

be expected that, under this arrangement, and due to the ad valorem tax, little over-invoicing of imported consumer goods would occur. However, the provisions do not prevent over-invoicing of capital goods and components usually exempt from customs duties. Under the provisions of Article 24, the burden of persuasion is placed upon the importers to ". . . substantiate the fact that the declared prices are in agreement with the normal prices in the country of origin."<sup>93</sup>

Regarding intra-company transfers in particular, the Ecuadorian Law contains a provision which places the burden of persuasion on the interrelated companies to prove any contractual arrangement they had between themselves.<sup>94</sup>

Ecuador's Central Bank oversees export and import procedures. It controls letter of credit issuances, collection authorizations and import licenses, as well as terms for import payment.<sup>95</sup> In

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achieved. In fact, there are rumors that shrimp exporters have been using transfer pricing quite effectively to their advantage in Ecuador. Telephone interview with Toni Diamond, Finance Officer for Ecuador, Ford Finance, in Miami, Florida (Oct. 13, 1988).

93. DUN'S MARKETING SERVICES, *supra* note 90, at 2.448.

94. 1 FOREIGN TAX LAW ASSOCIATION, ECUADOR INCOME TAX SERVICE 31 (1986). This section provides:

Article 46. Transactions Among Companies or Affiliated Individuals: The transactions carried out among companies or associated persons among themselves, of which a person or company is not subject to the income tax of Ecuador, they will be required to present evidence, proof or special documentation which establishes the bargain and sale or transfer of machinery, products, lands, transfers of rental, payments for services, whatever their nature may be, etc. For the purposes considered here, the Director's Office of Income Tax can establish specific individual regulations, to which the person or company who should pay the income tax in Ecuador will be subject, so that the computation of the tax caused, is the most beneficial to the country. Similarly, if a company or person is engaged in operations, a part of which is subject to the income tax, and the other not, the declaration rendered for the purposes of the income tax, can be submitted to specific individual regulations or provisions which the Director's Office of Income Tax will dictate.

According to one exporter, proving a price is particularly difficult when insurance, transport and installation are included along with the sale of products. The Ecuadorian government can demand a breakdown of all U.S. and Ecuadorian costs. Many expenses may not qualify, and the exporter could stand to lose a great deal of money if the transaction is not well documented. That same exporter stated that he personally lost US\$30 to US\$40 thousand dollars in sucres (the unit of currency in Ecuador, divided into 100 centavos) because of pre-shipment inspection delays of several weeks and disqualifications by the SGS. Other exporters have also lost large sums of money. In conclusion, he stated that exporters were not opposed to a reasonable and honest checking system, but that the system the SGS employed created a mess that was simply "ridiculous." Telephone conversation with Mr. Rafael Portela, Senior Vice President and Director, Contract Division, Calmaquip Engineering Corp., in Miami, Florida (Sept. 13, 1988).

95. U.S. DEPT. COMMERCE, OVERSEAS BUSINESS REPORTS: MARKETING IN ECUADOR 6

the past, the Central Bank had a contract with the Societe Generale de Surveillance S.A. (SGS) to physically inspect the quality, quantity, and price of exports.<sup>96</sup> After the SGS had inspected the export or import, it issued a "Report of Findings" containing its opinion of the transaction.<sup>97</sup> A "Clean Report of Findings" would satisfy the Central Bank as to the quality, quantity, and price of the export.

#### IV. HOW ECUADOR MIGHT BETTER DETER TRANSFER PRICING ABUSE

Ecuador has a simpler, more discretionary system for controlling abuse than does Argentina. Because the Febres Cordero Administration in Ecuador attempted to alleviate the country's internal economic crisis<sup>98</sup> by liberalizing domestic regulation of foreign investment,<sup>99</sup> the incoming government may wish to preserve whatever progress was made and should, perhaps, reconsider the further regulation of transfer pricing. In so doing, the government should analyze the potential impact on the present economy of a change in transfer pricing regulation. Because Argentina has a more highly developed tax code, Ecuador should begin by examining how Argentina tackles the same problem. Of course, Ecuador will want to consider other options available to deter transfer pricing abuse.

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(1985) [hereinafter OVERSEAS BUSINESS REPORT]. See also Trade Office Interview, *supra* note 34.

96. OVERSEAS BUSINESS REPORT, *supra* note 95. According to one official at the U.S. Embassy at Quito, the Central Bank decided to discontinue its contractual relationship with the SGS at the beginning of 1988. Because no alternative entity replaced the SGS, the Central Bank presently performs the functions previously delegated to the SGS under the contract. It is expected that the Ecuadorian government will either contract with another pre-shipment inspection firm, or re-hire the SGS in the near future. Whether the Central Bank or some other entity performs the transaction approval functions, opportunities for abuse continue to exist. The problem is exacerbated by the fact that, during the final year of its administration, the Cordero government made no attempt to confront the problem of transfer pricing. Moreover, the Borja government has not yet considered or proposed any changes to the tax code aimed at preventing such abuse. Telephone Interview with Gordon Jones, Commercial Attache, U.S. Embassy, Quito, Ecuador (Oct. 13, 1988). The Ecuadorian Trade Office affirmed that the Central Bank will continue to perform the duties once performed by the SGS. Trade Office Interview, *supra* note 34.

97. OVERSEAS BUSINESS REPORT, *supra* note 95.

98. U.S. DEPT. COMMERCE, FOREIGN ECONOMIC TRENDS AND THEIR IMPLICATIONS FOR THE UNITED STATES: ECUADOR 4-11 (1986) [hereinafter FOREIGN ECONOMIC TRENDS].

99. INVESTMENT CLIMATE, *supra* note 42, at 1-2.



A. *Steps Ecuador Has Already Taken To Deter Transfer Pricing Abuse*

As noted earlier, there are many reasons for engaging in transfer pricing abuse which are not motivated by a desire to evade taxes.<sup>100</sup> Ecuador has already eliminated some of the non-tax incentives for abuse. For example, Ecuador no longer requires that firms be nationally owned.<sup>101</sup> Thus, parent firms with holdings in Ecuador are no longer forced to use transfer pricing as a means to repatriate profits to the parent without splitting the revenue with local owners and without paying any tax on dividends.<sup>102</sup> Ecuador has also eliminated restrictions on repatriation of profits,<sup>103</sup> so that the incentive to use transfer pricing as a surrogate for repatriation is no longer present. However, shortly after the government transferred private foreign exchange transactions from the Central Bank to the free market — making transfer pricing less attractive — it withdrew this concession and increased the term for domestic currency deposits, forcing importers to deposit sucres equivalent to 100% of the value of imports for List 1B items (mostly capital goods and raw materials), and 160% for List 2 items (mostly luxury goods).<sup>104</sup> By engaging in this policy reversal, the government created an incentive to use transfer pricing as a means to avoid perceived difficulties in transacting business with the Central Bank. At this point, Ecuador may need to take additional steps toward decreasing the incentives for abuse.

100. See *supra* notes 11-13 and accompanying text.

101. INVESTMENT CLIMATE, *supra* note 42, at 1.

102. For a discussion of the problems with which Greece was faced regarding this situation, see Roumeliotis, *supra* note 26.

103. INVESTMENT CLIMATE, *supra* note 42, at 1. See also THE ECONOMIST INTELLIGENCE UNIT, COUNTRY PROFILE: ECUADOR 40 (1988) [hereinafter COUNTRY PROFILE]. As an encouragement to foreign investors, the new government in Ecuador has also taken economic measures to put its house in order. *Ecuador Announces Steps to Stem Economic Crisis*, J. Commerce (Sept. 1, 1988).

104. INVESTMENT CLIMATE, *supra* note 42, at 9. For details regarding the exchange rate, see COUNTRY PROFILE, *supra* note 103, at 40. For details on the requirements for approval of the transaction by the Central Bank, see *id.* at 12. The general perception that Ecuador is in the midst of an economic and political crisis adds to the incentive for transfer pricing abuse. For a summary of the political and economic problems facing the nation, see Martz, *Instability in Ecuador*, 87 CURRENT HIST. 17 (1988). Moreover, Ecuador's inability to repay its debt may further deter investment in the country. *Ecuador May Withhold Some Debt Payments*, J. Commerce (Sept. 2, 1988). See also *Official Says Country Must Renegotiate Debt*, Quito *Voz de los Andes*, Oct. 29, 1988, as reprinted in 88-213 Foreign Broadcast Information Service — Latin America (FBIS-LAT), Nov. 3, 1988, at 38.

B. *An Examination of the Alternatives Available to Ecuador*

Transfer pricing abuse is most likely to occur with finished or consumer goods, which are subject to import and value added taxes, because over-invoicing to transfer profit abroad will only result in increased import and value added taxes. By contrast, however, intermediate goods, capital goods, and raw materials carry relatively little import duty, and thus are more likely to be the subject of abuse. Similarly, where services are treated unfavorably, either by denial of deductibility or by imposition of a gross withholding tax, the benefits to be derived from transfer pricing abuse will be small enough to deter significantly any such actions. However, where services are subject to a low rate of withholding tax and deductibility, the advantages of, and opportunities for abuse will be significantly enhanced. Thus, with regard to those transfers in which the payment is deductible in Ecuador and little tax is levied on the transfer payment, abuse will be most likely to occur.

There are a number of methods Ecuador can use to deter transfer pricing abuse. In attempting to employ a method which utilizes the correct arm's length price, Ecuador should always begin by inquiring whether the expense is legitimate in the first place. Assuming that it is, Ecuador can go on to estimate a defensible transfer price. The method of establishing an actual transfer price through formal accounting procedures is currently used by Ecuador, and by Argentina for transactions involving goods. Other methods include: taxing intra-firm transfers; limiting the deductibility of certain expenses for services, as Argentina does; imposing artificial restraints; and using notional pricing for exports. There are two options which do not try to establish a true transfer price. The first involves a tax on world income, with tax credits given for foreign tax paid. This is a variation on the idea that there should be a single, world tax rate. The second of these options is the utilization of an apportionment scheme. While none of these approaches is perfect, some are better suited to Ecuador's situation than are others. Each alternative will be discussed and evaluated below, with an eye toward finding the least objectionable method by which Ecuador may deter transfer pricing abuse.



1. Attempt to establish the actual transfer price through formal accounting

At present, Ecuador attempts to determine the actual transfer price on a case-by-case basis.<sup>105</sup> The Ecuadorian code may thus appear quite unfavorable to multinational corporations, which have the burden of establishing that their prices are in conformity with normal prices.<sup>106</sup> Until recently, the SGS had a great deal of discretion in the implementation of this policy,<sup>107</sup> and very little guidance was available to investors who wanted to know exactly how the SGS reached its decisions and recommendations.<sup>108</sup> At the beginning of 1988, the formal accounting process once again became the responsibility of the Central Bank, although it remains quite possible that the government will enter into another contract with the SGS (or another firm) to handle the procedure.

The multinational corporations which Ecuador seeks to attract require more specific guidelines as to how the formal accounting process works, so that they have some indication of whether their transfer prices will meet with approval. Ecuador could create a more certain investment climate by limiting and defining the role of the Central Bank (or whomever is in charge of the pre-shipment inspection).<sup>109</sup> The Office of the United States Trade Representa-

105. See *supra* notes 81-84 and accompanying text.

106. DUN'S MARKETING SERVICES, *supra* note 90, at 2.448.

107. See *supra* note 96. For a general discussion regarding the broad powers delegated to pre-shipment inspection firms throughout the Third World, and the problems which result from their discretionary exercise of such powers, see Barone, *Make Inspection a Trade Issue*, J. Commerce (Apr. 5, 1988).

108. See *supra* note 97. According to one exporter, not only were exporters to Ecuador unable to understand how the SGS established prices, the SGS itself, when asked to elucidate its methods and bases for determining acceptable transfer prices, could offer no explanation. The exporter tried to obtain information from the SGS, the Central Bank, and other sources within the government of Ecuador, and finally concluded that no one "had any idea what SGS was doing." The pricing system, he stated, was extremely unfavorable to exporters, who had no predictable standard by which to measure the likelihood of transfer price approval. Thus, even those exporters who set their transfer prices in good faith, according to reasonable commercial standards, may have their transactions nullified or delayed for unknown and therefore unappealable reasons, either legitimate or illegitimate. Exporters, in turn, will be encouraged to "jack up their prices to cover for the delays and the uncertainty. . . . This is ultimately paid for by the Ecuadorian people." Telephone interview with Armando Paz, Treasurer, Calmaquip Engineering Corp., in Miami, Florida (Sept. 13, 1988). For a more generalized discussion of problems that occur with pre-shipment inspections, and in particular, problems associated with the SGS in Ecuador and elsewhere, see *Pre-shipment Checks: A Stranglehold or a Submission*, 60 TRADE FIN. 43 (1988).

109. Neither the Ecuadorian Embassy in Washington, nor the SGS offices in Miami and New York would provide the author with a copy of their agreement regulating the con-

tive has received numerous complaints about the SGS from U.S. exporters.<sup>110</sup> Representatives of exporters in Florida filed, but later withdrew, a Section 301 petition concerning the SGS and other pre-shipment inspection companies operating in Latin America.<sup>111</sup> It is apparent that dissatisfaction with the SGS and similar companies which operate as agents of foreign governments, impedes the flow of international trade.<sup>112</sup> Multinational enterprises are deterred from entering into business operations in Ecuador because of the present policy. Ecuador might change this situation by adopting the approach of Argentina, and spelling out in a more predictable and calculable manner how transfer prices are established for transactions involving goods. Like Argentina, Ecuador already has provisions establishing a credible price monitoring mechanism.<sup>113</sup> However, Argentina, unlike Ecuador, places the explicit use of these mechanisms in the Tax Law.<sup>114</sup> While Ecuador uses price listings overseas as a means to check abuse in a highly discretionary process,<sup>115</sup> Argentina uses similar information to create a range of objectively verifiable transfer prices.<sup>116</sup> This difference is significant, in that a foreign entity may perceive that Ecuador uses the price lists to make discretionary judgments, whereas Argentina presumes transfer prices to be reasonable and defensible and only uses the lists to check serious abuse in cases where prices are truly out of line. Although in reality both countries may make identical use of the lists, Argentina's approach seems more conducive and conciliatory to foreign investment. In short, Ecuador may wish to consider modifying public use of lists designed to check

duct of the SGS. The U.S. Departments of State and of Commerce similarly did not have a copy of the agreement for distribution. The State Department informed the author that the details of the agreement were confidential and not available to the public. This situation is a disincentive for investment in Ecuador because potential investors cannot obtain information on import guidelines.

According to British trade law professor, Clive Schmitthoff, "Exporters have complained that the inspection organization insisted on an unjustified reduction of a price firmly agreed with the overseas buyer, or that it demanded the disclosure of a price calculation regarded as confidential." *Pre-shipment Checks: A Stranglehold or a Submission*, *supra* note 108. For further criticism of pre-shipment inspections, see Barone, *supra* note 107.

110. Telephone interview with Betsy Stillman, Director for Andean and Caribbean Affairs, United States Trade Representative (Apr. 9, 1987).

111. *Id.* See also 51 Fed. Reg. 32,387 (1986).

112. *Id.* See also 51 Fed. Reg. 32,387 (1986).

113. See *supra* note 92.

114. See *supra* notes 72-76 and accompanying text.

115. See *supra* notes 90-95 and accompanying text.

116. See *supra* notes 72-76 and accompanying text.



transfer pricing abuse in order to alter the present perception that judgments are discretionary.

In addition to having an explicit price monitoring system, Ecuador could take two additional steps to ensure that actual transfer prices are in conformity with reported prices. First, Ecuador could audit the firm to verify reported prices. Tax authorities could gather information on prices from a variety of sources: other branches of government; Andean Pact and OPEC nations; other international agencies; the firm itself; and other nations. Because other nations may be reluctant to freely divulge such information without a bilateral treaty, Ecuador may wish to enter into agreements with its major trade partners to exchange information.<sup>117</sup> On the other hand, when entering into tax treaties with tax haven nations, Ecuador should insist on exchange of information agreements with these jurisdictions.<sup>118</sup> As an enticement to be party to such an agreement, Ecuador, along with other Andean Pact nations, could threaten to increase taxation on transactions with tax havens, as well as increase penalties for proven abuse in these areas. Further, Ecuador might impose a higher burden of proof on corporations dealing in tax havens to justify their transfer prices.

Second, correlative price adjustments should also be considered,<sup>119</sup> and could best be implemented where a tax treaty is in place. This would minimize the risk of double taxation while preventing transfer pricing abuse. Unfortunately, Ecuador has no single policy regarding the avoidance of double taxation.<sup>120</sup> The only nations with which it has ratified and signed a tax treaty are those of the Andean Pact.<sup>121</sup> Thus, when Ecuador audits a firm, Ecuador may wish to use a correlative adjustment procedure. This would allow any upward adjustment in Ecuador to be matched

117. Casey, *supra* note 2, at 240-41 (recommending the negotiation of international agreements for cooperation to assist governments in prohibiting transfer price manipulation).

Ecuador's major markets in 1984 were: United States, 64 percent; Latin American Integration Association (ALADI), three percent; and the European Community, three percent. Ecuador's major suppliers in 1984 were: United States, 32 percent; the European Community, 16 percent; Japan, 13 percent, and ALADI, 19 percent. U.S. Dept. State, Bureau of Public Affairs, *Background Notes: Ecuador* 1 (1986).

118. *Fiddlers*, *supra* note 6, at 109.

119. This is also referred to as "corresponding adjustments." OECD/1984, *supra* note 45, at 9.

120. PRICE WATERHOUSE/ECUADOR, *supra* note 81, at 94.

121. The Andean Pact consists of Bolivia, Colombia, Peru, and Venezuela. See *id.* Ecuador has no other signed tax treaties. See DELOITTE, *supra* note 80, at 11.

with a downward adjustment in the host country. The opposite would also hold true. There are two benefits to this procedure. First, it avoids the threat of double taxation.<sup>122</sup> Second, by not punishing the firm for arriving at a different conclusion than did the government, it acknowledges the difficulties in setting transfer prices. Thus, the mechanism ensures that the government can establish an arm's length price without discouraging foreign investment.<sup>123</sup> Although correlative adjustment mechanisms are highly regarded by some, one limitation on use of the mechanism is that

. . . the competent authorities have only a duty to negotiate; they are not required to reach an agreement, nor are they required to implement it when reached and; indeed, they may be unable to do so because of conflicting domestic law — such as that imposing time limits on the adjustment of assessments or on the making of refunds of tax. In the view of [multinational enterprises] this is a serious weakness in the arrangements.<sup>124</sup>

Furthermore, these arrangements empirically have been slow and unpredictable.<sup>125</sup> In addition, despite the 1979 OECD Model Convention's provisions,<sup>126</sup> Ecuador's correlative price mechanism should require and make explicit that Ecuador decides each case on its own merits. This would counteract the corporations' fear that when tax authorities attempt to agree, they may compromise one company's claim for that of another.<sup>127</sup> The mechanism should also allow for the corporations to be kept abreast of progress and discussions concerning the corporation's case.<sup>128</sup>

Finally, treaties could allow for the creation of binding arbitration between member nations when they disagree on the appro-

122. *Fiddlers*, *supra* note 6, at 109 (claiming that large scale, simultaneous audits by several jurisdictions will become more popular with international tax authorities in the coming years).

123. For a more detailed discussion of correlative adjustment mechanisms, see Irish, *supra* note 4, at 60. For a model provision showing how this mechanism would work, see MODEL CONVENTION art. 9, cl. 2 (OECD 1979) [hereinafter OECD/1979]. For a similar provision by the United Nations Group of Tax Experts, see Surrey, *United Nations Group of Experts and the Guidelines for Tax Treaties between Developed and Developing Countries*, 19 HARV. INT'L L.J. 1, 54 (1978). See generally UNITED NATIONS DEPT. INT'L ECON. & SOCIAL AFFAIRS, TAX TREATIES BETWEEN DEVELOPED AND DEVELOPING COUNTRIES — SIXTH REPORT, 1976, U.N. Sales No. E.76.XVI.3 (1980).

124. OECD/1984, *supra* note 45, at 17.

125. *Id.* at 8.

126. OECD/1979, *supra* note 123.

127. OECD/1984, *supra* note 45, at 18.

128. For a discussion of concerns about how this might function, see *id.* at 33.



appropriate transfer price.<sup>129</sup> This would aid to shore up the corporate perception of correlative price mechanisms by ensuring against the threat of double taxation. Further, exchange of information through treaty arrangements would enable Ecuador to have a better understanding of the operations of multinational corporations, improve their own audit abilities and monitor the pricing of firms with less administrative cost.<sup>130</sup>

Argentina's and Ecuador's present case-by-case method is only one of the options available in the regulation of transfer pricing in the area of intangible property. The United Nations has outlined the two main approaches most commonly taken.<sup>131</sup> The first approach involves either a lump sum payment for the patent or intangible property, or a royalty fixed in relation to a specific base such as gross sales, or production.<sup>132</sup> The second approach involves the sharing of research and development costs among related companies.<sup>133</sup> Ecuador could utilize both approaches, together with tax treaties and correlative adjustment procedures,<sup>134</sup> to develop a mechanism that would allow for legitimate expenses while guarding against abuse.

Determination of an arm's length price using monitoring, audits, and correlative adjustments works best when comparable goods are available on the open market. When no comparable good is available on the open market, and in the case of pricing services and intangibles, an appropriate price may be difficult or impossible to ascertain because there are no readily identifiable and comparable open market transactions, "comparable uncontrolled price methods"<sup>135</sup> of calculating the actual transfer price will not work.

129. The European Economic Community has a Draft Directive of the European Communities by the Assembly of the Communities and by the Economic and Social Committee under the Treaty of Rome, which essentially outlines how this could work. It is discussed in OECD/1984, *supra* note 45, at 21-25. A treaty solely between two nations should be more workable than the EEC one, which is quite complex.

130. Monitoring multinational corporations has been troublesome, even for the United States Internal Revenue Service. A treaty would do much to help Ecuador. See generally GLOBAL REACH, *supra* note 13, at 206, 282-83.

131. UNITED NATIONS, TAX TREATIES BETWEEN DEVELOPED AND DEVELOPING COUNTRIES — SEVENTH REPORT, 1978, at 35-36, U.N. Sales No. E.78.XVI.1 (1978) [hereinafter SEVENTH REPORT].

132. This appears to be the approach taken by Argentina.

133. For a more detailed discussion of these options, see generally Irish, *supra* note 4, at 22-25.

134. See *supra* notes 119-25 and accompanying text.

135. This is defined and discussed in OECD, TRANSFER PRICING AND MULTINATIONAL ENTERPRISES 34-38 (1979) [hereinafter OECD/TRANSFER PRICING].

The "resale price method"<sup>136</sup> is similarly plagued in those instances where there is a great deal of disagreement over what a "fair" mark-up for profit should be, or indeed whether there should be a profit at all. The "cost plus method" runs into trouble when the definition of "costs" is debated. For example, do costs include research, advertising, or management? Finally, the "negotiated price method" may be the worst method of all.<sup>137</sup> In the give and take of negotiation, the final price is often based on criteria which are not objectively verifiable. Moreover, this is the crux of the present criticism of the Ecuadorian system.<sup>138</sup> Thus, the determination of actual transfer prices should be explicitly limited to the area where it works best — transactions involving goods for which there is an ascertainable open market price.

In addition to considering Argentina's price guideline method of checking transfer pricing abuse with respect to goods,<sup>139</sup> Ecuador may wish to consider some of the following options.

## 2. Taxation of intra-firm transfers

With regard to goods being sold to Ecuadorian companies, there is less chance of over-invoicing due to ad valorem duties or the value added tax placed on most imported goods.<sup>140</sup> However, for those goods not covered by the import ad valorem tax,<sup>141</sup> as well as for services and intangibles, a tax on intra-firm transfers might be desirable to curb abusive transfer pricing. This would entail placing a withholding tax or a net income tax on the profit portion of the intra-firm transactions. Unfortunately, this method has a number of drawbacks.

First, there is the problem of determining which sales should be taxed. If Ecuador only taxes sales within the jurisdiction, a company can move the place of sale across the frontier. If extra-territorial sales are taxed, problems result with respect to taxing an

136. *Id.* at 38-40.

137. See, e.g., Fiddlers, *supra* note 6.

138. See *supra* note 109 and accompanying text.

139. Argentina's guidelines are similar to those suggested by the OECD Model Convention. See OECD/1979, *supra* note 123. See also TOUCHE ROSS INTERNATIONAL, TAX AND INVESTMENT PROFILE: ARGENTINA, *supra* note 53, at 32.

140. The value added tax is summarized in TOUCHE ROSS INTERNATIONAL: ECUADOR, *supra* note 77, at 18; DELOITTE, *supra* note 80, at 43.

141. Exempt items include medicine, magazines, books, newspapers, basic food products, exports, and other products. DELOITTE, *supra* note 80, at 43.



entity which is not a permanent establishment.

Second, services can easily be rendered outside of the taxing jurisdiction. Thus, unless Ecuador decides to tax services provided outside of Ecuador and ignore the lack of permanent establishment, Ecuador will not have a basis for taxing the provider of the service.

Ecuador might consider denying to Ecuadorian entities the deductibility of transactions beyond Ecuador's tax jurisdiction. Yet this might result in the denial of deductions for legitimate expenses, thereby motivating firms to engage in transfer pricing in other areas to make up for the loss in deductibility. Further, it would negate the positive steps Ecuador has already taken to curb abuse.<sup>142</sup> Thus, this is not a very satisfactory method of preventing abusive transfer pricing in Ecuador.

Argentina's scheme forbids a subsidiary or branch of a foreign corporation to deduct royalty expenses from gross income.<sup>143</sup> While this rule does give domestic firms a competitive advantage over the operations of foreign entities in Argentina, it may also serve to discourage foreign investment in that jurisdiction, since the rule eliminates the deductibility of legitimate expenses of a corporation. Argentina, because it is newly industrialized, and because multinational corporations prefer more developed markets, may be able to do this without causing investment disincentive.<sup>144</sup> Ecuador, however, cannot afford to discourage investment by adopting the Argentine rule. At present, Ecuadorian law calls for approval of royalty expense deductions and deductions for other intellectual property on a case-by-case basis,<sup>145</sup> with no deduction being given for related party transactions.<sup>146</sup> Ecuador's provisions regarding royalties could be modified to allow for defensible transfer prices without as much discretionary judgment as is now the case. This would better reflect the reality of international transactions and would decrease the motivation to engage in transfer pricing abuse

142. See *supra* notes 40-42 and accompanying text.

143. See *supra* notes 66-67 and accompanying text. Interestingly, this rule is contrary to the general rule of deductibility of license and royalty expenses paid to overseas companies by domestic firms. *Id.*

144. See *THIRD SURVEY*, *supra* note 18.

145. See *supra* note 81 and accompanying text.

146. *Id.* As noted earlier, even Argentina allows a deduction for related party transactions involving licenses, patents, knowledge, engineering, installation, assistance, and other services, provided that they are approved by the Authority of Application. See *supra* notes 58-61 and accompanying text.

in other activities. Further, a liberalization in this area would offset tightening restrictions in other areas. So long as the Ecuadorian government realizes the difficulties of setting a transfer price and allows the corporations a "good faith" range in which to set prices, liberalization of provisions regarding royalties and other transfers could enhance Ecuador's investment image.

### 3. Limiting the deductibility of expenses

Another method to deter abuse which Ecuador may wish to consider is using limitations on the deductibility of certain expenses. Argentina allows deductions for fees, salaries, and other remuneration to foreign members of a company's corporate board of directors.<sup>147</sup> However, the deductions are capped by objective, easy to compute formulas. Ecuador considers this a "payment for services" under Article 46, which again places the burden on the firm to establish the merit of the transaction.<sup>148</sup> Not only does Ecuador's provision increase uncertainty, but it also has the potential for creating a perception of uneven enforcement. The merit of Argentina's provision is that it is easy to enforce, as well as easy to comply with. As Ecuador already allows a deduction, a less discretionary standard may prove more manageable for both government and business.

Argentina allows the deduction of expenses for technology, financial assistance and other help from abroad even if the entities are related.<sup>149</sup> Yet, as with remuneration to board members, Argentina places an easily calculated, objective cap on the deductibility of these expenses.<sup>150</sup> In contrast, Ecuador places the burden on the parties to prove the legitimacy of the expenses before allowing a deduction.<sup>151</sup> Again, a liberalization of Ecuador's approach in this area might prove beneficial.

Argentina's approach with respect to remuneration to board members has the advantage of allowing for legitimate expenses while insuring that the deductions do not deviate too radically from the expected norm. Ecuador's case-by-case approach is a disincentive to foreign capital investment. Companies now required to

147. See *supra* notes 68-69 and accompanying text.

148. See *supra* note 94 and accompanying text.

149. See *supra* notes 70-72 and accompanying text.

150. *Id.*

151. *DUN'S MARKETING SERVICES*, *supra* note 90, at 2.448.



report to the Director's Office of Income Tax for specific individual regulations computed in a manner "most beneficial to the country,"<sup>152</sup> could, under this scheme, deduct defensible assistance expenses up to a reasonable limit.

On closer inspection, it becomes apparent this proposal is flawed as well. The determination of the expense is no more certain here than was the establishment of an actual transfer price under previous methods. This proposal has the additional limitation of not allowing for legitimate expenses above a certain artificially-imposed cap. Thus, this method also is vulnerable to criticism.

#### 4. Artificial restraints

Artificial restraints are yet another way to prevent abuse. Under this method, Ecuador would ban certain types of suspect payments to related entities outside of Ecuador. At present, Argentina bars any transfer price payment for trademarks.<sup>153</sup> This is probably the most drastic and least desirable method in today's business world, where firms are often dependent on related entities for information and expertise, trademarks, patents, engineering, machines, liquidity, and so on. Again, given the strides Ecuador has taken to deter abusive transfer pricing by improving the economic climate,<sup>154</sup> this approach may be least desirable for Ecuador.

#### 5. Notional prices

Posted or notional prices are often used for primary commodities. This method establishes the price of a primary good as a percentage of a downstream product for which a price is available. Such a system is also available for intermediate goods.<sup>155</sup> Thus, this mechanism can be used to establish an objectively verifiable transfer price.<sup>156</sup>

Notional prices can be used to check transfer pricing abuse with regard to primary products. Basically, notional prices amount

152. *Id.*

153. See PRICE WATERHOUSE, *supra* note 58.

154. See *supra* notes 39-41 and accompanying text.

155. *Supra* note 33, at 20.

156. See generally Irish, *supra* note 4, at 27-28; SEVENTH REPORT, *supra* note 131, at 34-35.

to an official export price listed by the government. They have the advantages of being both extremely easy to calculate and predictable. On the down side, notional prices can only be established where open market prices allow for such a price. Thus, the method is not really very practical where intangibles, services, and non-open market goods are involved. Given these shortcomings, the use of notional prices should be limited to the export of primary products.

The last two options available to Ecuador do not attempt to use methods to estimate the true transfer price. Instead, they break from these earlier methods by trying to use generalizations rather than accounting formalities to estimate a proper income allocation.

#### 6. Taxation of world income with tax credits

If there were a globally uniform tax rate, the tax evasion incentive for transfer pricing would disappear.<sup>157</sup> Whether profits surfaced in one country or another, the same tax would be due. Unfortunately, such a system does not now exist. Further, there may be policy reasons why such a system would be undesirable. Developing countries may wish to give tax incentives to encourage investment. Tax havens, which owe their wealth to their tax status, will obviously be reluctant to join in with such a plan. Thus, this concept is not feasible in today's economic world.

Yet Ecuador could consider a similar plan in an adapted form. This would entail computing the tax base as a company's worldwide income and then giving tax credits for taxes already paid overseas. Under this system, to the extent that a company is able to move profits from a high tax jurisdiction to another lower tax jurisdiction, the reward for such a transfer will be non-existent, because less tax credits will be accumulated in the low tax jurisdiction. In theory, this would put an end to the tax evasion incentive for transfer pricing abuse.

However, this system creates many additional problems. First, the scheme does nothing to discourage non-tax reasons for transfer

157. For a discussion of "international harmonization of taxes," see S. PLASSCHAERT, *supra* note 15, at 14, 104-05. Interestingly, Pope Paul VI's statements during Vatican II support the notion of a worldwide tax system. See R. BROWN, *THEOLOGY IN A NEW KEY* 33 (1978). Similarly, the World Council of Churches, a main line Protestant organization, has called for a system of international taxation for world development. *Id.* at 41.



pricing abuse.<sup>158</sup> Second, other developing nations would object to this formulation because it would financially deprive companies of the benefits they receive from operating in countries which grant tax holidays as a means to stimulate investment. Third, Ecuador would in effect be able to tax non-Ecuadorian foreign source income any time a company conducted business in any other country which had a lower tax rate than that of Ecuador. This would mean that corporations would be deterred from conducting business in Ecuador. Thus, this approach is not one which Ecuador should seriously consider.

### 7. Apportionment schemes

A final method by which Ecuador could effectively tax corporations on their Ecuadorian income and deter transfer pricing abuse is the use of an apportionment mechanism. This method taxes the entire unitary corporation on a portion of its worldwide income.<sup>159</sup> The portion taxed is determined by an apportionment formula, which allocates world income on the basis of such factors as sales,<sup>160</sup> property, and payroll. Many American states have apportionment formulas, although the formulas vary from state to state.<sup>161</sup> However, many states subscribe to the Council of State Government's "Multistate Tax Compact,"<sup>162</sup> which the U.S. Supreme Court has held to be valid, despite the fact that it lacks Congressional endorsement.<sup>163</sup> The compact outlines a uniform formula for allocating income for net income tax purposes among the states.<sup>164</sup>

The apportionment method has a number of virtues. First, it is easy to administer. Ecuador would not need to conduct elaborate audits to discover the "true" transfer price because transfer prices

158. Irish, *supra* note 4, at 75.

159. *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159 (1983).

160. *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978) (upholding Iowa's single factor formula as applied, based on percentage of sales in the state).

161. For example, Wisconsin has a statute on allocation, apportionment, and situs of income. WIS. STAT. § 71.07 (1985).

162. The compact is laid out in Corrigan, *Interstate Corporate Income Taxation - Recent Revolutions and a Modern Response*, 29 VAND. L. REV. 470 (1976).

163. *United States Steel Corp. v. Multistate Tax Comm'n*, 434 U.S. 452 (1978). See also Brooks, *Worldwide Combination Upheld at Cost to the Commerce Clause*, 2 J. STATE TAX 293-314 (1984); Christian, Howe & Harrington, *State Power to Tax Interstate Carriers: The Supreme Court's Decision in Burlington Northern Railroad Co. v. Oklahoma Tax Commission*, 55 TRANSP. PRAC. J. 219-41 (1988).

164. For a discussion of the compact, see Corrigan, *supra* note 162, at 423.

are irrelevant under this scheme. Multinationals can set the transfer price at whatever they like without influencing the overall profit of the unitary corporation. Second, it is predictable. Unlike the "fuzzy" nature of transfer pricing, apportionment formulas are clear and objective. This also aids in the avoidance of the favoritism presently engaged in by the tax administration under Ecuador's current system of discretion. Third, many multinationals operating in the United States are already familiar with the system and are accustomed to using it.<sup>165</sup> Even though the method is not popular outside of the United States, the fact that it has wide currency within the country suggests that it could be employed elsewhere.

Still, there are criticisms of apportionment systems. First, it may result in over- and under-taxation. For example, if parent of Unitary Corporation is located in country A, and related corporation, Subsidiary, is located in country B, if the overall profits of Unitary Corporation are \$100.00, an apportionment formula might allocate this profit \$50.00 to parent and \$50.00 to Subsidiary, assuming that labor, sales, and property were equally distributed between the two jurisdictions. However, in actuality, Subsidiary may have had a profit of \$120.00, and parent a loss of \$20.00, or vice-versa. Thus, the apportionment formula would over- or under-tax the entity.<sup>166</sup> But this criticism ignores the fact that apportionment allows the flexibility of averaging of taxes and income. Over- and under-taxation is the strength of apportionment because it allows corporations to use profits which would be taxed in one jurisdiction for investment in new areas which may create losses in the early years due to start-up expenses.

Second, critics of apportionment claim that the record-keeping involved in the system is too burdensome. Yet, since corporations operating in the United States are required to keep such records, many multinationals already have the records available. Ecuador could further ease the record-keeping burden by allowing records to be denominated in U.S. dollars instead of requiring that they be translated into sucres.

Third, it is argued that the system is unpopular with multinationals. Some American states have repealed their laws mandating

165. For an opposing viewpoint, see OECD/TRANSFER PRICING, *supra* note 135, at 14 (calling "global" methods "radical," and noting their non-conformity with Articles 7 and 9 of the OECD Model Double Taxation Convention).

166. *Id.* at 14 (global methods of income allocation called "arbitrary").



a unitary formula after foreign businesses threatened to pull out of the state.<sup>167</sup> In this respect, the apportionment method is admittedly quite controversial. However, it is important to note that the threats came to the states from foreign multinational corporations. Further, such objections may be a response to the certainty of taxation involved with this system. Apportionment allows for no transfer price evasion of tax. Thus, the objections by multinationals may be seen in another light as an acknowledgement of the perceived effectiveness of the plan at preventing tax evasion.

Fourth, apportionment has been criticized in the United States because it involves the states in the diplomatic arena. Indeed, while the Supreme Court has never flunked an apportionment scheme on its face, "Congress could prevent the use of the unitary business concept, and . . . a treaty might also forbid employing the concept."<sup>168</sup> Indeed, Congress has in one case mandated that states may not tax foreign corporations if all they do in the state is solicit orders.<sup>169</sup> Thus, states may be reluctant to adopt such a scheme because of a fear of later federal intervention. However, Ecuador need not have these concerns, being a sovereign nation. Thus, the appeal of apportionment becomes stronger.

Fifth, apportionment presents the problem of precisely defining a "unitary corporation." Depending upon the circumstances, tax authorities may want a broad interpretation, while corporations may desire a narrow view, or vice-versa. The inclusion of more overseas entities in a unitary corporation will yield two results. First, it will increase the income subject to apportionment. Second, it will decrease the percentage of that income which will be attributable to the jurisdiction. The U.S. Supreme Court has held that the taxpayer always has the "distinct burden of showing by 'clear and cogent evidence' that [the state tax] results in extra-territorial values being taxed."<sup>170</sup> Thus, the U.S. standard is a starting point. Ecuadorian tax officials could make their best calculation as to what constitutes a unitary corporation under Ecuadorian tax law and then place the burden on the taxpayer to rebut the presumption.

Sixth, apportionment raises the possibility of double tax-

167. Baldwin & O'Conner, Notes for Constitutional Law I 25 (Fall 1986) (unpublished notes for a course taught at the University of Wisconsin Madison Law School).

168. *Id.* at 24.

169. *Container Corporation of America v. Franchise Tax Bd.*, 463 U.S. 159, 175 (1983).

170. *Container Corp. of America*, 463 U.S. at 175.

tion.<sup>171</sup> Indeed, some of the income taxed by foreign nations without apportionment because attributed to a taxpayer's foreign subsidiaries, may also be taxed in Ecuador as the Ecuadorian portion of the total income of the unitary corporation of which Ecuadorian operations were a part.<sup>172</sup> Yet double taxation is not an inevitable result of apportionment. Apportionment merely uses mathematical generalizations to estimate the allocation of income, while the arm's length approaches utilize complex and formal accounting mechanisms. From one point of view, allocation on the basis of the factors of production and the amount of sales is a more accurate measure than allocation on the basis of arm's length accounting formalities.<sup>173</sup> Thus, if double taxation results because of Ecuador's acceptance of the apportionment notion, it may be as much due to the inaccuracy of the arm's length approach as to the overreaching of the apportionment scheme.

In order to reduce the threat of double taxation under the apportionment method, Ecuador could take several steps. First, it might develop its own multi-nation tax compact and encourage Andean Pact nations to consider joining.<sup>174</sup> This would establish a uniform formula, and help to avoid double taxation resulting from differing formulas. Second, Ecuador could use tax treaties as a means of coordinating taxation with other jurisdictions so as to avoid double taxation — something Ecuador does not now do even under the arm's length approach.<sup>175</sup> Third, Ecuador could use apportionment to set the level of taxation, while allowing corporations to petition tax authorities when threats of double taxation arise. Tax authorities could then consider the merits of the case and decide the case accordingly.

Ecuador's present economic situation would improve under the apportionment method. Ecuador's manufacturing sector is geared primarily for the internal market.<sup>176</sup> Additionally, Ecuador is a net importer of wheat and livestock.<sup>177</sup> Thus, arm's length ap-

171. OECD/TRANSFER PRICING, *supra* note 135, at 15.

172. This is analogous to the situation in *Container Corp.*, 463 U.S. 159.

173. Indeed, the United States uses apportionment in a number of cases in which formal accounting fails to produce an appropriate allocation. This is the "residual" method under I.R.C. § 482 (1988). Internationally, apportionment is accepted and used in shipping and air transport.

174. S. PLASSCHAERT, *supra* note 15, at 14 (advocating regional harmonization).

175. See *supra* note 119 and accompanying text.

176. U.S. Dept. State, *supra* note 117, at 7.

177. *Id.*



which are useful in these areas, would be put to little use in exporting. However, Ecuador's big export is oil.<sup>178</sup> World prices are useful with such a commodity, determining such things as know-how, exploration, and resale would be troublesome. Further, the complexities will be enhanced by multinationals such as Occidental, Belco, Esso/HighConoco, British Petroleum and Texaco/Pecten currently operating in Ecuador. Thus, a more certain and predictable method of apportionment might be preferred.

#### V. CONCLUSION

Transfer pricing abuse is an available tool for tax evasion. It has great potential for abuse which, if left unchecked, could result in significant tax evasion. However, countries like Ecuador must consider the policy implications of exercising stricter controls over transfer pricing. Ecuador has already taken a number of steps to control transfer pricing abuse. What remains to be done is to develop an appropriate mechanism for improving Ecuador's current system.

There are a number of approaches Ecuador could take to control transfer pricing abuse. Basically, the approaches fall into two categories: those which use accounting principles to determine a deemed transfer price based on the arm's length concept as a method to allocate income, and those which use mathematical formulas. In each case, selection becomes a process of weighing costs and benefits.

The first option, determination of the "actual" transfer price, is successful when used for transactions in goods for which an open market price exists. It is not as effective when dealing with nonmarket goods, services and intangibles. Its efficiency can be improved, however, by using monitoring systems, audits, tax rulings and correlative price adjustments. Computation of a deemed price will be very difficult under this approach and may not be more accurate than under other measures.

Another method to deter transfer pricing abuse is the taxation of party transfers. This works best for services and intangibles which are not subject to the value added tax. Yet,

problems surface as to what sales and services should be taxed if they are provided overseas. Were Ecuador to tax overseas services and sales, it might compromise the progress which it has already made. Thus, this method is probably not the one best suited for Ecuador.

A third method limits the deductibility of expenses. Yet this method, too, is faulted for not allowing for legitimate deductions. Since Ecuador's last two administrations have been attempting to make Ecuador a better place for investment, this would be a step backwards.

Artificial restraints are a fourth option. Under this system, certain expenses may not be charged by a parent to its subsidiary. Argentina's ban on payments for the use of trademarks is an example of an artificial restraint. This approach also discourages business by disallowing legitimate related party expenses. Thus, this approach should not be used in the case of Ecuador, which, unlike the larger and more economically developed Argentina, cannot afford to discourage investment.

Notional prices are a fifth option. These can be used only with primary products for which an open market price exists. They are not very useful when dealing with vertically integrated firms, such as Ecuador has in its area of primary export — oil. Thus, this method would be of limited value to Ecuador.

The sixth and seventh options differ from the previous five in that they break away from trying to establish an arm's length price. The sixth method calls for an Ecuadorian tax on worldwide income with the granting of tax credits for tax paid to other jurisdictions. Unfortunately, this sort of system is not popular internationally and would deprive companies of the benefit of investment in countries which grant tax holidays to encourage investment.

The final method, and the method this author most favors, is the apportionment method. Under this method, Ecuador would tax a unitary corporation on its worldwide income. Using an apportionment formula, Ecuador could estimate what portion of the unitary corporation's profits were Ecuadorian source income. This system is predictable and easy to administer. Further, it involves no messy attempts to determine the elusive defensible transfer price. Thus, this is the method recommended for Ecuador's use. It should be noted that apportionment may be useful even if it is not chosen as the primary method for Ecuador. It can be used as a



proxy to establish that which more formal accounting methods should produce.<sup>179</sup>

If Ecuador combines these suggestions with the other economic liberalization steps which it is already in the process of implementing, it should be able to cut back on the transfer pricing abuse which is now occurring. Further, it will avoid the perception of anomalous, discretionary results. Investors will perceive the new scheme as a reduction in the bureaucracy involved in the investment process. In short, as Ecuador moves from subjective to objective criteria in its taxation, investors will find it easier to comply with the law while the government will find it easier to enforce.

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179. OECD/TRANSFER PRICING, *supra* note 136, at 15.