burden of proof on the taxpayer. In Sweden, the principal burden of proof is still on Skatteverket, although this may in reality have changed with the new documentation requirements.

9.1.3 Penalty Systems

The penalties in the Swedish system may be said to be proportional to the offence, and definitely not too harsh. The detection rate has probably been low or medium due to Skatteverket’s limited resources. The limited resources and the burden of proof also require Skatteverket to select suspected targets strategically. Not overly harsh penalty rates combined with a not too high detection rate probably encourages some MNEs to take positions close to 0 on the tax compliance continuum.

Chinese laws threaten with extremely harsh penalties for non-compliance, but the detection rate is probably very low. For one thing, many disagreements between tax bureaux and MNEs are probably solved beforehand instead of after the tax returns have been handed in. Also, during the audit process plenty of opportunities for negotiations exist.

The American penalties are harsher than the Swedish, but still probably within OECD’s proportionality marginal. The detection rate is most likely much higher than in Sweden. Considering the rather low tax gap in relation to GDP, the USA seems to be in good control of the tax game.

9.1.4 Concluding Remarks

One obvious conclusion of the study is that statutory rules do not mirror the practical legal reality. Without the study of supplementary sources of law as well as the tax organisations a most incomplete picture would have resulted.

From the study both differences and similarities between jurisdictions have been discerned. Firstly, one can say that the three jurisdictions as such are, at first glance, very different in almost all imaginable aspects. The countries' overall legal development, culture and form of government are vastly different. Sweden, China and the USA belong to three different legal families and have also had a very different historical development of tax law. As a matter of fact, China as the youngest legislation has only had modern tax laws for some 27 years and transfer pricing regulations only since 1991. On the other hand, the need for transfer pricing regulations has perhaps not become urgent until the last 30 years with the expansion of MNEs over the globe.

One clear dividing line seems to be the one between a small country such as Sweden and larger (and more powerful) jurisdictions such as China and the USA. The similarities between China and the USA are remarkably many. On the contrary, membership in OECD does not seem to constitute a significant dividing line. True, the Swedish and American systems show some similar features not shared by the Chinese system (such as a real possibility to challenge tax authorities in court), but these similarities are probably not attributable to the membership in the OECD. These similarities are more likely explained by socioeconomic factors such as, for instance, the length of legal history and degree of politicization of the legal system. The dividing line may also be seen as between countries receiving plenty of foreign investments and countries less attractive (in comparison) as investment markets. The USA and China can afford to implement harsh rules, since their attractiveness has other origins.

One similarity between China and the USA is the vast amount of supplementary rules (although much more in the USA than in China). Neither in China nor in the USA do the supplementary rules necessarily increase certainty without adding new uncertainties. A difference is that loopholes are to be patched by the state in the USA, while in China loopholes may be intended by the Chinese authorities in order to retain some power and flexibility. This similarity is related to the shared similarity of non-concern for taxpayers (at least compared to Sweden).

One difference is that the American IRS's broad power ultimately comes from the Congress. In the new Chinese CIT this is also the case, but the Congress delegates in China are not elected in open elections. On the other hand, one may wonder how much de facto influence American taxpayers have. In China the larger MNEs try to exert lobbying power against the Chinese legislators and in the USA they do the same. And in China, just as in democracies, the legislator does not have to listen. Lobbying probably exists in all jurisdictions regardless of the degree of democracy. The question of "no law without representation" could actually be strongly questioned in the case of America, since the IRS has such a broad power and since many taxpayers cannot make their voices heard. As usual, the small- to medium-sized MNEs are probably most exposed to ill-founded audits and reallocations. This trait is probably shared by Sweden as well,

since it seems that small- to middle-sized MNEs are the losers no matter which way is chosen for remedying uncertain tax laws. Too detailed regulations will require assistance from expensive tax lawyers, while too rigid documentation requirements will also require expensive tax lawyers. Clearly, the real actors in the international tax game are the ones with sufficient resources and power.

9.2 Result of OECD Harmonisation Efforts

The OECD Model Convention has indeed contributed to some harmonisation of customs and legislation on transfer pricing, especially in international tax treaties. And the Guidelines, although not always acknowledged as a supplementary source of law, are probably widely used in all three jurisdictions. In China, the American rules are also held in high esteem. However, “widely used” does not necessarily imply deference or even partial compliance. As is often the case in international law, compliance is a matter of power and strength of the involved jurisdictions. Viewed in this perspective, the fact that China and the USA have reserved their positions on almost every article related to transfer pricing in the OECD Model Convention appears quite symptomatic of present-day balance in international politics. And consequently, the state of the international tax game probably mirrors the state of present-day international politics. Perhaps the Guidelines’ focus on taxpayers’ protection is not at all exaggerated, but rather called for.

In all three jurisdictions there are uncertainties in transfer pricing rules. Given, sometimes, considerable domestic uncertainties the international uncertainties become even more problematic. Considering the dissimilarities in practice and legal traditions, the OECD harmonisation efforts have reached far, but the way is still long to actually offsetting harmful effects on international trade and un-fair shifts of tax revenue. Partly, the shortcomings may owe to unwillingness to harmonise transfer pricing practices. After all, interested parties in control of the international tax game (such as powerful states) have no economical incentives to comply with standards that will reduce their tax revenues.

9.3 The Future

There is an inbuilt contradiction in the OECD presumption that upholding the arm’s length principle contributes to the creation of a free market. A free market implies a market with no or at least minimal governmental interference in regulating supply, demand, and prices. Even if the presumption holds that associated companies on a free market would act at arm’s length in their dealings with each other, this presumption does not explain why governmental interference is needed to enforce such dealings at arm’s length. Furthermore, a global free market is far from an evident goal for all OECD members. Actions of the states in the international tax game

clearly indicate as much. Further harmonisation will only be possible if the states with the internationally most important markets have more to gain by harmonised rules than by rules of their own choice. The option to negotiate APAs in China and the USA can in this perspective be seen as an alternative road when harmonisation efforts have not succeeded. Through the APA option predictability can be achieved and the problems of unclear tax law can be circumvented without very far-going international harmonisation. Also, through the APA option predictability may be achieved without the burdensome costs related to a rigid documentation requirement system without the APA option. As usual, winners would then be big states and large MNEs, while small countries and small MNEs would be losers. One way of equalizing the conditions between large and small MNEs would be to allow for placing the burden of proof differently depending on the size of the MNE. Such a solution would of course clearly violate the principle of equality in most modern tax systems. On the other hand, no matter which rules are applied, the conditions will always be different for big and small players.

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