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**A REVIEW OF ARGENTINE AND
ECUADORIAN TAX LAW REGARDING
TRANSFER PRICING AND
RECOMMENDATIONS FOR IMPROVING
ECUADOR'S APPROACH**

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I. INTRODUCTION

In recent years, issues surrounding the use and abuse of transfer pricing¹ have received a great deal of attention.² The United

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1. A transfer price is defined as the price used for internal sales of goods and services between the divisions of a business enterprise. Rugman & Eden, *Introduction*, in *MULTINATIONALS AND TRANSFER PRICING 1* (Rugman & Eden eds. 1985) [hereinafter *MULTINATIONALS*].

2. The area of law addressed in this article is rapidly developing. A new government has been elected in Ecuador and will be confronting many of the problems discussed in this investigation. This article reflects information available up to February 1989. However, the reader is advised that the law cited is in a process of change. Therefore, if specific questions should arise in practice, it often may be necessary to consult with legal or accounting representatives in the appropriate country.

For a general survey of current issues, see R. ECCLES, *THE TRANSFER PRICING PROBLEM* (1985); R. MARTINEZ, *LOS PRECIOS DE TRANSFERENCIA EN LA PLANIFICACION EMPRESARIAL* (1981); Aud & Wright, *Intercorporate Transfer Pricing and Puerto Rico, Revisited: A Comment*, 12 *INT'L TAX J.* 43-48 (1986); Bohman & Bohman, *Transfer Pricing under the Tax Reform Act of 1986 — Sections 482 and 1059A*, 14 *INT'L TAX J.* 83-90 (1988); Casey, *International Transfer Pricing*, 67 *MGMT. ACCT.* Oct. 1985, at 31; Coburn, Ellis & Milano, *Dilemmas in MNC Transfer Pricing*, 63 *MGMT. ACCT.*, Nov. 1981, at 53; Dekker, *The Netherlands: Transfer Pricing*, 40 *BULL. FOR INT'L FISCAL DOCUMENTATION* 502 (1986); Eccles, *Control*

States has given its Internal Revenue Service the discretion to correct abuses in deductions, credits and income distribution between two related entities.³ Other nations have their own mechanisms for controlling abuse.

This article will examine how Ecuador, one of the less economically developed Latin American nations, handles transfer pricing in comparison with how Argentina, a more economically advanced state, deals with the same issues. Based on the lessons learned from the Argentine model, improvements will be suggested to the Ecuadorian system. However, a number of definitions and concepts should first be addressed.

A. Definitions of Transfer Pricing and its Abuse

Transfer pricing is a transaction in which the normal market forces do not determine the price paid by a buyer to a seller for a particular good, service, or technology. Instead, the price is established at the seller's discretion.⁴ Transfer pricing occurs when two

with *Fairness in Transfer Pricing*, HARV. BUS. REV., Nov-Dec. 1983, at 149-61; Finn & Munter, *The Importance of Transfer Pricing to Oil and Gas Companies*, 35 OIL & GAS TAX Q., Sept. 1986, at 136-47; Fisher, *I.R.C. Sec. 482 — Applying the Arm's Length Standard to Transactions Between Foreign Car Manufacturers and Their United States Subsidiaries*, 4 WISC. INT'L L.J. 134-61 (1985); Goldsmith, *Summary of Rules Applicable to Transfer Pricing in France*, 40 BULL. FOR INT'L FISCAL DOCUMENTATION 564-68 (1986); Gordon & Donohue, *Tax Reform Act of 1986: Transfer Prices for Imported Merchandise*, 35 CANADIAN TAX J. 1543-46 (1987); Granwell, Hirsh & Milton, *Worldwide Unitary Tax: Is It Valid Under Treaties of Friendship, Commerce and Navigation?*, L. & POL'Y INT'L BUS. 695 (1986); Greenhill & Herbolzheimer, *International Transfer Pricing: The Restrictive Business Practices Approach*, 14 J. WORLD TRADE L. 232-41 (1980); Hongskrailers & Jap, *Thailand: Transfer Pricing Provisions, Rulings and Case Law*, 40 BULL. FOR INT'L FISCAL DOCUMENTATION 514 (1986); Jensen, *Transfer-Pricing and Output Decisions: The Dynamic Interaction*, 17 DECISION SCIENCES 428 (1986); Keegan & Howard, *Making Transfer Pricing Work for Services*, 165 J. ACCOUNTANCY, MAR. 1988, at 96; Lanthier, *Canada: Draft Guidelines on International Transfer Pricing*, 40 BULL. FOR INT'L FISCAL DOCUMENTATION 487 (1986); Rafferty, *The Profit-Split Method of Income Allocation in Intercompany Pricing Disputes: The Eli Lilly Case*, 64 TAXES 662 (1986); Schindler, *Intercorporate Transfer Pricing*, 19 TAX ADVISER, May 1988, at 378; Schindler, *U.S.A.: Taxation of Intercorporate Transfer Pricing — A Management Responsibility*, 40 BULL. FOR INT'L FISCAL DOCUMENTATION 497 (1986); Terbrueggen, *Can a Central Cash Pool Work for Transfer Pricing?*, 68 MGMT. ACCOUNTANT, July 1986, at 31; Wheeler, *An Academic Look at Transfer Pricing in a Global Economy*, 40 TAX NOTES 87-96 (1988); Yoost, Watanabe & Fox-Moore, *Japan: The New Inter-Company Pricing Rules*, 40 BULL. INT'L FISCAL DOCUMENTATION 506 (1986); Gutfeld, *IRS Plans to Toughen Rules for Taxing Transfer Among Firms, Overseas Units*, WALL ST. J., Oct. 20, 1988, at C18.

3. I.R.C. § 482 (1988). See also 5 D. TILLINGHAST, *TAX ASPECTS OF INTERNATIONAL TRANSACTIONS* 54-55 (2d ed. 1984).

4. Irish, *Transfer Pricing Abuses and Less Developed Countries* 2 (1985) (unpublished

related parties, often a parent company and its subsidiary, engage in a transaction.⁵

Transfer pricing abuse is more difficult to define,⁶ because transfer prices are not easy to determine, even when they are set in an honest manner.⁷ An abuse is said to occur when the price falls outside the normal expectation for the expense.⁸ However, it is rare to find a single, expected price.⁹ In fact, it is probably more accurate to speak of an acceptable range of normal transfer prices.¹⁰ This latitude makes detection of abuse less accurate and more complex. A brief description of the ways in which transfer price abuse produces financial rewards may aid in further defining the scope of the problem.

B. How Transfer Pricing Can Be Used

There are basically three reasons why firms engage in transfer pricing abuse. First, transfer pricing allows companies to circumvent restrictions on repatriation of income and currency conversion.¹¹ Second, transfer pricing may be used to ". . . quietly withdraw profits in the face of economic uncertainties in host countries or in any instance in which business considerations dictate showing low profits in a particular jurisdiction."¹² This inquiry focuses pri-

manuscript) (available at offices of INTER-AM. L. REV.).

5. C. KORTH, *INTERNATIONAL BUSINESS: ENVIRONMENT AND MANAGEMENT* 562 (1985).

6. *New Tune for Corporate Tax Fiddlers*, *ECONOMIST*, June 20, 1981, at 108-09 [hereinafter *Fiddlers*].

7. McGuinness, *Comments on the Difficulties in Regulating Transfer Prices*, in *MULTATIONALS*, supra note 1, at 309.

8. Van Hoorn, *Problems, Possibilities and Limitations with Respect to Measures Against International Tax Avoidance and Evasion*, 8 GA. J. INT'L & COMP. L. 763 (1978).

9. C. KORTH, supra note 5, at 505.

10. Irish, supra note 4, at 3. For a comprehensive, yet concise chart depicting the complexity of establishing a transfer price, see R. ECCLES, supra note 2, at 29.

11. C. KORTH, supra note 5, at 505. Before oil price deregulation, United States oil firms tried to skirt Department of Energy restrictions by using transfer prices. *Fiddlers*, supra note 6, at 108-09. See also R. TANG, *TRANSFER PRICING PRACTICES IN THE UNITED STATES AND JAPAN 79-98* (1979) (discussing the objectives for using transfer pricing).

12. Irish, supra note 4, at 8. For a discussion of other motives for transfer pricing, see Drumm, *Transfer Pricing in the International Firm*, 23 MGMT. INT'L REV. No. 4, 32-33, 38-42 (1983); Kassiech, *International Intra-Company Transfer Pricing*, 29 OPERATIONS RES., July-Aug. 1981, at 817, 819-27. For a summary of data on the relative importance of transfer price objectives, see Yunker, *A Survey Study of Subsidiary Autonomy, Performance Evaluation and Transfer Pricing in Multinational Corporations*, 18 COLUM. J. WORLD BUS., Fall 1983, at 51, 58-59. For an outline of alternative transfer price methods, see Grosse, *Financial Transfers in the MNE: The Latin American Case*, 26 MGMT. INT'L REV. No. 1, 33 (1986).

marily on the third purpose of transfer pricing abuse: tax evasion. In this context, abuse occurs where a taxpayer takes an aggressive position in setting the transfer price in order to avoid taxation. The following scenario illustrates the use of transfer pricing to evade or lower taxes.¹³

Suppose a parent company with two subsidiaries is located in a high-tax jurisdiction. Subsidiary I is located in a moderate-tax jurisdiction, while Subsidiary II is located in a low-tax jurisdiction (a so-called "tax haven"). If the parent has a product it wishes to sell to Subsidiary I's country, barring any tax restrictions, the parent may work out the following transfer price scheme to drastically lower its tax liability. If the product costs fifty cents to produce and the parent wishes to sell the product for one dollar, it could simply sell the product to Subsidiary I, and realize a fifty-cent profit, on which it would pay tax accordingly. However, a more complex transaction could lower the parent's tax liability. The parent could sell the product to Subsidiary II for fifty cents and realize no profit in its own high tax jurisdiction. Subsidiary II could then re-sell the product for one dollar to Subsidiary I, and realize a fifty-cent profit in that low-tax jurisdiction. Subsidiary I could then re-sell the product locally, and realize no profit at all. The savings to the entire corporation (parent and subsidiaries) under this scenario is equal to the difference in tax between the high- and low-tax jurisdictions. Corporations have learned to use this scheme to their advantage whenever possible.¹⁴

C. Determining the General Frequency of Transfer Pricing Abuse

Not a great deal of research has been done to ascertain the parameters and frequency of abuse.¹⁵ Any statistics that do exist with regard to transfer pricing abuse are suspect, because the figures in corporate accounts on which taxes are based and which form the basis for any dispute between the tax authority and the company bear little resemblance to the final settlement created by

13. For more detailed examples, see R. BARNET & R. MULLER, *GLOBAL REACH: THE POWER OF THE MULTINATIONAL CORPORATIONS* 157-59 (1974) [hereinafter *GLOBAL REACH*].

14. *Id.* at 277-82.

15. S. PLOSSCHAERT, *TRANSFER PRICING AND MULTINATIONAL CORPORATIONS* 11-12 (1979); Lall, *Transfer Pricing and Developing Countries*, 7 *WORLD DEV.* 59, 60 (1979); Lecraw, *Some Evidence on Transfer Pricing by Multinational Corporations*, in *MULTINATIONALS*, *supra* note 1, at 223, 229.

the tax authority.¹⁶ Moreover, given that much international trade takes place between related parties, there remains great opportunity for abuse.¹⁷ One study estimated that one-third of all parent company exports went to related firms.¹⁸ United States related-party imports in the third world are estimated at 43.4% of total imports.¹⁹ In the petroleum industry, the figure climbs to 59.6% of total imports.²⁰ In the area of royalties, licensing fees, and technical assistance, with regard to parent companies located in Great Britain and the United States, the figure for intra-company trade can climb to as high as eighty to eighty-five percent of the total revenue received by the parent.²¹

Further, data reveals that "very high proportions of some United States imports from developing countries originate with related parties; there are frequently large differences between import unit values in related-party trade and those in non-related-party trade."²² Investigation reveals that export tax increases in the 1970s led multinationals to justify increased market prices in the United States, while retaining a constant nominal purchase price for bananas in Central America.²³ Thus, while total tax revenue increased, the countries received only a portion of the taxable increase in revenue due to the government because of pricing schemes by multinational enterprises.²⁴ Similarly, copper marketing companies in Zambia have been able to deprive partially nationally-owned operating companies of profit, transferring the money to tax havens.²⁵ Another study has found that from one to

16. *Fiddlers*, *supra* note 6, at 108. For a discussion on how eventual settlements may have little relation to legal mandates, see also S. Hendrix, *Is What You See What You Get?: Perspectives on Post-Verdict Bargaining*, (Fall 1985) (unpublished seminar paper given at a seminar on Disputes Processing, at the Univ. of Wisconsin) (available at the offices of INTER-AM. L. REV.).

17. Irish, *supra* note 4, at 4

18. U.N. CENTRE ON TRANSNATIONAL CORPORATIONS, *TRANSNATIONAL CORPORATIONS IN WORLD DEVELOPMENT — THIRD SURVEY* 1983, at 160, U.N. Doc. ST/CTC/46, U.N. Sales No. E.83.II.A.14 (1983) [hereinafter *THIRD SURVEY*].

19. Helleiner, *Intra-Firm Trade and the Developing Countries: An Assessment of the Data*, in *MULTINATIONALS BEYOND THE MARKET* 31, 46 (Murray ed. 1981) [hereinafter *BEYOND THE MARKET*].

20. *Id.*

21. *Id.* at 120.

22. *Id.* at 54.

23. Ellis, *Export Valuation and Intra-Firm Transfers in the Banana Export Industry in Central America*, in *BEYOND THE MARKET*, *supra* note 19, at 61-75.

24. *Id.* at 73-74.

25. Lamaswala, *The Pricing of Unwrought Copper In Relation To Transfer Pricing*, in *BEYOND THE MARKET*, *supra* note 19, at 77, 84-85.

nineteen percent under-invoicing of Greek aluminum resulted in a loss of more than \$4 million in government revenue in 1976 alone.²⁶ In Brazil, a number of abuses have been reported in firms, including Yamaha Musical do Brazil (a subsidiary of Nippon Gakki Company), Ericsson (a telecommunications firm), and Cargill (a firm in the grain sector).²⁷ Recent data for Brazil also shows that multinational entities paid twenty-one to thirty-nine percent higher import prices in sample areas.²⁸ In addition, not only were prices higher, on the average, in multinational firms, but the prices also displayed greater variability.²⁹ Furthermore, widespread literature on the manipulation of transfer prices available to multinational corporations³⁰ suggests that abuse by that sector may be common.³¹

D. Frequency of Abuse in Ecuador and Argentina

There is not a great deal of information available on the degree of transfer pricing abuse in Ecuador and Argentina. However, some limited data for Argentina is available. In 1976, entities affiliated with companies based in the Federal Republic of Germany which had operations in India, Mexico, Argentina and Brazil, transacted approximately sixty percent of their sales with related entities abroad.³² This would suggest that the opportunity for abuse exists. In fact, one study in Argentina found that over-invoicing did occur in the pharmaceutical industry.³³ Subsidiaries of foreign entities which sold drugs in eight different therapeutic groups charged 143 to 700% more than the price for which the same products could have been purchased from other sources.³⁴

26. Roumeliotis, *Underinvoicing Aluminum From Greece*, in *BEYOND THE MARKET*, *supra* note 19, at 86.

27. Greenhill & Herbolzheimer, *supra* note 2, at 238 (citing U.N. CTAD, *Annual Report on Legislative and other Developments in Developed and Developing Countries in the Control of Restrictive Business Practices* at para. 163, U.N. Doc. TD/B/750 (1979)).

28. Natke, *A Comparison of Import Pricing By Foreign and Domestic Firms in Brazil*, in *MULTINATIONALS*, *supra* note 1, at 212, 220.

29. *Id.*

30. Irish, *supra* note 4, at 6. See, e.g., Charles, *The Economics Approach to Transfer Price*, 96 *Acct.*, June 1985, at 110; Kassiech, *supra* note 12, at 817-27.

31. M. GRUNDY, *THE WORLD OF INTERNATIONAL TAX PLANNING* 15-22 (1984).

32. *THIRD SURVEY*, *supra* note 18, at 160.

33. U.N., *TRANSNATIONAL CORPORATIONS IN THE PHARMACEUTICAL INDUSTRY OF DEVELOPING COUNTRIES* at 17, U.N. Doc. ST/CTC/49, U.N. Sales No. 84.IIA.10 (1984) [hereinafter *PHARMACEUTICAL INDUSTRY*].

34. *Id.* The Ecuadorian government feels it too may be the victim of over-invoicing in the pharmaceutical industry. In 1988, the Central Bank discovered one company that had

Thus, there is some evidence to suggest that where an opportunity for abuse exists, there may be a strong incentive to use transfer pricing as a vehicle for tax evasion. Another study attempted to measure the opportunity for abuse in Argentina by estimating intra-firm payments as a percentage of total payments in 1972.³⁵ That study found that in sample areas, forty-two percent of total payments in Argentina were made between related entities.³⁶ That same study went on to assert that although exact results computing the difference in price are difficult to reach, evidence of transfer price abuse exists in Argentina.³⁷

There is no reason to believe that Ecuador's situation is very different from Argentina's. An analysis of the general data for related-party transactions in the third world creates at least an inference of the potential existence of abuse in Ecuador. Further, the lack of detailed and specific data for Argentina and Ecuador should not be used as a reason to ignore what may in reality be or become a serious area of abuse. Consequently, Argentina and Ecuador need controls to prevent undefensible transfer pricing. As one scholar noted:

Since the volume of intra firm transactions is high worldwide, and the incentives to engage in transfer pricing abuses are generally greater in the less developed countries than in the industrialized countries, and the risk of detection usually is less in the less developed countries than in the industrialized countries, it also is logical to conclude that however great a problem transfer pricing abuses are in industrialized countries, they are an even greater problem in the less developed countries.³⁸

Thus, based on information available with respect to other jurisdictions, as well as on information available for Ecuador and Argentina, it is likely that the absence of attention is, in fact, a sign

been charging Ecuadorian customers over twice the rate it was charging Colombian customers for identical products. Telephone interview with Juana Caicedo, Minister Counselor, Ecuadorian Government Trade Office, New York City (Nov. 17, 1988) [hereinafter *Trade Office Interview*].

35. Chudnovsky, *Pricing of Intra-Firm Technological Transactions*, in *BEYOND THE MARKET*, *supra* note 19, at 119, 120.

36. *Id.*

37. *Id.*

38. Irish, *supra* note 4, at 7. See also Plasschaert, *Transfer Pricing Problems In Developing Countries*, in *MULTINATIONALS*, *supra* note 1, at 247. For a discussion of the view that multinational corporations have no moral problems with abuse, see *GLOBAL REACH*, *supra* note 13, at 187. President Rodrigo Borja has stated that transfer pricing poses great problems for the Ecuadorians. *Trade Office Interview*, *supra* note 34.

that transfer pricing abuse is a serious problem.

E. *The Policies Involved in Transfer Price Control*

Both Ecuador and Argentina must consider the likely impact of implementing programs to control transfer pricing abuse. Because multinational corporations prefer more developed markets,³⁹ a newly-developing country like Ecuador might be uncomfortable adding controls which would discourage investment.⁴⁰ Thus, Ecuadorian transfer pricing abuses may be tolerated or ignored by the government because of the economic disadvantages associated with curbing abuse. Multinationals provide many benefits to the emerging Ecuadorian market, including employment, foreign exchange, and exports.⁴¹ Indeed, the Febres Cordero administration created a substantial incentive program to attract multinationals and significantly liberalized the actual implementation of investment guidelines from the Andean Pact to encourage investment.⁴² Foreign investment appeared to be on the rise in Ecuador, at least until the new government of President Rodrigo Borja came to power in 1988.⁴³ The present regime is concerned with balancing the goal of eliminating or controlling transfer pricing abuse with the risk of losing valuable foreign investment.

In implementing any programs aimed at countering abusive pricing schemes, Ecuador must consider two factors.⁴⁴ First, in order to preserve legitimate multinational corporate interests, corporations must be allowed the discretion to set prices within a flexible range.⁴⁵ This is important because it establishes boundaries

39. THIRD SURVEY, *supra* note 18, at 17.

40. For a discussion of the difficulties of regulating abuse without discouraging investment, see GLOBAL REACH, *supra* note 13, at 207.

41. C. KORTH, *supra* note 5, at 275-302.

42. American Embassy Quito, 1986 Investment Climate Statement for Ecuador 1 (Sept. 23, 1986) (internal memorandum) [hereinafter Investment Climate] (available at offices of INTER-AM. L. REV.).

43. *Id.* at 4. For examples of the "bad press" received by the new administration, see *President of Ecuador Terms Debt Unpayable*, J. Commerce (Aug. 15, 1988); Robinson, *Anti-U.S. Mural Highlights Ecuadorian's Inauguration*, Wash. Post, Aug. 11, 1988, at A23, cols. 3-4. These articles suggest that investors rethink the idea of investing in Ecuador. However, Ecuador is receiving some new investment from the Inter-American Development Bank and the Andean Development Corporation. See *Ecuador to Get \$1 Billion for Development Projects*, J. Commerce (Feb. 10, 1989).

44. For a discussion of these two factors, see Irish, *supra* note 4, at 12-13.

45. ORGANIZATION FOR ECONOMIC COOPERATION & DEVELOPMENT (OECD), TRANSFER PRICING AND MULTINATIONAL ENTERPRISES 12 (1984) [hereinafter OECD/1984].

within which a corporation can still use transfer pricing to reap a reasonable profit. Moreover, setting prices, even in an honest manner, can be a difficult task,⁴⁶ while determining a range of acceptable prices is more realistic and ascertainable. Second, to counter the negative effects of increased regulatory control on the multinationals which Ecuador wishes to keep in or attract to the country, the nation may also wish to take measures to enhance its investment climate by creating an impression that the government is merely streamlining the bureaucracy and cutting back on the institutional inefficiencies which create the opportunity for transfer pricing abuse in the first place.⁴⁷ Alternatively, Ecuador may wish to use another system, like apportionment, which does not require a complex calculation to determine a transfer price or range. A careful consideration of these factors will enable the government to curtail transfer pricing abuse without seriously injuring the investment climate.

Having laid out what transfer pricing is, how it occurs, its frequency, and why it is a difficult subject for control, it is now appropriate to turn to the substantive law of Ecuador and Argentina to examine how each of these nations counteracts the abuse.

II. HOW ARGENTINA PRESENTLY COPE WITH TRANSFER PRICING AND ITS ABUSE

A. *Summary of Argentina's Corporate Tax System as It Affects Multinational Corporations*

In Argentina, affiliated companies of foreign corporations are taxed at the same rate as are domestic corporations.⁴⁸ That rate is thirty-three percent of total profits.⁴⁹ In addition, both foreign affiliates and domestic corporations must pay a 17.50% tax on non-stock or profit dividends distributed to overseas beneficiaries, making the effective tax rate about forty-five percent — a rate equal to the highest individual marginal tax rate.⁵⁰ Similarly, Argentine branches of overseas companies pay forty-five percent on their profits.⁵¹ However, for both the branch and the subsidiary of a for-

46. Irish, *supra* note 4, at 12-13.

47. *Id.*

48. *International Tax Notes*, 10 INT'L TAX J. 373, 374 (1984).

49. *Id.*

50. *Id.*

51. *Id.*

foreign corporation, home office expenses can be allocated to the local office and used as a deduction if they "are necessary to obtain taxable income in Argentina."⁵² An additional withholding tax of fifteen to twenty-five percent is due when remittance of profit net of income tax exceeds twelve percent of the registered capital.⁵³ Interest is subject to a forty-five percent withholding tax on twenty-five percent of the gross amount, yielding an effective rate of 11.25 percent.⁵⁴ Generally, royalties are subject to a forty-five percent withholding tax.⁵⁵ Salaries, wages, and directors' fees usually carry a forty-five percent withholding tax.⁵⁶ These amounts are different, however, in a number of Argentina's international tax agreements.⁵⁷

In general, although Argentina tries to treat transactions between related parties in the same manner as transactions between unrelated parties,⁵⁸ it will do so only if the price and conditions of the transaction approximate those of an arm's length transaction.⁵⁹ Argentina is particularly concerned about transfer pricing abuse with regard to loans and technology. Loans are reported to the Central Bank, which may object to the terms of the loan within thirty days if it believes the terms to be unreasonable.⁶⁰ Under the Transfer of Technology Law No. 21617 which governs intra-company transfers of licenses, patents, knowledge, engineering, installation, assistance, and other services, such transactions must be approved by the Authority of Application. Transactions are approved when they approximate the expected market costs between unrelated parties. One exception to the transfer price approval process occurs when trademarks are transferred. In those cases, no matter how similar the transaction is to an arm's length exchange, no transfer price will be accepted.⁶¹ Yet, once the transaction is approved and registered,⁶² the purchaser is allowed to pay for the

52. *Id.*

53. TOUCHE ROSS INTERNATIONAL, TAX AND INVESTMENT PROFILE: ARGENTINA 29 (1984) [hereinafter TOUCHE ROSS INTERNATIONAL: ARGENTINA].

54. *Id.* at 30.

55. *Id.*

56. *Id.* at 30-31.

57. *Id.* at 31.

58. PRICE WATERHOUSE, DOING BUSINESS IN ARGENTINA: PRICE WATERHOUSE INFORMATION GUIDE 49 (1980) [hereinafter PRICE WATERHOUSE].

59. *Id.*

60. *Id.* at 54. See also COOPERS & LYBRAND, 1987 INTERNATIONAL TAX SUMMARIES A-11 (1987) [hereinafter COOPERS & LYBRAND].

61. PRICE WATERHOUSE, *supra* note 58, at 10-11.

62. Transactions are registered in the National Register of Contracts of License and

service and then deduct any corresponding expenses from tax due.

B. How Tax Rates Applicable to Foreign Entities in Argentina Provide an Incentive for Transfer Pricing Abuse

Because Argentine corporations may be taxed at a rate up to 45% (if they distribute non-stock dividends overseas)⁶³ there is a strong incentive to use transfer pricing to move profits from Argentina to a home office or related entity located in a foreign jurisdiction where the tax rates are lower. However, whether a corporation is willing to use transfer pricing to evade Argentina's steep tax may depend, in large part, on the severity of governmental restrictions and efficacy of their enforcement by the government of Argentina.

C. Argentine Regulations Aimed at Controlling the Abuse of Transfer Pricing

Argentina places a number of restrictions on the use of transfer pricing which are specifically aimed at curbing its abuse. These include a generally applicable rule, as well as regulations in certain distinct areas, such as intra-company transfers of royalties, setting of directors' salaries, transfers of technological and financial assistance, and monitoring and setting of export and import prices. Each of these rules and regulations is addressed below.

1. General rule of non-deductibility of overseas expenses

As previously stated,⁶⁴ the general rule in Argentina is that overseas expenses cannot be deducted from gross income, even if the company's home office is overseas. The rationale for this rule is the presumption that overseas expenses have been incurred in the production of foreign income. In exceptional cases, however, this presumption can be rebutted. The Tax Board may allow a deduction for overseas expenses if the company can prove that those expenses directly affect the production of source income in Argentina.⁶⁵

Transfer of Technology. *Id.*

63. See *supra* notes 48-50 and accompanying text.

64. See *supra* notes 48-52 and accompanying text.

65. Ganancias art. 116 (Arg. 1982)..

2. Non-deductibility of royalties paid to a related party overseas

The first of Argentina's specific regulations concerns the deductibility of royalty expenses paid by a local entity to a related foreign company. In an important decision, the Supreme Court of Argentina denied the right of a subsidiary or branch office to deduct royalty expenses from gross income.⁶⁶ In that case, the parent corporation owned over ninety-nine percent of the local entity's shares. The Court taxed the parent on the amount because it considered the expense Argentine source income subject to the corporation's income tax rate. This decision runs counter to and narrows the general rule that domestic corporations may deduct license and royalty expenses paid to overseas companies.⁶⁷

3. Limits to the deductibility of salaries and remuneration of overseas board members

Argentina generally allows board member fees to be deductible from the fiscal balance sheet to which the payment is related⁶⁸ However, if the directors reside overseas, the deductions available for members who perform their duties abroad are limited.⁶⁹ Local entities can deduct salaries and remuneration up to 12.5% of all business profits earned by the entity, provided that those profits are fully distributed as dividends. This is a fixed amount when the service is provided "desde el exterior" (from outside of the country). Salaries and remuneration are limited to 2.5% of profits when no dividends are paid. When some dividends are paid, there is a sliding scale, ranging from 2.5% to 12.5%, which can be deducted depending upon the amount of dividends distributed.⁷⁰ Fees paid to overseas board members are also included in the next section, dealing with assistance expenses.

66. Judgment of Jul. 31, 1973, la Corte Suprema de Justicia de la Nación, Arg., 286 Fallos 97.

67. Leyes y Decretos Impositivos art. 73 (Arg. 1982); Ganancias arts. 116, 117 (Arg. 1982). Argentine Law No. 21617 provides that royalty payments for the use of trademarks are not allowed. See also Chudnovsky, *supra* note 35, at 126.

68. Ganancias art. 136 (Arg. 1982).

69. Leyes y Decretos Impositivos art. 81(e) (Arg. 1982); Ganancias art. 138 (Arg. 1982).

70. Leyes y Decretos Impositivos art. 81(e) (Arg. 1982); Ganancias art. 138 (Arg. 1982).

4. General deductibility of expenses for technological and financial assistance by related companies

As a general rule, Argentina allows its business entities to deduct fees and remuneration paid for technological, financial, or other assistance from overseas; however, the maximum deduction is limited by two caps.⁷¹ The first cap occurs when such fees and remuneration represent three percent of sales or gross income of the entity, whichever figure has formed the basis of the contract for assistance. The second cap is fixed at five percent of the total amount in fact invested in the assistance which was provided. Any payments beyond these caps are not deductible. Moreover, they are subject to the forty-five percent withholding tax for income remitted abroad.

For transactions which were the product of technical or financial assistance by a parent, subsidiary, branch, or other related entity (including third parties financially related to them), to an enterprise in Argentina, the government will regard these transactions between related parties as taking place between unrelated entities, provided that the transactions comply with income tax law restrictions. However, if there is noncompliance with the law, the payments and transactions will be deemed to have produced profits of the foreign entity in Argentina.⁷²

71. Ganancias art. 138 (Arg. 1982).

72. Leyes y Decretos Impositivos art. 14 (Arg. 1982). Article 14, paragraphs 3 and 4, reads as follows:

Los actos jurídicos celebrados entre una empresa local de capital extranjero y la persona física o jurídica domiciliada en el exterior que directa o indirectamente la controle serán considerados, . . . entre partes independientes cuando sus prestaciones y condiciones se ajusten a las prácticas normales del mercado entre independientes, con las limitaciones siguientes:

1. Préstamos: Deberán ajustarse a las disposiciones establecidas en el inciso l, del artículo 20 de la Ley No. 21.382.

2. Contratos regidos por la Ley de Transferencia de Tecnología: De acuerdo con lo que al efecto establezca dicha ley.

Cuando no se cumplimenten los requisitos previstos en el párrafo anterior para considerar a las respectivas operaciones como celebradas entre partes independientes, las prestaciones se tratarán con arreglo a los principios que regulan el aporte y la utilidad.

(Judicial acts and agreements between domestic corporations with foreign capital and a physical or juridical person domiciled abroad who directly or indirectly controls it will be considered arm's length transactions provided the terms and conditions reflect current market norms among independent agencies with the following limitations: (1) Loans: Should adjust to the conditions established in clause 1, article 20 of Law 21.382; (2) Contracts governed by the Technology Transfer Law: According to the procedures established by this law. Provided the conditions set forth in the preceding paragraph for the characterization of the

5. Monitoring of export prices by the wholesale market price at the place of destination

In general, Argentine exporters realize domestic source income and are therefore subject to Argentine income tax.⁷³ When the price of exports falls below the wholesale price at the destination, the Tax Board may consider whether the transaction was made between related parties. Indeed, given the presumption that the law creates, and in the absence of contrary evidence, the tax authorities may deem the exporter to have earned additional profits subject to a forty-five percent tax rate, thus treating the parties as if related.⁷⁴ The parties have the opportunity to justify the price. If the Board maintains that the price is unjustified, it may tax the Argentine exporter on the profits from the transaction using the wholesale market price at either the foreign destination or the exporter's own market.⁷⁵

6. Monitoring of import prices by the wholesale market price at the place of destination

The controls on import price are quite similar to the controls on export price. Generally, when foreign exporters realize a profit from a sale to Argentina, they do not have Argentine source income. Thus, they will not have any tax liability in Argentina.⁷⁶ Yet, if the Argentine importer is paying a price higher than the wholesale market price in the country of origin plus appropriate shipping and insurance charges, the Tax Board may find that the transaction has taken place between related parties. As with exporting, the entities may submit evidence to justify the price set. Assuming that the Tax Board still finds the price to be inappropriate, the Board can charge an income tax based upon the created margin or, in the alternative, upon local wholesale prices.

transaction as arm's length are not met loans between the parties will be treated according to capital and equity principles.)

73. Leyes y Decretos Impositivos arts. 14, 5, 8(a) (Arg. 1982).

74. TOUCHE ROSS INTERNATIONAL: ARGENTINA, *supra* note 53, at 26.

75. *Id.* See also Ganancias arts. 8(a), 9, 10 (Arg. 1982).

76. Leyes y Decretos Impositivos arts. 5, 8 (Arg. 1982).

III. HOW ECUADOR PRESENTLY COPE WITH TRANSFER PRICING AND ITS ABUSES

A. A Brief Summary of Ecuador's Corporate Tax System as It Affects Multinational Corporations

In Ecuador, corporations have differing tax rates depending on their domicile or place of incorporation. Generally, there is a twenty percent tax on undistributed profits.⁷⁷ The basic income tax rate on distributed profits for stockholders in Ecuador, including the prior twenty percent rate on undistributed profits, is twenty percent.⁷⁸ The rate of basic income tax on distributed profits to foreign stockholders residing abroad is forty percent.⁷⁹ In addition, the Ecuadorian code makes no provision for the filing of consolidated tax returns.⁸⁰

One investment guide for Ecuador summed up the tax law involving intercompany charges as follows:

The law provides for the deductibility of necessary commissions and expenses incurred abroad, as in the case of exportations. Such expenses are determined on the basis of specific contracts or as a maximum of 2 percent of export sales. Advertising contracted abroad to promote sales of the local company is, in practice, accepted as deductible without giving rise to withholding of income taxes.

Contracts involving technical, administrative and management assistance from abroad and, in general, any type of service that calls for the payment of fees, royalties, etc., on account of intangible technical contributions require approval from the authorities on a case by case basis. The authorities have the right to regulate the period of the contract and the terms of payment. . . . [With respect to royalties] no payment abroad is deductible when the transaction or the contract is entered into between affiliated companies. Withholding of income taxes applies to all the foregoing payments.⁸¹

77. TOUCHE ROSS INTERNATIONAL, TAX & INVESTMENT PROFILE: ECUADOR 14 (1984) [hereinafter TOUCHE ROSS INTERNATIONAL: ECUADOR]; PRICE WATERHOUSE, CORPORATE TAXES: A WORLDWIDE SUMMARY 112-16 (1988) [hereinafter PRICE WATERHOUSE/CORPORATE TAXES].

78. PRICE WATERHOUSE/CORPORATE TAXES, *supra* note 77, at 112-16.

79. *Id.*

80. DELOITTE HASKINS & SELLS, TAXATION IN ECUADOR: A GUIDE FOR THE FOREIGN INVESTOR 34 (1986) [hereinafter DELOITTE].

81. PRICE WATERHOUSE, DOING BUSINESS IN ECUADOR 82-83 (1981) [hereinafter PRICE WATERHOUSE/ECUADOR]. See also DELOITTE, *supra* note 81, at 11. Intra-firm royalty payments are not deductible under Decision 24 of the Andean Pact. Chudnovsky, *supra* note

Additionally, a special tax provision for foreign construction companies permits a deduction of home office expenses of up to twenty percent of the construction contract's value.⁸² However, the home office must use a public accountant or governmental agency to certify that the payment was credited to the home office accounts.⁸³ This documentation must be notarized by the Ecuadorian consul abroad.⁸⁴

Ecuador charges a withholding tax on a number of types of transfer payments. While no withholding tax is levied on interest, loans are subject to a one-time special tax of one-half to two percent of the loan principal at the time of registration with the Central Bank.⁸⁵ There is a forty percent withholding tax, plus additional surtaxes, on fees and royalties for technical assistance.⁸⁶ This forty percent plus surtax rate also applies to professional fees remitted abroad.⁸⁷ Finally, for dividends credited or remitted to non-resident shareholders, there is a twenty percent withholding tax with additional surtaxes.⁸⁸

B. How Tax Rates Applicable to Foreign Corporations and Shareholders in Ecuador Provide an Incentive for Transfer Pricing Abuse

The fact that the tax rate for foreign entities in Ecuador is as high as forty percent in the aggregate,⁸⁹ creates an incentive for abuse. If a company can use pricing to transfer profits from Ecuador to either the home office or a third country with a lower tax rate, that company will be able to avoid paying some of its tax liability. The statutes of Ecuador reveal Ecuador's attempts to curb this abuse.

35, at 126.

82. PRICE WATERHOUSE/ECUADOR, *supra* note 81, at 83.

83. *Id.*

84. *Id.*

85. DELOITTE, *supra* note 80, at 17.

86. *Id.* at 18.

87. *Id.*

88. *Id.*

89. See *supra* notes 77-81 and accompanying text.

C. Specific Ecuadorian Laws Aimed at Controlling the Abuse of Transfer Pricing

Articles 17, 19, and 20 of the Law in Ecuador substantively impact on transfer pricing. Article 17 states that: "When the normal price depends on the quantity of a sale, such price will be determined on the assumption that the sale is limited to the quantity of commodities set forth in the declaration."⁹⁰ The text of Articles 19 and 20 is as follows:

Article 19. The price shown on the commercial invoice (except when there is a doubt as to the correctness of the data contained thereon) will be taken as a basis for determining the customs value, provided that it complies with the conditions stipulated for determining the normal price of the commodities.

Article 20. An importer should declare the value of the commodities in conformity with the preceding Articles. Also, he should provide the Customs and the Central Valuation Office with all the data and commercial documents relating to the importation that may be required for the purpose of verifying the taxable value. The obligation prescribed in the preceding sentences will be enforced on the importer for all commodities declared at the Customs, including those which are exempted, in whole or in part, from duties, and those which are subject to specific duties. The Central Valuation Office is authorized to make such investigations as it may deem necessary for verifying the taxable value.⁹¹

The penultimate sentence in Article 20 is significant because it provides that, whether or not an ad valorem tax is levied, the pertinent information is available to tax authorities for computation of transfer prices. Yet, these provisions apply to the customs value of goods and appear to be more concerned with low prices than high prices. In fact, Article 21 authorizes the Minister of Finance to establish minimum prices for commodities. Ecuadorian consuls and commercial advisors abroad send wholesale price information back to Ecuador to aid in the compilation of price lists.⁹² It might

90. DUN'S MARKETING SERVICES, EXPORTERS' ENCYCLOPAEDIA 1986/1987 2.448 (1986) [hereinafter DUN'S MARKETING SERVICE].

91. *Id.*

92. *Id.* See also Trade Office Interview, *supra* note 34. One exporter stated that, in his opinion, the Ecuadorian government was relying almost exclusively on the import duty to prevent transfer pricing. Price lists are not used to establish maximum prices. However, this may not prevent transfer pricing. Further, with other countries in the Andean Pact — countries for which a much lower tariff schedule applies — the goal of deterrence may not be