Globalization, Multinationals and Tax Base Allocation:
Advance Pricing Agreements as Shifts in International Taxation?

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Abstract

This paper elaborates on the emergence of so-called Advance Pricing Agreements (APA) in international taxation and corresponding APA programs in individual countries. It refers to how globalizing business processes trigger governance change on the nation state level regarding the identification and allocation of the tax base of multinational companies. The introduction of APA programs and the generation of APAs are considered to be an example of such governance change. On the basis of a governance choice model, the paper seeks to identify factors which might explain variation in the evolution of national APA programs and the implementation of individual APAs between the taxpayer and the tax authorities. Differences in institutions, economic conditions, and the actors involved are important in explaining variation across countries.

Keywords: Advance pricing agreement, multinational companies, transfer pricing, international taxation, cooperation, non-bureaucratic, governance choice.
JEL: F02, H11, H87, K34, L14

1 Introduction

Taxing multinational companies has become a fuzzy enterprise for both the taxpayer and the tax collector. While the globalization of international business structures has developed at an impressive speed and scope, the international institutions, regimes, and organizations regulating such cross-border businesses still seem to be in their infancy. International taxation appears to lack governance structures which correspond to expanding global business activities, especially with respect to transfer pricing.

Although OECD tries to play the role of a 'standard' setter by developing a certain degree of international standard and regime,[2] international taxation governance still appears to need an administrative shift from domestic to comprehensive global governance in terms of regulation and procedure, and in terms of tax collection. However, this development appears to lack global institutions and coordination (Garcia, 2005: 12; comp. also Roin, 2002; Tanzi and Zee, 2000) including enforceable governance for both the taxpayer and the tax authority. A large volume of pending litigations on international tax issues demonstrates this lack of global institutions.[3]

A recent development for avoiding disputes ex ante is the advance ruling systems and so-called APA programmes in many industrialized countries and individual advance pricing agreements (APAs) between multinational corporate taxpayers and tax authorities. APAs are mostly used in the field of transfer pricing to resolve international tax controversies.[4] They can be labelled as a sort of negotiation mechanism between sovereign states and between the multinational taxpayer with taxing state(s) to resolve tax transfer pricing disputes (Waegenaere et al., 2005).

This paper examines factors which may affect differences between countries in terms of the existence of APA programmes and the use of individual APAs. It proposes a mechanism to explain the existence of APAs and – as I hypothesize – its temporary deployment in international taxation. It also reveals possible reasons as to why certain countries have introduced APA programmes and what relevance APAs may play in international taxation in the future. To provide for the contextual nature of APAs, some key features of transfer pricing are presented first.

2 Transfer Pricing and APAs

Cross-border business between foreign affiliated parties of multinational corporate company groups is of increasing importance in today's business world. Depending upon the countries involved, a large share of the total cross-border exchange of business transactions is coordinated within the boundaries of multinational companies (MNCs) at the turn of the 21st century.[5] With the continuing globalization process in the modern business world, we can expect this proportion to increase significantly for many countries in the near future. Alongside this development, several multinational groups have been changing their organizational and business structures. For example, many MNCs are organized along business lines irrespective of legal entity structures (Brem and Tucha, 2005; Lengsfeld, 2005; Wilkinson, 2002; Buckley and Casson, 2000).

2.1 Transfer pricing and MNC

While new business structures seem to ignore national borders, taxing income generated through such business is still governed on a national basis through country-specific accounting and

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2 OECD Model Tax Convention (OECD, 1995a) and OECD Transfer Pricing Guidelines (OECD, 1995b).

3 Irving (2001) reports litigation periods of up to 15 years; also Walpole (1999), Erard (2001).

4 In its Transfer Pricing 2001 Global Survey, the tax consulting company Ernst & Young interviewed 638 parent corporations and 176 subsidiaries in 22 countries: 85% of parents and 94% of subsidiaries stated that transfer pricing is the most important tax issue for them. Among the interviewed parent companies, 52% in the US, 48% in UK, and 19% in Japan considered an APA in the future; see also http://www.legalmediagroup.com/default.asp?Page=1&SID=15032

5 European Commission 2002, 2001; Neighbour 2002 [reporting a share of up to 60%]; OECD 2001a; The Economist 2001; Whalley 2001; Owens 1998; Feldstein et al. 1995.

taxation principles and provisions allocating the jurisdiction's tax base. The rules vary significantly across different countries and even between countries within comparatively harmonized economic regions (European Commission, 2001), which are subject to domestic legal and administrative traditions. This variation in tax rules across national tax jurisdictions (countries) causes different degrees of complexity and uncertainty for both the tax authority and the taxpayer regarding tax base allocation (comp. Messere, 1993; OECD, 2003). Such complexity and controversy can be especially identified in the field of transfer pricing.

Transfer pricing refers to the pricing of goods, services, capital and technology inputs, managerial skills, financial services, shared/support services, etc. if they are transferred between affiliates of MNCs. With respect to today's global business structures, intra-group transfers of technology, management services, and financial loans move around within the MNC family. Intermediate goods (parts, components, and subassemblies) flow downstream for further processing within the boundaries of the MNC (or coordinated by it) before a final sale to third parties (B-to-C or B-to-B). At the same time, some affiliates may provide shared services to group business services (legal, accounting, advertising, IT, etc.) on behalf of the group, or its headquarters (Eden and Kurdle, 2005; Brem and Tucha, 2005; Eden, 1998).

In tax terminology, the pricing of intra-group transactions is normally based upon so-called transfer pricing methods (TPMs), of which at least six categories are internationally recognized for tax purposes.[6] The basic framework for applying TPMs is provided by the internationally accepted Arm's Length Principle (ALP) (OECD 1995a: Art. 9(1)) which says that a transfer price needs to be in accordance with a price the two parties would have agreed on in a market transaction outside the group of related parties under similar conditions. With respect to the comparability of related-party transactions and market transactions and given the limitations in comparable data availability, the combination of ALP and TPMs provides much room for interpretation, discretionary power, design options, and transfer price manipulation affecting the tax base allocation.

With the emergence of national documentation requirements implemented by an increasing number of national tax authorities to enforce ALP (OECD 1995a), MNCs are now becoming increasingly aware of the need to set appropriate ("non-manipulated") transfer prices for delivering goods and services within a MNC. However, intra-group flows often associated with intra-group trade such as patents, trademarks and financial services, etc., are what leaves both the taxpayer and the tax authorities puzzled on pricing individual related-party transactions and/or offsetting with other related-party transactions. Also, various facets of tangible related-party transactions (e.g. goods, services) open a wide range of possible interpretations as to what is the appropriate transfer price which meets the ALP criteria.

As a consequence, almost any transfer price is exposed to the uncertainty as to whether it is assessed as arm´s length or not and, if not, to what extent the income from such related-party business will be adjusted by tax authorities. This tax uncertainty is even more striking since the feedback from the tax authority as to whether a transfer price is arm's length often comes several years after the transaction between related parties took place. Also, accounting and tax provisions often leave transfer pricing as a "game of dice" for the taxpayer and the tax authorities: whether a transfer of economic value needs to be priced or not depends upon the interpretation of country-specific provisions. MNCs and tax authorities have controversial positions about – or are often not fully aware of – which kind of value transfer need to be priced and which do not. Consequently, many such interpretations are done by courts rather than, in the first place, by the taxpayer. Since much related-party business is outside any pricing mechanism at all (Ernst &

[6] TPMs are: transaction-based methods such as Comparable Uncontrolled Price (CUP), Cost Plus (C+), Resale Price Minus (R-), Transactional Net Margin Method (TNMM); profit-based methods are Residual Profit Split Method (RPS), Comparable Profit Method (CPM), and Profit Split Methods (PS). Some countries also consider Formula Apportionment using certain allocation factors (e.g. assets, sum of wage, turnover) as an appropriate TPM (comp. Eden, 1998).

Young, 2003), today's tax bases of multinationals are generally underestimated, let aside the controversial search for appropriate prices.

2.2 Identifying the tax base

Transfer pricing and income allocation in the course of taxing multinationals is primarily driven by the problem of defining and identifying the tax base.[7] To do so, transfer pricing experts, such as internal experts of MNCs, as well as consultants and tax authorities, make use of analyses on the basis of so-called functions, risks, and assets to assess transfer prices under ALP. However, despite these analytical exercises and the use of top-level expertise,[8] transfer pricing can be characterized by vagueness, fuzziness, premature concepts, and lack of transparency. Transfer pricing is still at an early stage of institutionalization and standardization – if compared with classical national tax issues. For example, whether, in principle, a trademark is valuable or not is subject to the business partners' assessment (as long as the relevant accounting principles do not prescribe the valuation and its accounting). The size of the trademark's value may be even more subject to the business partners' discretion and assessment. The answers to such questions significantly affect whether the cost expensed in developing such a trademark is deductible for tax purposes. So, the amount of the state's corporate income tax revenue depends to a large extent on the view that both MNC (and its related-party taxpayer) and tax authorities can agree on various items defining the tax base.

An even more challenging problem in setting appropriate transfer prices in accordance with ALP is related to business restructuring activities and investment issues. This is an ongoing process of shifting business functions, risks, and assets from one tax jurisdiction to another one – mostly from a high-wage or high-tax jurisdiction into a more preferential one. Regularly, a shift of the tax base accompanies business restructuring. If, for example, in a high-tax country expenses were deducted in the course of developing, say, a production site including patents and manufacturing processes, the multinational company may have reason to shift such functions to a low-tax and/or low-wage country at a time when, along the product life cycle, the product starts generating high profits. Such a shift is often realized after the investment has been paid and deducted (depreciation) and the loss carry forwards are wiped out. As a consequence of outbound business restructuring at the time of the product life cycle, the tax jurisdiction loses twice: firstly through the shift of tax base of future profits and, secondly, when it previously allowed the deduction of expenses (depreciation) to establish this tax base (and in many cases, thirdly, even through tax holidays granted for the investment).

In general, the identification of an MNC's relevant tax base and the allocation of this tax base into the jurisdiction in which the multinational operates (or was operating), is a key problem in corporate income taxation. Some steps to harmonize international or supranational corporate income taxation have already been taken: the dense net of double tax treaties, the OECD model tax convention and the OECD Transfer Pricing Guidelines, or the initial attempts of the EU tax

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[7] As is often misunderstood in the public debate on tax reforms and tax burdens, the key challenge in both domestic and international taxation is not the size of the tax rate but whether principles such as "tax withholding" vs. "revenue sharing with information exchange" between countries are applied (Keen and Ligthart 2005). Under the latter case, the determination and identification of the tax base is the core problem. One reason for the misleading discussion on the relevance of (nominal) tax rates on the total tax burden of a taxpayer might be caused by the economic models used for cross-country comparisons of the tax burden. These models normally assume comparable procedures and methods to identify the tax base on which a different tax rate is applied and for what affect it will have on the taxpayer (e.g., investment behaviour). Often the large variance across countries to define the tax base is not reflected, especially in the field of pratised transfer pricing with its huge dependency upon the definition of expenses and cost in a given jurisdiction of accounting principles. Transfer pricing plays a key role in identifying the tax base, hence constituting a 'hot topic' in international taxation (Eyk, 1995; Bartelsman and Beetsma, 2000; Ernst & Young, 2003).

[8] All major tax and business consultancies including audit units (PricewaterhouseCoopers, Ernst & Young, KPMG, Deloitte & Touche, Transfer Pricing Associates, GlobalTransferPricing) do run a global team of top transfer pricing experts providing services to their international clients. Consultancy fees for transfer pricing services are among the highest in the tax consulting service industry segment.

harmonization process. However, the general institutionalization process in international taxation is still in its infancy and is characterized by a low level of harmonization regarding cross-country procedures.[9]

2.3 About APAs in Taxing Multinationals

Several national tax authorities have established Advance Pricing Agreement (APA) programmes (for an overview, see Brem, 2005; the analysis is provided the next section). An APA is an arrangement that determines, ideally in advance of controlled related-party transactions, an appropriate set of criteria for the determination of transfer pricing for those transactions over a fixed period of time (Sawyer, 2004; Vögele and Brem, 2003a). The criteria shaping an APA are, for example, the transfer pricing method(s) used, the possible third-party comparables and appropriate adjustments, and the so-called critical assumptions which define economic indicators as a framework for using TPMs: ranges of currency fluctuation, market development, economic crises, etc.

2.3.1 The OECD perspective on APAs

Normally, an APA is formally initiated by a taxpayer and requires negotiations between the taxpayer, one or more related-party entities, and the tax administration(s) of one or more nation states. APAs are intended to supplement the traditional administrative, judicial, and treaty mechanisms for resolving transfer pricing issues. They may be most useful when traditional mechanisms to allocate income of related-party business within a multinational group fail or are difficult to apply because of a lack of institutionalization and standardization in international taxation aspects such as transfer pricing and tax base allocation (OECD 2001b: Par. 4.124).

The OECD Transfer Pricing Guidelines describe an APA as having the following characteristics (in reference to the mutual agreement procedures (MAP) of the OECD):

> […] The objectives of an APA process are to facilitate principled, practical and co-operative negotiations, to resolve transfer pricing issues expeditiously and prospectively, to use the resources of the taxpayer and the tax administration more efficiently, and to provide a measure of predictability for the taxpayer.
>
> […] To be successful, the process should be administered in a nonadversarial, efficient and practical fashion and requires the co-operation of all the participating parties. It is intended to supplement, rather than replace, the traditional administrative, judicial, and treaty mechanisms for resolving transfer pricing issues. Consideration of an APA may be most appropriate when the methodology for applying the arm's length principle gives rise to significant questions of reliability and accuracy, or when the specific circumstances of the transfer pricing issues being considered are unusually complex.
>
> […] One of the key objectives of the MAP APA process is the elimination of potential double taxation. (OECD, 2001b: A 9.-11.).

In contrast to the traditional form of tax assessment, which is often an adversarial mechanism imposed by a sovereign tax authority, an APA is a kind of cooperative arrangement between tax authorities (of at least one jurisdiction) and a multinational corporate taxpayer (Ring, 2000; OECD, 2001b: Par. 4.135). In addition to classical *ex post* binding rulings, an APA serves to

[9] This can be also illustrated by the fact that, if a certain tax case enters the process of so-called Mutual Agreement Procedures (MAP), in many countries the Ministry of Foreign Affairs needs to be involved to meet the requirements of such country to interact internationally.

resolve, in a cooperative manner before the business has taken place, the potential transfer pricing disputes between these parties. As the OECD points out:

> APAs, including unilateral ones, differ in some ways from more traditional private rulings that some tax administrations issue to taxpayers. An APA generally deals with factual issues, whereas more traditional private rulings tend to be limited to addressing questions of a legal nature based on facts presented by a taxpayer. The facts underlying a private ruling request may not be questioned by the tax administration, whereas in an APA the facts are likely to be thoroughly analysed and investigated. In addition, an APA usually covers several transactions, several types of transactions on a continuing basis, or all of a taxpayer's international transactions for a given period of time. In contrast, a private ruling request usually is binding only for a particular transaction. (OECD, 2001b: Par. 4.133).

Advance ruling systems and, in particular, APA programmes, are increasing in number and are now deployed by many states, particularly OECD member states. However, such states differ in the timing, type, and scope of APAs used for resolving transfer pricing issues. Early forerunners include the United States, Canada, the Netherlands, the United Kingdom, France, and Japan. China, Korea, and Mexico, among others, are following such examples.

The most comprehensive study on transfer pricing is the Ernst & Young Global Transfer Pricing Study, which is published every second year since 1995. The latest available edition is the 2005 Survey (Ernst & Young, 2005). The survey of 2003 (Ernst & Young, 2003) contains information about APAs on over 800 MNC entries, of which 14 per cent of parent companies and 18 per cent of subsidiaries used the APA process to seek a higher level of transfer pricing certainty (p. 23). Out of the companies which used APA processes – almost 90 per cent (87 percent of parents, 89 per cent of subsidiaries) – indicated that they would use the APA process again.

The survey also states (Ernst and Young, 2003: 23) that

> [N]onetheless, if tax administrations want their APA programs to attract taxpayers, they must still overcome the perception that they are not “user friendly”. The trend among non-APA using parents to consider use of APAs in the future continued to decline in this survey. Only 33 percent of parents responded favorably in 2003, down from 38 percent in 2001, and 45 percent in 1999. However, this year we find that non-APA using subsidiaries indicate increasing openness to future use of APAs – 47 percent this year, compared to 34 percent in 2001 and 41 percent in 1999.

In general, the preliminary approval of a certain transaction is considered appropriate in cases where such transactions are rare and would need complex statutory provisions. APAs normally refer to such special cases, namely complex related-party transactions of multinationals for which standard transfer pricing technique may not apply or might be viewed differently by the parties involved (e.g. taxpayers and tax administrations of countries involved).

In countries that apply the OECD Model Tax Convention and the OECD Transfer Pricing Guidelines, the APA process is designed to produce a formal agreement between the taxpayer and the revenue authority on four basic issues (OECD, 1999; IRS, 2002; Ernst and Young, 2003: 22):

- the factual nature of inter-company transactions to which the APA applies;
- an appropriate transfer pricing methodology to apply to those transactions;
- the expected arm’s length range of results from application of the transfer pricing methodology to transactions;
- in a bilateral or multilateral APA, in addition to the agreement between the taxpayer and the domestic tax administration (e.g. the local revenue authority), a mutual agreement between the competent authorities of participating states.

As the Ernst & Young 2003 Survey indicates (Ernst & Young, 2003: 22), an APA links the prospective application of agreed transfer pricing methodology to the taxpayer's covered transactions, usually for a period of five years. In addition, such methodology may also apply to all open tax years (years not yet audited) prior to APA years. Such rollback may sometimes cover as many as six or seven years. For bilateral APAs, a MNC can thus achieve certainty on two jurisdictions' treatment of its related-party transactions for a significant period of time. Though it can be a lengthy and somewhat costly process, an APA presents an efficient alternative to the traditional means of resolving a transfer pricing dispute and can provide certainty for a period of over a decade.

2.3.2 Implemented programmes

The most detailed and widespread APA programme is operated by the US-IRS, a forerunner implementing a defined "APA Program" for transfer pricing and international tax issues. Under the US approach, the taxpayer voluntarily submits an application for an APA, together with a user fee as outlined in the respective Rev. Proc. 2004-40 (here: § 4.12). An APA under jurisdiction of the US-IRS APA Program is in principle a contract between the tax administration and the taxpayer. Given the contractual nature of this agreement under private law, the tax administration enjoys a relatively high degree of flexibility. The contract rules out the key fact pattern of the transfer pricing case as considered later for audit purposes, the determination of the respective transfer pricing method for this business, and the critical assumptions underlying this method. The contract also determines the length of the agreement and, if necessary, the mode of adjustment which applies to any changes in business and/or the critical assumptions.

In direct contrast to other countries, such as Germany, the US IRS has established its APA programme with dedicated resources and capabilities (offices, human power, etc; see Figure 1). In 2004, the APA office consisted of four branches with Branches 1 and 3 staffed with APA team leaders and Branch 2 staffed with economists and a paralegal. Branch 4, the APA West Coast branch, is headquartered in Laguna Niguel, California, with an additional office in San Francisco, and is presently staffed with both team leaders and an economist.

Director's Office 1 Director 1 Special Counsel to the Director 1 Secretary to the Director			
Branch 1 1 Branch Chief 1 Secretary 7 Team Leaders	Branch 2 1 Acting Branch Chief (also Special Counsel) 1 Paralegal 4 Economists	Branch 3 1 Branch Chief 1 Secretary 7 Team Leaders	Branch 4 1 Branch Chief 1 Secretary 3 Team Leaders 1 Economist

Figure 1 Office structure and APA staff of the US-IRS APA Program

Source: IRS (2005a: 6).

The APA Program has responded to the needs of top economic and procedural transfer pricing expertise with established internal training programmes for its personnel. The APA office continues to emphasize the priority of training (comp. IRS 2005a: 6) and has developed dedicated training packages. Training sessions address APA-related current developments, new APA office practices and procedures, and international tax law issues. The APA New Hire Training materials are updated throughout the year as necessary. The updated materials are available to the public through the APA internet site.[10] Though these materials do not constitute an explicit guide on the application of the arm's length standard (IRS 2005a: 6), by making the materials public, it is

[10] See http://www.irs.gov/businesses/corporations/article/0,,id=96221,00.html

hoped taxpayers may consider the views of the APA Program on developing, discussing, negotiating, and enforcing APAs. The IRS also seeks to achieve a higher level of mutual understanding of complex transfer pricing issues for the parties and people involved, including tax consultants, foreign tax authorities, and their competent authorities.

The APA process can be broken into five phases (Sawyer, 2004: 46; IRS, 2004: 3-6):

- application
- due diligence
- analysis
- discussion and agreement
- drafting, review, and execution

2.3.3 Non-adversarial governance of transfer pricing matters

It is a common understanding among transfer pricing experts that an APA is a mechanism through which the tax authority collaborates with the taxpayer in defining and determining the tax base of selected legal entities of a multinational group (Ring, 2000; OECD, 2001b; European Commission, 2001; Rodemer, 2001; Romano, 2002; Waegenaere, 2005). An APA is described as a collaborative governance model that involves state agency flexibility and provisional regulatory (IRS, 2000, 2005a) – in contrast to more inelastic, bureaucratic, and quasi-fixed codification of traditional tax base determination.

APAs are conceptually understood to be a non-bureaucratic coordination mechanism between the taxpayer and the tax authorities involved (normally two or more countries) on unique or controversial case facts and their treatment for transfer pricing purposes (Sawyer, 2004: 44). Although there is a certain level of international agreement among tax jurisdictions on the type and nature of transfer pricing issues and principles to be applied (e.g. the OECD-wide accepted ALP), not all jurisdictions in which the multinational operates (or is sought to be liable for taxation) have the same view on fact patterns and interpretation of legal principles (Rodemer, 2001; Sawyer, 2004). For example, the specific use of transfer pricing methods is causing increasing controversy between taxpayer(s) and their tax administration(s). Also, the increasing relevance of intangible assets (e.g. trademarks, patents, or know-how on production processes) determining the performance, profitability, and rentability of modern business organizations regularly causes transfer pricing controversy, and APAs may be used to resolve such disputes.

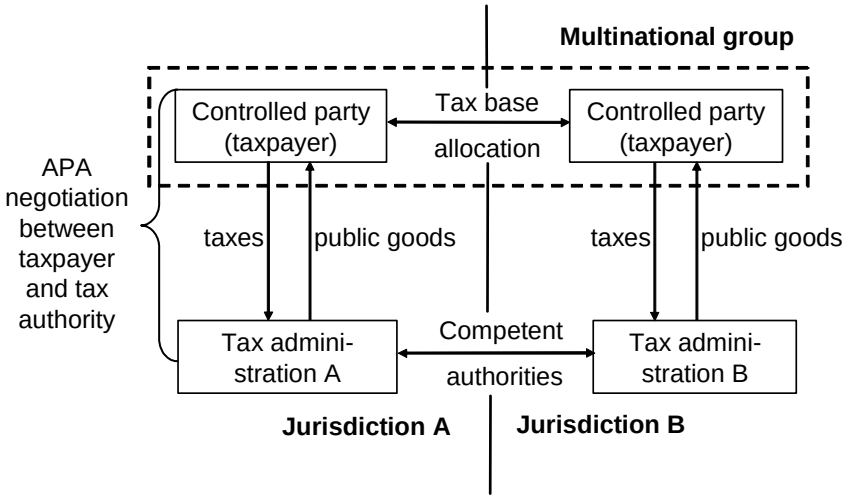
In general, the APA process is designed to enable taxpayers and tax authorities to agree on proper treatment regarding transfer pricing matters. The most important transfer pricing matters covered by APAs include (comp. IRS 2005b):

- the identification of functions performed, risks borne, and assets deployed for business with related parties of a MNC;
- the selection of an adequate transfer pricing method (i.e. a method to determine the arm's length result) out of a possible set of transfer pricing methods provided by the national transfer pricing regulations of countries involved;
- the definition of transactions covered by the APA and the case-specific design of the transfer pricing methods, including the determination of which (profit level) indicators will be used for comparing the related party's (= tested party's) profit margin with third-party comparables (unrelated companies);
- the definition of so-called "critical assumptions" which, independent from the filed income statement, are to be met by the taxpayer in order to deem the transfer pricing case in accordance with the terms and conditions of an APA when the tax case is assessed;

- the type and scope of required documentation which the taxpayer has to submit (normally each year) so that the tax administration can assess compliance with the APA provisions.

An APA refers to the relationship between the taxpayer and the tax administration (unilateral APA) in a given country. If more than one tax jurisdiction is involved (e.g. two nations), the APA is bi- or multilateral, and refers additionally to the relationship between tax authorities of both jurisdictions. In a bilateral or multilateral APA, the contractual arrangement between the jurisdictions is governed by the Mutual Agreement Procedures, if the relevant double tax treaty between these countries provides for that. The number of parties involved in an APA is not definite but subject to the APA in question. Figure 2 illustrates the basic structure of a bilateral APA.

Figure 2: Basic Structure of Bilateral APAs



Source: Vögele and Brem (2003b: 364).

2.3.4 APAs and binding rulings

Similar to APAs are so-called *binding rulings*. A binding ruling can provide the taxpayer with greater certainty and the tax administration with higher effectiveness of processing tax assessment and auditing than traditional tax measures may achieve (Sawyer, 2004: 41). The binding ruling is normally designed to illustrate the tax consequences of a given transaction either before the associated arrangement becomes unconditional, or at least before the tax return is filed and a tax position is taken concerning the arrangement.

In some tax jurisdictions, the terms APA and *binding ruling* refer to the same purpose, i.e. *ex ante* ruling. In other tax jurisdictions, the term *binding ruling* is referred to as an *ex post* procedure to reach an agreement on controversial case facts (hereinafter referred to as Binding Ruling Type I), while the term APA is considered explicitly for *ex ante* agreements.

Germany, for instance, offers a slightly different type of binding ruling called *Verständigungsverfahren* (hereinafter referred to as Binding Ruling Type II) to settle disputes in the tax auditing process (Herzig, 1996; Hahn, 2001). The purpose of the *Verständigungsverfahren* is to resolve an ongoing auditing process for a taxpayer and, by doing so, should produce a common understanding between the taxpayer and the tax authorities involved about same (or similar) fact patterns in future years. While the Binding Ruling Type I regularly covers tax cases

which have been already started to be realized as business but have not yet been assessed or audited, the Binding Ruling Type II deals with cases which are under tax audit. In Germany, the Binding Ruling Type II is becoming increasingly important to help resolve transfer pricing controversies of the past and, by finding an agreement between relevant parties, to lay ground work to avoid such controversies in the future.

Romano (2002: 486) elaborates on some differences between binding rulings and APAs: legally, a binding ruling is a unilateral agreement, only affecting the respective tax administration and the taxpayer, while APAs can be unilateral, bilateral, or multilateral. Also, in general, binding rulings are a one-sided statement of the tax administration; the taxpayer can or cannot accept the Ruling issued. In the case of an APA, it is an agreement between both (all) parties where the taxpayer at least approves the content (i.e. *de facto* it is an agreement). In a binding ruling procedure, the taxpayer may have a participating role in the initial phases of the process. Finally, APAs normally bind both the taxpayer and the tax authority, while binding rulings normally bind the tax authority alone. Such binding normally refers to one specific transaction or case pattern, whereas the APA may cover a set of transactions or even a complex transfer pricing structure with various related party transactions involved.

In the language of governance concepts, the introduction of APA programmes in many tax jurisdictions may characterize a shift from bureaucratic taxation to a form of cooperative interaction between the taxpayer and tax authorities. As Lacaille (2002) points out, the increasing relevance of APAs may indicate a new direction in administering law, i.e. from bureaucracy to negotiation. Given the administrative nature of APAs, and in the light of globalization and the debate on internationalization, the emergence of APAs seems to be an interesting case for the political analysis of shifts in international tax policies. Three aspects of APAs appear to be of special relevance:

- the factors determining the existence of an APA programme in a given country
- the non-bureaucratic negotiation between parties in order to reach an APA
- the *ex-ante* nature of an APA, i.e. the APA is normally negotiated and agreed by the parties prior to generation of the income to be taxed

3 From Bureaucracy to Non-Adversarial Coordination

3.1 Public bureaucracies: governance choice

To explain why APAs have evolved in the past, I refer to a theory of governance choice, which is based on a concept outlined by transaction cost economics (TCE) as developed by Williamson (1985) and in line with new institutional economics (for an overview on New Institutional Economics, see also North, 1990; Richter, 2005). I hypothize that the evolution of APA programmes – and probably their temporary relevance in a period of transition into a "global world" – can be understood by looking at the governance choice model of Williamson (1998). This model can explain the shift from bureaucratic state administration towards more regulative and hybrid governance in the field of tax base identification and assessment with respect to international taxation. The model of governance choice based on TCE involves issues of internal and external coordination, administrative traditions, actor behavior, as well as institutional design and change.

3.1.1 Making use of TCE

TCE structures societal phenomena into discrete choices of coordination which is subject to transaction costs. Allen (1991: 3) defines transaction costs as the resources used (and burdens assumed) to establish and maintain property rights. They include resources used to protect and capture (appropriate without permission) property rights, plus any deadweight costs that result from potential or real protecting and capturing. The need for establishing and maintaining

property rights is caused by two basic principles of human behaviour: bounded rationality and opportunism (Williamson, 1985, 1998).

As proposed by Williamson (1999), the concept of governance choice can be not only deployed for the make-or-buy decision but also for public policy design. In this approach (see **Error! Reference source not found.**), unassisted market (*M*), unrelieved hybrid (X_U), hybrid contracting (X_C), private firm (*F*), regulation (*R*), and public agency (*B* for bureau) are distinct governance modes for coordinating exchange between transaction partners. In the traditional TCE perspective, *M*, X_U, and X_C are governance modes of external coordination, whereas *F*, *R*, and *B* refer to internal coordination. TCE poses the question – and seeks to answer – whether a given exchange problem (transaction) should be coordinated in either governance mode. In the case of hierarchical, internal governance, this would be *F* (within a firm), *R* (through regulation), or even B (within the public agency), though feasible alternatives of external governance exist and can be described (Williamson 1999). Features such as forming incentives, administrative control, autonomous behaviour, enforcement, and safeguarding against hazards determine the choice of governance.

The basic mechanism of governance choice in TCE can be seen in **Error! Reference source not found.**. With increasing contractual hazards (*h*) and the need for contractual safeguard (*s*), the transaction cost efficient governance choice is, instead of *M* or X_U, a hybrid contracting X_C or, even more transaction cost efficient, a organization-internal coordination (*F*, *R*, or *B*). Among these three options, public agency (mode *B*) provides the most safeguarding, given high asset specificity and contractual hazards. However, there is a trade-off against lower incentives, high administrative control, and less autonomous behaviour. In contrast to private bureaucracy *F* such as a firm, governance mode *B* describes the internal organization of transactions. According to Williamson (1999: 336), *B* results in the highest level of bureaucratization, adaptive integrity, and staff security. Also, it provides the lowest level of incentive intensity, adaptive autonomy, executive autonomy, and legalistic dispute settlement.

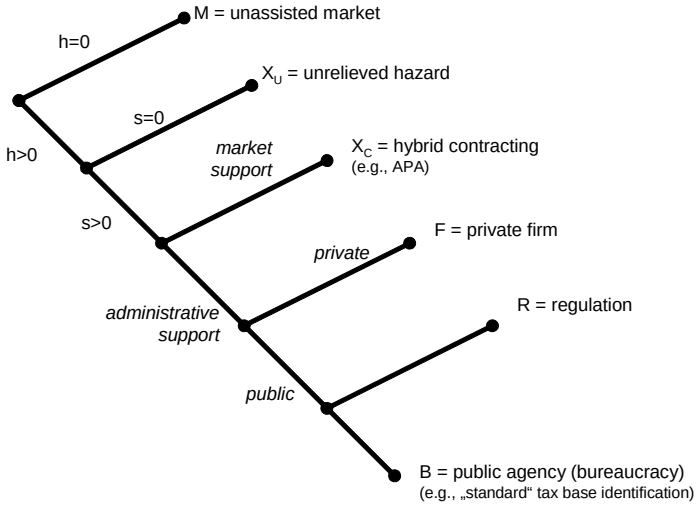


Figure 3: Contracting Schema Extended

Source: Adopted from Williamson (1999: 337).

Williamson mentions the following features of public bureaucracy (1999: Table 2, p. 336): (a) very low-powered incentives, (b) extensive administrative controls and procedures, (c) appointment and termination of the agency's leadership by a quasi-independent sovereign (e.g. president, legislature), and (d) an elite staff with considerable social conditioning and

security employment. For example: "… private bureaucracy (contracting out) [i.e., the governance change from public bureaucracy (e.g., state government agency) to a private firm, *M.B.*] has the strongest incentives and the least administrative control, the strongest propensity to behave autonomously (display enterprise and be adventurous) and the weakest propensity to behave cooperatively (be compliant), works out of a (comparatively) legalistic dispute settlement regime, appoints its own executives, and affords the least degree of security of staff employment. The public bureaucracy is the polar opposite in all of these respects, while regulation (public agency plus private firm) is located in between these two along all dimensions (with the caveat that regulation may have more administrative controls, possibly of a dysfunctional kind)" (Williamson 1999: 336).

Given this basic mechanism of governance choice, it may be more efficient for the governance of (domestic) taxation to follow B: the state coordinates the process of generating its revenue by means of bureaucratic organization, and there is a trade off between highly bureaucratic principles of organization and provisions, low incentives, small space for discretional decision-making, high administrative control, high legalistic dispute settlement, and high job security for personnel. The (bounded) rationale for transaction cost efficiency behind this governance mechanism includes probity, equity, and neutrality. Since the sovereign state may gain most benefit if its main 'budget generation process' (= taxation[11]) is equitable and neutral, B might be the most transaction cost efficient governance structure for taxation.

3.1.2 State interacts with taxpayers: relying on bureaucracy to generate state revenue

In addition to the internal view of a public agency organization, a comprehensive perspective on bureaucratic governance allows a focus on external transactions, i.e. how the interaction is organized between the public agency and its external 'transaction partner' (here: taxpayer). While a public agency may offer external contracts for certain transactions, like for any consumer or firm (e.g. spot market purchase of office furniture, hybrid contracting of regularly recurring transactions such as computer purchases associated with frequent maintaining services), it normally resorts to bureaucratic governance for transactions regarding sovereign administrative tasks such as tax base assessment and tax collection. Taxation is an interaction between the taxpayers and the tax authority to generate state budget, and can thus be deemed 'bureaucracy' (mode B). Under such TCE perspective, the taxpayer is hierarchically bound to bureaucratic tax mechanisms which the state imposes to safeguard its tax base.

TCE interprets a public bureaucracy "as a response to extreme conditions of bilateral dependency and information asymmetry" (Williamson 1999: 337). Instead of private ordering, public bureaucracies provide safeguards against contractual hazards beyond M, X_U, X_C, or F (comp. **Error! Reference source not found.**). As mentioned above, factors why – in a world of domestic tax cases – bureaucracy may govern these hazards more efficiently than market-like mechanisms include probity (1999: 338) and, in taxation, neutrality of treatment. For example, the sovereign state has incentives to treat taxpayers with neutrality, in accordance with the tax code and its revenue procedures. Otherwise, in a constitutional state, administrative unpredictability could trigger lawsuits against the tax authority and the taxpayer would have incentives to shift his tax base into another tax jurisdiction (tax emigration) or to underperform.

Terms like probity can be paraphrased with concepts such as trust, relational contracting, corporate culture, or influence aspects. What probity has in common with these terms is the impact from transaction cost optimization on the governance of contractual hazards *h*. Because taxation requires a high level of probity, and this level may be best endured through a public agency, equitable and fair taxation may be efficiently coordinated through bureaucratic interaction with the taxpayer: The sovereign state (public agency) generates its budget by means of

[11] Of course, in addition to the "taxation" mechanism, a sovereign state can also generate budget through non-administrative activities such as running firms, taking part in capital and currency markets through publicly-owned banks and through central banks, imposing tariffs and fees on services, etc.

bureaucratic *ex post* money subtraction from the taxpayer's income.[12] If an entity falls under tax liability given the legal principles in the jurisdiction, the agency assesses *ex post* the facts of the tax case, the tax base, methods of taxation, and further circumstances. In addition, under a classic taxation mechanism, parties do not negotiate on the tax case in advance.

As a compromise, the public agency may use the transaction cost efficient mechanism to establish an exchange process of taxation with a high level of probity and neutrality. In contrast to other governance forms, bureaucratic state revenue collection may provide a climate where the revenue donator (taxpayer) can rely on probity and neutrality.

3.2 Taxation: unilateral asymmetric information

The key for explaining bureaucratic governance as a contractual safeguard for the taxing jurisdiction is asymmetric information. Measurements which are subject to a high level of asset specificity determine a situation where the taxpayer has an information advantage over the tax authority. In tax terms, the transaction attributes have synonyms, such as compliance costs and legal uncertainty, which are subject to two types of asset specificity. One type refers to the jurisdiction's need to generate budget in order to be able to fulfill its tasks to which the sovereign state has committed through its constitution or public policies (provision of public goods such as law-making, legal enforcement, national defense, social programmes, etc.). The other type of specificity stems from cross-country discrepancy in tax systems, and the resultant problem identifying the true tax base. The informational advantage on the taxpayer's side is linked to transaction attributes and thus determines whether the state applies 'standard' bureaucratic governance for the "tax base identification and tax collection". An alternative to the tax base identification model is withholding taxes which simplifies taxation with the effect that tax principles such as neutrality and equity are not necessarily met (Keen and Ligthart 2005).

Measurement problems (what is the 'true' tax base?) and asset specificity (location specificity of taxpayers such as individual employees, companies) lead to 'standard' taxation (= bureaucratic) as part of transaction cost optimal governance. Bounded rationality and opportunism are assumed to be characteristic human behaviours in this situation. The tax authority *ex ante* lacks information about the true facts and circumstances on the taxable case, whereas the taxpayer has strong incentives not to disclose all available information about the case. Given a constitutional state with democratic principles, the sovereign tax authority is *ex post* legally bound to laws and administrative procedures, around which the taxpayer may design his tax strategy. As a consequence of asymmetric information, and to the disadvantage of the tax authority, the state does not negotiate with the taxpayer about the identification of facts and the determination of the tax base. In this asymmetrical situation (i.e. a hybrid or market governance structure where the tax authority bargains with the taxpayer about the assessment of the tax case), negotiation seems to be less efficient. Because of the high costs of establishing and maintaining probity, an opportunistic (cheating) taxpayer would generate lower revenues for the state agency under a non-bureaucratic governance structure.

Following Hart (1995: 20; see also Hart and Moore, 2005), a transaction cost efficient choice for a governance structure does not reduce asymmetric information *per se*. Likewise for taxation, public-bureaucratic taxation cannot eliminate the information problem for the public agency (tax authority). Rather, from a TCE point of view, the sovereign's choice to resort to public bureaucracy in generating revenue can be explained as such: equalizing information is too costly for the state so it has to resort to bureaucratic tax collection.[13] "Try markets, try hybrids, try firms, try regulation, and resort to public bureaus only when all else fails" (Williamson 1998: 47).

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[12] I follow Williamson's (1999: 316) "remediableness criterion" which holds that an extant mode of organization is efficient if no feasible alternative can be described and implemented with expected net gains.

[13] For an examination of the distinction between costs of equalizing asymmetric information and costs of apprising an arbiter of the true information condition, see also Williamson (1996: 65). Tanzi and Zee (2000) describe the role of information exchange for taxation in a borderless world.

3.3 Taxing multinationals: two-sided asymmetric information

In a purely one-jurisdictional situation, taxation may be a transaction which is preferably (efficiently) governed by bureaucracy: with respect to internal coordination as well as regarding external relationships. However, if MNCs are to be taxed, the parties on both sides of taxation face asymmetric information affiliated with measurement and specificity problems: MNC taxpayers lack ex ante information about the ex post assessment of its transfer prices; the taxing state lacks – as indicated above – information about the true case facts. In the field of transfer pricing, the taxpayers are not able to foresee whether a tax authority will accept the TPM and the tax base deployed in a given transfer pricing case. They are also unaware if, and to what degree, the filed tax base allocation between the legal entities of the MNC will be adjusted by the authorities in the audit process several years later.

This results in hazards not only for the tax authority but also for the taxpayer. In the international context of transfer pricing and corporate income tax base allocation, with its underdeveloped institutionalization process and heterogeneous tax systems around the globe, there is a high likelihood that the taxpayer is exposed to double taxation (if at least one jurisdiction adjusts the taxpayer's allocated profit). The choice of a "correct" transfer pricing approach has not yet been uniformly defined and accepted by the international taxation community. Moreover, the ALP is in itself arbitrary – it cannot provide for the "true" taxable pie but, if at all, a likely range of arm´s length results.

The deficient institutionalization of cross-border taxation provides ground for a governance shift away from an adversarial tax regime (bureaucratic) to a collaborative interaction (hybrid). Not only the authority but also the corporate taxpayer has to cope with asymmetric information, resulting in a mutual information asymmetry (two-sided information asymmetry). Factors such as the inadequacy of the ALP in transfer pricing (Rodemer 2001; Oestreicher 2000) and the discrepancy between tax systems (Radaelli 1997; European Commission 2001) frequently expose the involved parties to hazards and legal uncertainty. Thus, collaborating on matters such as identifying the correct TPM and determining the tax base can significantly reduce transaction costs accruing in the process of income allocation (taxpayer) and of running a neutral tax system (tax authority).

In contrast to intra-jurisdictional tax base allocation, the relative lack of institutionalization in inter-jurisdictional tax rules requires MNCs to gamble on several choices regarding corporate income tax filing: (a) the critical assumptions underlying basic assumptions of the overall transfer pricing case; (b) appropriate TPM; (c) the appropriate tax base allocation through arm's length transfer prices (or profits) in accordance with functions performed and risk borne; and (d) due allocation of the tax base into jurisdictions where the legal entities of MNCs are subject to taxation. Such decisions have to be taken by both the taxpayer and the authorities (of all jurisdictions), with a wide range of interpretation, definition, and unpredictability, resulting in legal uncertainty for a potentially long period of time.

These factors may lead to extreme contractual hazards for both the tax administration and the taxpayer in the case of taxing cross-border related-party business. In the international context of taxation, with vague models of transfer pricing and related-party income tax base allocation, these transactional attributes can be translated as follows: discrepancy between the different jurisdictions' tax systems can cause high specificity, as neither the tax authority nor the taxpayer can overrule the other jurisdiction's tax system without risking double taxation; they are highly dependent upon the other jurisdiction's tax assessment. Likewise, the investments of the taxpayer are often highly specific to the location and/or time; for this reason the taxpayer is economically hindered to shift its business unit (i.e. function) into a more preferential tax jurisdiction for the short-term. Uncertainty in international taxation is high because of the unforeseeable transfer pricing assessment of jurisdictions involved and the unidentified facts of a business case. Finally,

differences in accounting standards across countries leave room for companies to design their own annual statement. Again, this results in higher tax base measure costs for the tax authority.[14]

3.4 APA as alternative mode for identifying and allocating the tax base

Effort to rebut the presumption of transfer pricing manipulation and illegal income tax base shifting on the taxpayer's side as well as double taxation and transfer pricing penalties imposed by the tax administration will lower both the taxpayer's earnings after taxation and the state's incentive structure to attract international investments. In the light of taxation as a transaction to be governed between the state and the taxpayer, costs of compliance with country-specific regulations and possible losses in earnings after taxation (e.g. income adjustments, penalties, foregone business opportunities) can be deemed transaction costs.[15] Given the criterion for economizing transaction costs in "taxation", the two-sided information asymmetry may trigger the evolution of alternatives in the case of taxing multinationals – in contrast to traditional bureaucratic governance. One of these alternatives, which provides a reduction in contractual hazards, is the APA, i.e. an *ex ante* collaboration between both parties to reach a mutual understanding of how a given transfer pricing situation should be considered for tax base allocation purposes.

The emergence of APA programmes in an increasing number of countries can be explained by mechanisms of governance change in light of TCE: from bureaucracy to hybrid systems (as indicated by a shift from mode B to mode H_C in **Error! Reference source not found.**). The collaborative interaction between the corporate entities (taxpayers) and the tax authorities can be understood as a kind of hybrid system (Freeman, 1995, 1997; Williamson, 1996) – or, at least, a non-bureaucratic governance.[16] As opposed to 'standard' taxation and its one-sided information asymmetry, in an APA the tax authority negotiates with the taxpayer on tax facts and circumstances ("What are the critical assumptions?") and on the assessment of the tax base ("What transfer pricing method?"; "What allocation mechanisms?").

3.5 Factors explaining the use of APAs

In light of TCE with its basic model of institutions, actors, and governance structures, factors determining the governance choice of tax base identification can be classified on four analytical levels:

- institutional framework to establish an APA programme
- institutional framework to work out an individual APA
- economic conditions and attractiveness
- actors

Table 1, as derived from Brem (2005), illustrates these levels with respect to a case comparison on factors determining an APA in Germany and the United States. Data are from a recent case study.

[14] For example, because of shortcomings in traditional tax auditing of MNCs, the German Ministry of Finance released the 'electronic audit' provisions as part of Germany's landmark 2000 Tax Reduction Act. These provisions, having taken effect on January 1, 2002, grant Germany's tax inspectors access rights to taxpayer computer systems for auditing purposes, indicating a measure to lower transaction costs to access information on the tax case. This adversarial tax behavior could be seen as an alternative to APAs, representing a move away from possible governance choices i.e. in opposition to collaborative governance.

[15] Erard (2001: 317-335) reports compliance costs of about 2.7 per cent of taxes paid for a weighted fortune in a top 500 Canadian non-financial corporations sample in 1995 (average compliance costs C$ 507,000), and of about 3.2 per cent for a weighted fortune in a top 500 US corporations sample (average compliance costs US$ 2,100,000); compliance costs increase significantly if foreign affiliated operations are involved. This estimation does not yet reflect costs of income adjustments on the basis of transfer pricing audits, which may exceed the actual tax burden and/or any penalties incurred in transfer pricing documentation provisions.

[16] Interestingly, and to my best knowledge, in contrast to other sovereign state activities such as labour contracting, running companies, defence, etc., both the internal governance of taxation and the relation between tax authorities and taxpayers (external governance) have remained bureaucratic over the modern age. As a historical overview of U.S. government contracting reveals (Nagle, 1999), taxation has not been a matter of non-bureaucratic 'contracting' over the past two centuries. I welcome examples that dispute this fact.

Table 1: Factors determining the existence of APAs

Analytical Level	Factor	Definition and Item Description	Countries Compared		Effect
Institutional framework to establish an APA program in a given country			**Germany ***	**USA**	Relative favouring of APAs in the USA compared to Germany
▪ Political Framework	**Federalism**	Organization of a jurisdiction's tax system (nation level)	Federal income tax; but tax is assessed at federal state level; under current tax organization principles, federal states have assessment authority and thus coordinate APAs	Federal income tax; tax assessment authority is allocated at the federal level; APAs are coordinated on a federal level	Yes
	Legislative process	Constitutional procedure for federal tax legislation on introducing APA programs	complex involvement of federal states (*Bundesrat*) in the case of income taxation ("*Zustimmungsgesetze*")	Federal tax legislation without political involvement of the states for issuing an APA program	Yes
▪ Legal	**Principle of assessment**	The type of investigation and assessment of the tax case in a given country	Official Investigation Principle (*Amtsermittlungspflicht*) Consequence: Assessment by tax office normally yields small divergence between assessment and *ex-post* audit results	Self-Assessment Principle (*Selbstveranlagung*) Consequence: Self-assessment by the taxpayer normally yields higher probability of divergence between the view of the taxpayer and that of the tax authorities (audit)	Yes
	Principle of international income taxation	Source-based *versus* world-wide income	Source-based	World-wide income	No information
▪ Administrative	**Administrative tradition**	Type of administrative system	"Weberian model" on the basis of Roman-Law traditions	Anglo-American system	Yes
	Administrative organization	Organizational type of tax administration	Tax administration governed by the federal states	Federal (national) tax administration in the field of federal corporate income taxation (transfer pricing)	Yes
▪ Judicial	**Tax courts**	Relative importance of tax courts to trigger institutional change	High relevance of Federal Tax Court and regional tax courts; APA cases have not yet been brought to the court	High relevance of the competent tax courts	Indifferent

Analytical Level	Factor	Definition and Item Description	Countries Compared		Effect
Institutional framework to generate an individual APA					
▪ Administrative	**Legal title**	Nature of legal right to receive an APA	*De lege*, taxpayer has no legitimate title to receive an APA	*De facto*, taxpayer has legitimate title to contract an APA	Yes
▪ Legal	**Agreement type**	Nature of agreement between tax authority and taxpayer	"Receiving" an APA from the tax authorities	"Contracting" an APA between the tax authorities and the taxpayer	Yes
	Distortion on legal enforceability	Relative advantage of taxpayers over tax administrations in the courtroom	Taxpayers have won most international tax cases in the courtroom; however, this has been many years after audit	Taxpayers have won most international tax cases in the courtroom; however, this has been many years after audit	Indifferent
Economic conditions and attractiveness					
▪ Economy	**Economic demand for APAs**	Share of cross-border related-party business (MNC business) to total cross-border business between two countries	Large share	Large share	Indifferent
▪ Industry	**Business type**	Type of transaction and business to be covered by the *ex ante* APA (possible characteristics: large profit/loss volatility, high margins, high relevance of intangibles like patents, trademarks, etc.)	Industry type: e.g., computer and electronics manufacturing, aeronautics industry, pharmaceuticals, banking, etc. Transaction type: sales of tangible and intangible, services, use of intangible, financial loans	dto. Comp. IRS statistics (e.g., IRS 1999 through 2005a)	Indifferent No publicly available statistic in Germany available to compare with US-statistics
▪ Economic	**Economic environment**	Degree of economic stability and reliability (e.g., "post-industrialized" countries *versus* "transition" countries)	Post-industrialized economic environment; relative mature tax code system	Post-industrialized economic environment; relative mature tax code system	Indifferent
▪ Governance	**Type of audit**	Purpose of audit in the course of corporate income taxation	Audit as an administrative step in the course of the tax authorities' taxation process	Audit as an essential administrative test to check for the taxpayer's correctness of self-assessment	yes
	Type of application	Request versus application	„Request" for APA process	"Application" for APA process	More market-like

Analytical Level	Factor	Definition and Item Description	Countries Compared		Effect
Actors					
▪ Taxpayer	**Experience of the taxpayer**	Level of preference and experience with APA processes	New methodology of reducing tax risk for selected transactions	Higher level of knowledge and know how due to "experience" and "expertise"	Yes
▪ Tax administration	**Experience of tax administration**	Dedicated APA resources such as APA personnel, resources, procedures	Low level of experience with advance ruling in the area of „transfer pricing" No specialized APA Program and unit with dedicated tax experts and economists	The APA Program explicitly dealing with APAs The APA unit within the federal tax administration with dedicated tax experts and economists	Yes
▪ Tax consultant	**Experience of tax consultant**	Average number of APA cases per transfer pricing consultant	Small number of cases No specialized APA consultancy	Large number of cases Specialized APA consultancy within the "Big Four" tax consulting firms	Yes
▪ OECD	**Impact from international organization**	Acceptance/Incorporation of international regime principles by national tax administration	Yes; *Vice versa*, Germany partly has impact on OECD	partly; Vice versa, USA significantly influences OECD positions on transfer pricing guidelines	Yes

* In Germany, the upcoming constitutional reform of the federal system of legislative approval by the second chamber (Bundesrat) may bring in changes in legislative and executive authority in the field of tax assessment and tax revenue redistribution.

The overview above provides a preliminary model based on TCE which requires more empirical investigation. Notwithstanding the incompleteness of the model, the following factors could be identified for a possible explanation of the evolution of APA programmes and the use of individual APAs:

- Institutional frameworks to establish APA programmes: National institutions (*statics*) and their history (*dynamics*) appear to matter significantly in the development of national APA programmes.
  - Federal structures of a national jurisdiction are important if they lead to an authoritative structure below the federal level with respect to income taxation.
  - Legal and constitutional principles regarding taxation may affect the evolution of APA programmes. The principle of tax assessment (*official investigation* vs. *self-assessment*) may be one possible distinction. It seems that self-assessment supports the establishment of an APA programme. No information could be analyzed as to whether tax principles such as "source-based income taxation" vs. "world-wide income taxation" affect the evolution of an APA programme.
  - Administrative traditions determine the space for discretional power at the administrative level. Compared with the "Weberian" model, it seems that the Anglo-American model of administrative tradition shows some demand (or susceptibility) for APAs because of the higher degree of discretional power assigned to administrative units and officers. Also, the organization of an administration in a nation state was identified as an important factor in the emergence of APAs. For example, in Germany the tax assessment authority on corporate income tax is assigned to the federal state, preventing the current federal tax administration, including the Federal Ministry of Finance, to launch a fully fledged APA programme similar to that in the United States.
  - Tax courts and the judicial role in institutionalizing transfer pricing provisions may also impact the evolution of APA programmes. However, the analysis could not identify clear information on this factor. Yet, both in the United States and in Germany highest court decisions and regional court decisions on transfer pricing cases have increased the awareness among the parties to treat controversial issues *ex ante* through an APA.
- Institutional frameworks to generate an APA, i.e. if an APA programme or similar mechanisms are already in place:
  - The legal title of an APA means the tax authority is obliged to accept and process an APA request and this may be part of its relative attractiveness. In some countries (e.g. the United States), the taxpayer is entitled to claim an APA, while in other countries the taxpayer may have no legitimate title to claim an APA.
  - The legal nature of an APA is relevant for cross-country comparisons. In Anglo-American countries, an APA is normally a contract, while under Roman Law principles the taxpayer receives a legal statement from the tax administration. Another important factor is the "distorted legal enforceability" power. For example, in Germany, most important tax cases in transfer pricing were finally won by the taxpayer (e.g. the seminal Federal Tax Court decision on transfer pricing documentation dated October 17, 2001).
- Economic factors describe the conditions under which an APA is an attractive mechanism to govern the tax base allocation problems behind transfer pricing:
  - Without "economic demand" for APAs, such non-adversarial mechanism may not be the most attractive method to resolve transfer pricing cases. There are several upfront costs associated with an APA process – compared with a large, but unknown range of *ex post* cost possibilities because of audit and income adjustments. Economic demand

might be measured by the share of cross-border business within multinational groups – measured as business between two countries – to total cross-border business between these two countries.

- The industry the MNC's transfer pricing case belongs to seems to play a role in relative attractiveness of an APA. As it is often the case in high-tech business or in the chemical and pharmaceutical industry, related-party transactions affiliated with a high level of intangibles are more likely to be candidates for APA solutions than transactions with the involvement of routine functions and standard business processes (e.g. contract manufacturing). One reason could be the demand for *ex ante* certainty on the appropriate transfer pricing method and pricing principles in such non-routine transactions (e.g. shift of intangibles).
- The economic environment may provide stable and reliable business conditions or unstable and unforeseeable thresholds which determine a particular transfer pricing policy. As economic and institutional stability in the field of transfer pricing increases, we might hypothesize that transfer pricing controversy may decrease and, hence, the binding ex ante nature of the APA-vehicle may become less favourable to the tax base allocation problem. In stable economic environments, it might be preferable to resolve a particular controversy in a standardized tax world outside APA governance.
- The governance provided by APA programmes also determines the relative attractiveness of APAs. Here, the type of application (e.g. "request" vs. "application") and the type of audit in a given country may affect the relative preference for an APA.

- Finally, the actors involved in drafting individual APAs and in designing APA programmes appear to have explanatory power regarding the existence of APAs:
  - The taxpayer's preference for *ex ante* mechanisms and information disclosure in the course of an APA process, as well as their experience, is likely to determine whether an APA is considered the preferred solution to allocate the tax base in a given transfer pricing situation.
  - The same theory applies for tax administration. Some tax administrations (e.g. the US IRS) have dedicated resources for an APA programme so the marginal administrative costs (processing, administering, organization) for each new APA decrease. Other states initially have to invest in start-up activities in order to re-organize resources of the country's tax administration (mainly human resources such as economists and transfer pricing experts) in order to develop an APA process.
  - Likewise, tax consultants may or may not have experience with APA processes. Some tax consultants are specialized in transfer pricing and APAs, while others may feel that an APA is challenging or even suspicious.
  - Finally, OECD plays the role of rule setter in international taxation. Some countries construct their transfer pricing agreements on the basis of the OECD Transfer Pricing Guidelines (OECD 1995b) and international regime, including the guidelines on APAs (OECD 1999). Other states choose not to use the guidelines, or they take only part of the information. In the case of the United States, the OECD guidelines on APAs are heavily influenced by the US-IRS system of APA processes, which suggests that the existence of an APA programme may not necessarily follow the relative influence OECD has on each country, given that OECD has not had an effective influence over US policies (rather, it is the other way round). It seems that whether a certain nation is member of the OECD or not does not fully explain the relative influence OECD can have on national APA programmes and individual APAs. Also, other international institutions, such as WTO, IMF or UN do not seem to have a major influence on national decisions regarding APAs.

4 Final Remarks

The deployment of APAs and the evolution of corresponding national APA programs is an interesting example of a shift in international tax policy. This paper analyses taxing multinational companies (MNCs) to illustrate how global business processes may force governance change in international income tax base allocation. The underlying question is: how can we explain changes in the interaction of the sovereign state and the MNC-taxpayer regarding the allocation of the tax base related to cross-border income? As globalization and the integration of global business processes within the boundaries of multinationals continue to grow in number and volume, we expect that the question on shifts in international governance of tax base allocation will also substantiate.

The analysis on governance change is illustrated by APAs, a new form of formalized negotiation and cooperation between the main parties involved in transfer pricing and tax base allocation. An APA is featured as a cooperative arrangement between the tax administration and the MNC-taxpayer and, if bi-/multilateral, between other states' tax administration and the MNC-affiliates present in this state. The agreement determines, ideally in advance of controlled related-party transactions within the boundaries of a MNC, an appropriate set of criteria for the determination of transfer pricing for these transactions over a fixed period of time. As the role of transfer pricing between related-party corporations of a multinational group dramatically increases in the globalizing business world, the taxpayer and the tax authorities face complex problems of tax base allocation (OECD, 2001a; European Commission, 2001; Ernst& Young, 2003).

APAs are intended to supplement the traditional administrative, judicial, and treaty mechanisms for resolving transfer pricing issues and tax base allocation. They are assumed to be most useful when traditional mechanisms to allocate income of related-party business within the multinational group fail or are difficult to deploy because of a lack of institutionalization in international taxation and the transfer pricing systematic.

Based on this analysis, we can make some recommendations on governing international taxation in the field of transfer pricing and international tax base allocation: In the long run, state activity such as taxation finds its transaction cost efficient governance structure – as it is for private sector transactions. In the case of taxing MNCs, the tax base allocation is in some instances efficiently governed in a non-bureaucratic form (non-hierarchical), i.e. as a cooperative mechanism based on principled negotiation. International tax policies should consider that cooperative, non-adversarial mechanisms can be a helpful tool to resolve transfer pricing and tax base controversies which could otherwise not be governed properly, leaving both the taxpayer and the tax authorities involved with deadweight losses.

However, non-bureaucratic governance may not be the most efficient policy design under all circumstances – as the prevalence of bureaucratic taxation mechanisms in almost all tax jurisdictions proves. In international taxation, as international regimes and international organizations begin to provide problem-solving principles, rules, norms, and provisions to both the taxpayer and the tax administration, resolving transfer pricing disputes *ex ante* through the APA vehicle is likely to be a temporary mechanism. If, by means of, say, better tools or principles, transfer pricing becomes a standardized mechanism in international tax base allocation, bureaucratic governance may supersede the hybrid APA governance mode. However, such a prospected disapparence of non-bureaucratic governance in the field of international tax base identification and allocation may be accompanied by a shift in some elements of tax sovereignty from the nation state to supranational and/or international jurisdiction.

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