The Arm's-Length Standard in North America

by Lorraine Eden

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Tax legislation is normally developed by national tax authorities and passed into law by national governments. The authorities then write detailed regulations or guidelines to the legislation, and follow up by enforcing the laws and penalizing offenders. This process has been followed by the three governments in North America in terms of regulating transfer pricing as part of the corporate income tax. In this paper, we briefly document the historical development over the 20th century of transfer pricing regulation in the three countries and summarize the key similarities and differences. In the United States, the U.S. Treasury has the responsibility for developing tax law, which is interpreted and enforced by the Internal Revenue Service (IRS). In Canada, the Department of Finance and the Canada Customs and Revenue Agency (formerly Revenue Canada) play similar roles to the U.S. Treasury and IRS, one proposing, the other implementing. In Mexico, the Secretaría de Hacienda y Crédito Publico (the Ministry of Finance and Public Credit, known as Hacienda or SHCP) is responsible both for developing and for interpreting and applying tax law.[1]

If a tax practitioner examines the historical development of transfer pricing regulation in North America, he or she cannot fail to be struck by the differing roles played by the three governments. The U.S. government was clearly the first mover, the innovator, in all major aspects of transfer pricing regulation. Canada and Mexico played follower roles. Despite the timing differences, at present (January 2000), the three countries have highly similar transfer pricing regulatory systems. How did this happen?

The Transfer Pricing Regime

Transfer pricing regulation in North America can be best understood using a theoretical framework developed by political scientists called an *international regime*. International regimes are "sets of implicit or explicit principles, norms, rules, and decision-making procedures around which actors' expectations converge in a given area of international relations." (Krasner 1983: 2). Regimes have a *purpose* (one or more rationales) and *scope* (range of issue areas and numbers of participants), a set of *principles* (beliefs) and *norms* (standards of behavior in terms of rights and obligations), and a detailed set of *rules* (specific prescriptions and proscriptions) and *procedures* (prevailing practices for making and implementing choices and settling disputes).

We argue that there is a transfer pricing regime in place in North America, developed primarily in the United States, diffused to Canada and Mexico, and based on the norm of the arm's-length standard.[2] See Table 1 on the following page. The purpose of the transfer pricing regime is to determine true taxable income and prevent tax avoidance on related-party transactions. Its scope consists of all cross-border related-party transactions by resident taxpayers in the three countries. Its rules consist of a variety of acceptable transfer pricing methods (for instance, the comparable uncontrolled price (CUP) method, the resale price method, and the transaction net margin (TNMM) method). The regime has a variety of procedures in the form of reporting and documentary requirements and dispute resolution techniques (for example, advance pricing agreements (APAs), contemporaneous documentation).

In Table 2, we list all the major changes in transfer pricing legislation and regulations by country, according to the components of an international regime: purpose and scope, definition of the fundamental norm (the arm's-length standard), rules, and procedures. This organization helps us to see how an international regime has developed and strengthened within North America, and to track which government was the innovator and which the followers.

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[1]For a detailed history and analysis of transfer pricing regulation in North America, *see* Eden (1998).

[2]This argument is developed in much greater detail in Eden (1998, Ch.2).

Table 1: The North American Tax Transfer Pricing Regime

Purpose	To prevent tax avoidance and ensure that taxpayers report their true taxable income.
Scope	Issue Area: the appropriate valuation of cross-border transactions among related parties so as to ensure that income and expenses are properly allocated among jurisdictions for tax purposes. Geographic Area: cross-border transactions between non-arm's-length parties that are resident in one of the three North American countries.
Principles	Equity and neutrality.
Norms	The arm's-length standard (ALS): each unit of the MNE is expected to declare, for tax purposes, the profits which it would have made had it been a distinct and separate enterprise operating at arm's length from its parent and sister affiliates.
Rules	Governments adopt a transactions based, water's edge approach to allocating the MNE's income and expenses among jurisdictions. Different methods apply for valuing goods, services and intangibles, but all follow the arm's-length standard.
Procedures	Domestic Procedures: $ Auditing process with appeals through the domestic courts $ Penalties for noncompliance. $ Publication of rules, procedures, acceptable methods through regulations, rulings and information circulars. $ Reporting, information and documentary requirements. $ Advance pricing agreements. International Procedures: $ Bilateral income tax treaties. $ Exchange of information agreements. $ Simultaneous audits. $ Binding arbitration.

Source: Adapted from Eden (1998: 104).

The Development of the Arm's-Length Standard in North America

Transfer pricing regulation in North America began in 1917 when the U.S. government added section 41 to the Internal Revenue Code, giving the government the right to allocate income and deductions among related parties. In 1928, a purpose for this reallocation was established: to prevent tax avoidance and determine the true taxable liability of the parties. In 1935, the arm's-length standard was formally introduced into the code. The arm's-length standard (ALS), defined as transactions between an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer, was to be used by the commissioner to achieve a clear reflection of income and prevent tax evasion among related parties. Thus, by 1935, the main purpose and scope of transfer pricing regulation in the United States had been established as part of the Internal Revenue Code. Until the mid-1960s, the U.S. Treasury used this transfer pricing code section (renumbered as section 482) to offset attempts by U.S. multinationals to shift income to tax havens and U.S. possessions. The last major change in this "first wave" of U.S. transfer pricing regulation occurred in 1968 when the first IRS regulations were published, detailing rules for goods, services, and intangibles, and outlining the fundamental trio of acceptable transfer pricing methods: CUP, resale price, and cost-plus.

The "second wave" began in 1986 with the addition of the commensurate with income rule to section 482. This one-line sentence led to a major overhaul of the IRS regulations, completed in 1994, after much international and domestic controversy.[3] At the same time as the rules were being tightened and expanded, the IRS introduced several new procedures designed to improve enforcement of section 482: reporting requirements, APAs, contemporaneous documentation (CD), and inaccuracy penalties. At the end of the 1990s, the U.S. government now has a broad array of rules and procedures at its disposal to enforce the ALS.

How did the U.S. approach to the arm's-length standard spread outside its borders? Eden, Dacin, & Wan (forthcoming) argue that this cross-border diffusion to other tax jurisdictions was partly deliberate. In the 1970s, the U.S. Treasury actively encouraged the OECD's Committee on Fiscal Affairs (CFA) to develop transfer

[3]The most controversial changes were periodic adjustments, the comparable profits method (CPM), contemporaneous documentation, and the inaccuracy penalty. *See* Eden (1998, Chs. 8 and 9).

Table 2: The Arm's-Length Standard in North America, 1917-99

Date	Gvt	Transfer Pricing Regulatory Change
		I. Purpose and Scope
1917	US	S.41: IRS has right to allocate income and deductions among related parties.
1928	US	S.45 provides rationales (prevent tax avoidance, determine true taxable liability) for allocating income and deductions.
1939	CA	S.23B: Revenue Canada can adjust cross-border payments to offshore related parties (outbound transfers).
1949	CA	S.23B is broadened to include inbound transfers and renumbered as S.17(3) [overinvoicing of inbound transfers] and 17(3(A)) [underinvoicing of outbound transfers].
1952	CA	S.17(3(A)) is renumbered as S.17(4).
1972	CA	S.17(3) and 17(4) are renumbered as S.69(2) and 69(3).
1976	MX	A.64: Transactions between related parties must be conducted at arm's-length.
1992	MX	1992 Income Tax Law gives SHCP the authority to reallocate fiscal profits and losses of related parties, regardless of the party's tax residence.
1994	US	Final version of IRS 482 regulations restates purpose of legislation: To ensure taxpayers clearly reflect income attributable to controlled transactions, and to prevent the avoidance of taxes with respect to such transactions. Determine true taxable income of controlled taxpayer.
1994	MX	A.64 amended to give SHCP the right to make adjustments in three situations (non-FMV, sales below cost, export-import transactions & remittances). A.64-A added to give SHCP specific authority to apply the ALS only if the transactions are between related parties and not conducted at arm's-length.
1995	MX	Dec 1994 amendment applies transfer pricing rules to maquiladoras starting in 1995.
1997	MX	A.64-A: In Dec.1996, Mexico passes its first comprehensive transfer pricing legislation. Transfer pricing rules are expanded beyond maquilas to apply to all taxpayers (domestic and foreign) with Mexican income and intrafirm (domestic and international) transactions. Definition of "related party" very broad: two parties are related if one participates directly or indirectly in the management, control or capital of the other (no minimum percent control or ownership requirement).
1997	CA	S.247: Canada introduces new transfer pricing legislation to replace S.69(2,3). Applies to all transactions between Canadian taxpayers and nonresident persons with whom the taxpayer does not deal at arm's-length. Transactions include arrangements or events. Broadens previous legislation to specifically include partners, partnerships and qualified cost contribution arrangements.
1998	US	March 1998, IRS issues proposed transfer pricing regulations to cover entities engaged in global trading (securities dealing).
1998	MX	Dec.98, Mexico tightens tax rules, broadens its tax base and raises tax rates. Definition of permanent establishment (PE) broadened, with maquilas to be treated as PEs in 2000. Resident corporations are defined as entities either incorporated under Mexican law, with their place of administration or seat of effective control in Mexico. Nonresident entities can no longer be part of a consolidated group for tax purposes even if they have a permanent establishment or fixed base in Mexico. The percentage of a subsidiary's income or losses that can be consolidated with the group is reduced from 100% to 60%.
1999	MX	U.S.-Mexico dispute over applying the ALS to maquilas leads to three-year temporary compromise. A U.S. maquila will not be treated as PE if entity reports income above threshold percent of assets or operating costs, or has APA certifying that prices between the maquila and its U.S. parent are at arm's-length.
		II. Definition of the Arm's-Length Standard
1935	US	S.45-1(b) defines the arm's-length standard as that of an uncontrolled taxpayer dealing at arm's-length with another uncontrolled taxpayer.
1952	CA	S.139(5) defines arm's-length relations; S.17 defines the arm's-length price as the "reasonable amount".
1972	CA	S.69(2,3): Transfer prices for cross-border related party transactions should be reasonable in the circumstances. 69(2) deals with overpayment of outbound transfers; 69(3) with underpayment of inbound transfers.
1976	MX	A.64: Transactions between related parties must be conducted at arm's-length.
1994	US	IRS S.482 regulations: A controlled transaction meets the arm's-length test if the results are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in a comparable transaction under comparable circumstances (arm's-length result).
1997	MX	A.64-A incorporates the arm's-length standard in the OECD Guidelines. Taxpayers must conduct transactions with related parties using the prices and amounts that would have been utilized between independent parties in comparable transactions.

Table 2: The Arm's-Length Standard in North America, 1917-99

Date	Gvt	Transfer Pricing Regulatory Change
1997	CA	S.247: Canada introduces new transfer pricing legislation to replace S.69. ALS defined similar to OECD 1995 guidelines. Non-arm's-length parties must conduct their transactions under terms and conditions that would have prevailed if the parties had been dealing at arm's length with each other.
1998	CA	S.247 becomes law on June 18, 1998, effective for 1998 tax year.
		III. Transfer Pricing Rules
1968	US	IRS 482 Regulations: establishing types of transactions and acceptable pricing methods (CUP, RP, C+, other).
1986	US	S.1059A: customs valuation is added as fifth method, provides ceiling on the transfer price.
1986	US	S.1231(2): adds sentence to S.482 stating that transfer prices of intangibles must be "commensurate with the income" (CWI) earned from the intangibles.
1987	CA	Revenue Canada issues Information Circular 87-2 transfer pricing guidelines establishing types of transactions and acceptable pricing methods (CUP, RP, C+, other)
1988	US	U.S. Treasury White Paper outlines possible transfer pricing methods for intangibles, recommends BALRM (basic arm's-length return method).
1992	US	IRS issues proposed S.482 regulations based on CWI standard. Introduces best method criterion, arm's-length range, comparable profits method (CPM) & periodic adjustment of transfer prices for intangibles. Widely criticized inside and outside the U.S., including by the OECD's Committee on Fiscal Affairs.
1993	US	IRS issues temporary S.482 regulations that re-affirm commitment to the arm's-length standard, reduce role of CPM.
1994	US	IRS issues final S.482 regulations. Reaffirms arm's-length standard. Keeps best method, arm's-length range, CPM & periodic adjustments.
1994	CA	Finance & Revenue Canada issue joint News Release clarifying Canadian transfer pricing rules in light of S.482 changes ("hold fast") and recommending against the use of CPM.
1994	MX	SHCP issues transfer pricing regulations establishing four acceptable pricing methods (CUP, RP, C+, profit split).
1995	MX	SHCP begins to implement transfer pricing rules, starting with maquiladoras. Maquilas also no longer exempt from business assets tax, but there is a safe harbor rule: Maquilas are exempt from the business assets tax if they pay income tax equivalent to a minimum 5% taxable return on inflation adjusted assets, both domestic and foreign owned, or prove their transfer pricing methods satisfy the ALS. Thus, maquilas can no longer be treated as cost centers, but rather as profit centers.
1997	MX	A.64-A: All methods in 1995 OECD Guidelines are acceptable methods, including TNMM. Methods are not priorized. Comparability is defined in terms of transactions or enterprises. The ALS includes a range of acceptable prices, based on statistical methods. Generally acceptable accounting methods are required. Rules effective Jan.1997.
1997	CA	Canada initiates review of transfer pricing legislation to take account of U.S. 482 changes and 1995 OECD guidelines. Issues draft legislation S.247 and draft Information Circular 87-2R to accompany legislation. Circular recommends MNEs use method that produces the "most reliable result". Once higher ranking method satisfied, no need to review lower ranked methods. Transactional methods preferred to profit based methods. CUP #1 in transactional. Profit splits preferred to TNMM. TNMM method of last resort. CPM is not to be used. Hindsight not appropriate for determining value of intangibles, but Revenue Canada can recharacterize transactions under certain circumstances.
1998	US	IRS issues proposed global dealing regulations as S.482-8. Best method rule applies. Methods include CUP, RP, C+ and profit splits; CPM cannot be used.
1998	CA	New transfer pricing legislation very similar to draft legislation passed in June 1998, replacing S.69 with S.247, for tax years starting Jan.1998.
1998	MX	1998 tax reforms authorize the Mexican tax authority to make transfer pricing adjustments using secret comparables (confidential third party information). Information may not be revealed except in a judicial proceeding contesting the tax adjustment.
1999	CA	Final version of Information Circular 87-2R issued in Sept. 1999. Closely tracks draft IC 87-2R and IRS 482 regulations. CPM, if applied in manner consistent with TNMM, is acceptable method. Examples provided of various methods.
		IV. Transfer Pricing Procedures
IV.1. Reporting Requirements		
1962	US	S. 6038-1: Annual information reporting by U.S. parent corporations on their intrafirm transactions with foreign affiliates (Form 2952; in 1982 changed to Form 5471).

Table 2: The Arm's-Length Standard in North America, 1917-99

Date	Gvt	Transfer Pricing Regulatory Change
1982	US	S.6038A: Requires annual information reporting on intrafirm transactions by U.S. corporations with 50% or more foreign ownership (Form 5472).
1989	US	S.6038A: Annual reporting for firms with foreign ownership over 25%.
1988	CA	S.233.1: Annual reporting requirements for all firms engaged in non-arm's-length transactions with nonresidents (Form T106).
1990	US	S.6038C: Broadened to include U.S. branches of foreign MNEs. Now all foreign corporations regardless of percentage of foreign ownership must file.
1990	MX	All large firms are required to file a Tax Report identifying international trade & related party transactions.
1995	CA	Form T106 modified. Boxes added for transfer pricing methods.
1997	CA	Foreign reporting rules introduced in Feb.1995 budget. Passed into law April 1997. Canadian residents must file information return when they own as interest in a foreign affiliate, engage in transactions with non-resident trusts, or own more than $100,000 in foreign investment property. Failure to file or false statements lead to penalties. First filing deadline: June 1998.
1997	MX	December 1996 tax reforms require that, starting in 1998, taxpayers must file an annual information return each February, detailing their investments made or maintained in tax haven countries, with possible incarceration penalties for failure to file within three months.
1999	CA	Form T106 modified and expanded to reflect new S.247. Applies to corporations, individuals, trusts and partnerships with non-arm's-length transactions in excess of C $1 million. Taxpayers must indicate whether they have transfer pricing documentation on hand and whether their transfer pricing methodology changed during the year.
IV.2. Request for Documents		
1982	US	S.982: IRS can make formal document request; taxpayer cannot withhold documents without penalty except for reasonable cause and evidence of substantial compliance.
1988	CA	S.231.6: Revenue Canada can make formal document request that a Canadian taxpayer provide within 90 days any information or document inside or outside of Canada. The taxpayer cannot withhold documents without penalty except for reasonable cause and evidence of substantial compliance.
IV.3. Record Keeping Requirements		
1989	US	OBRA '89: New record keeping requirements for intrafirm transactions. Records must be maintained in the U.S. Penalties for failure to maintain records.
IV.4. Advanced Pricing Agreements (APAs)		
1991	US	IRS issues Rev. Proc.91-22 outlining Advance Pricing Agreement procedures as new dispute resolution method.
1994	CA	Information Circular 94-4 provides circular on APA rules.
1994	MX	In 1994, SHCP initiates APA process and encourages maquiladora firms to apply. A coalition of maquilas forms a Transfer Pricing Committee to examine the transfer pricing for maquilas. Starting in 1995, Mexico requires maquilas to use arm's-length pricing methods. First maquila APA ruling issued in November 1995.
1995	MX	SHCP issues formal APA regulations based on return on capital employed method.
1996	US	Rev.Proc.96-53: APA revised procedures issued. Penalty Committee introduced.
1996	MX	A.34-A: APAs can be extended for up to four years before and after the tax year (9 years total). Multilateral APAs are restricted to countries with which Mexico has a tax treaty. A.37: Tax authorities have eight months to process an APA request.
1998	US	Notice 98-65: APAs for small businesses (gross income less than $200 million) introduced. Less information required, more flexible procedures, reduced user fee, quicker decision time.
1999	US	IRS announces it will make APAs public. Congress debate leads to compromise. IRS will make annual report on APAs, but individual APAs remain confidential.
1999	MX	Mexico sets up an APA Board that will meet quarterly to review APA applications. Maximum APA length to be cut from nine to five years.
IV.5. Contemporaneous Documentation of Transfer Pricing Methods		
1990	US	S.6662: Contemporaneous documentation of transfer pricing methodology required to avoid transfer pricing inaccuracy penalties.
1994	US	IRS issues final 482 regulations and final 6662 regulations requiring contemporaneous documentation of transfer pricing policies.

Table 2: The Arm's-Length Standard in North America, 1917-99

Date	Gvt	Transfer Pricing Regulatory Change
1995	MX	Starting in 1995, all maquiladoras must determine, use and document a transfer pricing method that conforms with Mexican transfer pricing law.
1997	MX	A.58: In December 1996, Mexico passed A.58 requiring all Mexican corporations conducting operations with foreign related parties to obtain and retain contemporaneous documentation on their transfer pricing policies and that they satisfied arm's-length criteria. No penalty applies for failure to comply.
1997	CA	Draft transfer pricing legislation includes contemporaneous documentation requirements in order to avoid inaccuracy penalty.
1998	CA	S.247(4): Contemporaneous documentation required starting 1999 tax year.
1998	MX	Implementation of A.58 deferred until the 1997 tax year. Corporate tax returns must include a statement that applicable transfer pricing documentation requirements have been met, no later than six months after filing the tax return.
IV.6. Accuracy-Related Transfer Pricing Penalties		
1990	US	S.6662: Inaccuracy penalty for S.482 violations introduced.
1994	US	IRS issues temporary 6662 regulations on accuracy-related penalty to accompany final 482 regulations. Penalties effective as of 1994.
1996	US	IRS issues final 6662 regulations. Sets up Transfer Pricing Penalty Oversight Committee to ensure uniform application of reasonableness standard and documentation requirements on a national basis.
1997	MX	In December 1996, Mexico introduces tax penalties of 50%-100% of adjusted tax, for underpayment of taxation due to transfer pricing adjustments. The penalty is halved if the taxpayer has satisfied contemporaneous documentation requirements supporting an approved pricing method.
1997	CA	Draft legislation introduces inaccuracy penalty of 10% of net adjusted income unless party made reasonable efforts to use arm's-length and CD its method. The Minister has the discretion to not give beneficial transfer pricing adjustments. Neither the penalty nor interest on penalty are tax deductible.
1998	CA	Penalty legislation becomes law June 1998, effective for tax years after 1998.
1999	MX	Clarification of penalty regime to take account of losses. If the taxpayer has documentation and losses, the transfer pricing penalty is reduced to 15-20% of the overstated loss.
IV.7. Bilateral Income Tax Treaties within North America		
1936		First U.S.-Canada bilateral tax treaty.
1942		Second US-Canada bilateral tax treaty.
1980		Third U.S.-Canada bilateral tax treaty signed in 1980, amended by protocols in 1983 and 1984, takes effect Jan.1985.
1989		U.S.-Mexico exchange of information agreement.
1990		Canada-Mexico exchange of information agreement.
1991		Canada-Mexico bilateral income tax treaty, takes effect Jan. 1992.
1992		U.S.-Mexico bilateral tax treaty and protocol signed in September 1992, takes effect Jan. 1994. Typical treaty except that maquiladoras are not considered to be permanent establishments for Mexican income tax purposes.
1994		U.S.-Canada protocol signed in 1994, revised in 1995, takes effect Jan. 1996.
1994		U.S.-Mexico protocol signed in Sept. 1994, takes effect Jan. 1996.
1997		U.S.-Canada protocol signed July 1997, takes effect December 1997.

pricing standards that would be adopted by all OECD member countries, arguing that a unilateral regulatory approach would not work in a world of mobile capital. The Treasury was successful; the 1979 OECD guidelines closely followed the three-method approach pioneered by the 1968 IRS regulations. Subsequent OECD transfer pricing guidelines (the 1984 and 1995 guidelines) have also followed the U.S. policy lead. The U.S. tax authority has continued, and continues, to play the dominant role in the development of transfer pricing and international tax guidelines within the Committee on Fiscal Affairs.

The adoption of the arm's-length standard by Canada was initially slow and gradual. In 1939, section 23B was added to the Income Tax Act, giving the government the right to adjust outbound transfers between related parties; 10 years later, inbound transfers were added. The legislation, renumbered as 69(2,3), was not well enforced until after the publication in 1987 of Information Circular (IC) 87-2, which was based on the 1968 IRS regulations and the 1979 OECD transfer pricing guidelines (Canada has been a longtime OECD member). Revenue Canada also followed the IRS's lead on the procedural front, bringing in reporting requirements and APAs in the early 1990s. However, Canada strongly resisted following the IRS 1994 transfer pricing regulations, even after the OECD published its own guidelines in 1995. This resistance lasted only until 1998, when section 69(2,3) was replaced by section 247. Though long and convoluted, section 247 in spirit and approach now resembles section 482. The revised Information Circular (IC 87-2R), finalized in September 1999, also adopts many of the innovations in the 1994 IRS section 482 regulations, including the best method rule, the arm's-length range, TNMM (and possibly even CPM). Contemporaneous documentation and an inaccuracy penalty were also introduced, following the IRS's lead.

The spread of U.S. transfer pricing regulation to Mexico was much slower than to Canada. Mexico did not adopt the ALS until 1976. Formal legislation amending the Mexican tax code to specify the types of transactions and transfer pricing methods appeared only in the mid-1990s, after Mexico joined NAFTA and the OECD in 1994. The pace of legislative and regulatory change has quickened substantially since then, with new changes now occurring at least yearly. At the end of the 1990s, Mexico's transfer pricing system looks very much like those of its northern neighbors.

Looking at the historical data in Table 2, it is clear that the U.S. government was the first mover, and the Canadian and Mexican governments followers in developing transfer pricing regulation. The gap in time between U.S. tax changes and Canadian responses fell over the period, both in terms of the specific rules and procedural changes. Canada can be seen as a fast follower in adopting the U.S. version of the ALS, whereas Mexico is clearly a latecomer (although the adoption rate has accelerated enormously since the mid-1990s).

Eden, Dacin, & Wan (forthcoming) argue that there were a variety of reasons why Canada was an early adopter and Mexico a latecomer. Canada had, and has, much stronger and larger cross-border linkages with the United States in terms of foreign direct investment (FDI), trade, and intrafirm trade flows than Mexico. There were more vested interests in Canada (U.S. and Canadian multinationals) anxious to have a common set of rules governing intrafirm trade and FDI flows. Canada also has stronger cultural linkages and ties with the United States. Canadian and U.S. tax authorities have regularly interacted at the bilateral level (through the competent authority provisions under the Canada-U.S. tax treaty) and multilateral (OECD) level for many years, whereas Mexico did not participate in this institution until the mid-1990s.

What motivated the Canadian and Mexican governments to adopt U.S.-type transfer pricing regulation? Their membership in the OECD, and the active advocacy role of the U.S. Treasury, are partly responsible. Both governments were also driven by their need to offset expected revenue losses from U.S. tax changes (a reaction effect), and they voluntarily emulated policies they believed useful (a replication effect).[4] In the 1990s, cross-border adoption of the ALS by Canada has primarily been in the form of reaction effects, as the Canadian government sought to protect its revenue base from the (perceived) grasping hands of the U.S. Treasury. Hacienda's responses in the 1990s, on the other hand, were motivated by the Mexican government's desire to achieve membership and legitimacy in NAFTA and the OECD. This legitimacy was expected to encourage inward FDI and economic growth.

Even though Canadian and Mexican transfer pricing legislation and regulations are not identical to those in the United States, they are very close. At the end of the 1990s, we argue that cross-border diffusion of the U.S. version of the arm's-length standard has created a North American transfer pricing regime with common purposes and scope, rules, and procedures. This is outlined in Table 3.

Conclusion

Transfer pricing experts tend to focus on the here and now — what the legislation says today and how to interpret the regulations. However, the development of transfer pricing law and practice has a long history in North America. Our short study illustrates the dominant role played by the U.S. Treasury and the Internal Revenue Service in creating today's arm's-length standard. In January 2000, the beginning of a new millennium, a look back at history is appropriate and may also provide useful signals as to how the tax transfer pricing regime is likely to evolve in the future. Will current transfer pricing issues (for instance, e-commerce, global trading) follow the path of their predecessors? We will see.

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[4]Hacienda even invited the IRS to help develop Mexican transfer pricing rules and procedures, and train Mexican auditors, in the mid-1990s. *See* Eden, Dacin, & Wan (forthcoming).

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Table 3: The Arm's-Length Standard in North America, 2000

Gvt	Arm's-Length Standard Categories
	I. Purpose and Scope of the Arm's-Length Standard
US	Ensure taxpayers clearly reflect income attributable to controlled transactions, and to prevent the avoidance of taxes with respect to such transactions. Determine true taxable income of controlled taxpayer.
CA	Any transaction between a taxpayer and a related non-resident party where [1] terms and conditions differ from those made by arm's-length parties or [2] the transaction would not have been entered into by arm's-length parties and its purpose was not primarily bona fide other than to obtain a tax benefit
MX	Tax profits and losses of related parties, regardless of the party's tax residence, can be reallocated when operations are at less than fair market value, sales of goods are at cost or less than cost, export-import transactions, and payments abroad.
	II. Definition of the Arm's-Length Standard
US	A controlled transaction is arm's-length if the results are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in a comparable transaction under comparable circumstances (arm's-length result).
CA	Non-arm's-length parties must conduct their transactions under terms and conditions that would have prevailed if the parties had been dealing at arm's-length with each other.
MX	Taxpayers must conduct transactions with related parties using the prices and amounts that would have been utilized between independent parties in comparable transactions.
	III. Transfer Pricing Rules
US	CUP, resale price, cost plus, computed profits method (CPM), profit splits. No ranking, but preference for CUP. Best method rule requires comparison among methods based on comparability, quality of data and assumptions. There is a range of arm's-length results; if price is outside range, adjust to midpoint of interquartile range. Periodic adjustments to intangible contracts if transfer price lies outside 80-120% range.
CA	CUP, resale price, cost plus, profit splits. Transactional net margin method (TNMM) is method of last resort. CPM acceptable if applied like TNMM. CUP is the #1 preferred method. Transactional methods are preferred to profit based methods; profit splits are preferred to TNMM. The method must produce "most reliable result", implying comparisons must be made across methods. However, once a higher ranking method is satisfied, there is no need to review lower ranked methods. There is a range of arm's-length results. Hindsight is not appropriate for determining value of intangibles, but Revenue Canada can recharacterize transactions under certain circumstances.
MX	CUP, resale price, cost plus, TNMM, profit splits. CPM not listed but "net cost plus" defined as (net profit /(COGS + operating expenses)) is acceptable. Methods are not priorized but preference for transactional methods. Best method rule does not apply. There is a range of arm's-length results; if price is outside range, adjust to median of interquartile range.
	IV. Transfer Pricing Procedures
IV.1. Reporting Requirements	
US	Transactions with related parties must be reported annually. Penalties for failure to report.
CA	Resident corporations must report transactions with related parties annually. Residents must also file information returns when they own as interest in a foreign affiliate, have transactions with non-resident trusts, or own more than $100,000 in foreign investment property. Penalties for failure to file.
MX	Large firms required to file a Tax Report identifying international trade & related party transactions. Taxpayers must file an annual information return detailing investments made or maintained in tax haven countries. Penalties for failure to file.

Table 3: The Arm's-Length Standard in North America, 2000

Gvt	Arm's-Length Standard Categories
IV.2. Request for Documents	
US	Foreign documents must be presented upon request. Must be translated into English. Noncompliance penalties.
CA	Foreign documents must be presented within three months of a request. Noncompliance penalties.
MX	No procedure.
IV.3. Record Keeping Requirements	
US	Records must be maintained in U.S. Penalties for failure to maintain records.
CA	No specific transfer pricing regulation, but books and records for Canadian taxpayers must be maintained in Canada and produced upon request. Penalties for failure to maintain records.
MX	No procedure.
IV.4. Advanced Pricing Agreements (APAs)	
US	APAs encouraged. New small business APAs. Dispute over whether IRS should make APAs public information. Solution: IRS to issue annual APA report but individual APAs to remain confidential.
CA	APAs for large taxpayers encouraged, especially bilateral APAs.
MX	APA program initially directed to maquilas; now open to all large firms.
IV.5. Contemporaneous Documentation (CD) of Transfer Pricing Methods	
US	CD when file tax return is required in order to avoid inaccuracy penalty.
CA	CD by tax filing return due date is required in order to avoid inaccuracy penalty.
MX	CD required but no specific penalty for failure to document transfer pricing methods.
IV.6. Inaccuracy-related Transfer Pricing Penalties	
US	20% [40%] of tax payable for substantial [gross] misvaluations unless demonstrate "reasonable cause and good faith" through CD and best method rule. Interest on penalty tax deductible.
CA	Inaccuracy penalty of 10% of net adjusted income unless party made reasonable efforts to use arm's-length method and CD. Negative adjustments only taken into account at discretion of the Minister. Neither the penalty nor interest is tax deductible (recent court case may change this).
MX	50%-100% of adjusted tax payable, plus surcharges, for improper transfer pricing. If tax adjustment comes from an audit, penalty is cut in half if CD of transfer pricing method. Reduced penalties if taxpayer has losses but CD.
IV.7. Bilateral Income Tax Treaties	
Most recent treaties, or protocols to treaties, in effect as of: Canada-Mexico (1992), U.S.-Mexico (1994), U.S.-Canada (1997). Treaties follow the OECD Model Income Tax Convention; e.g., definitions of tax bases, establishment of mutual agreement procedure, reductions in withholding tax rates. National treatment and most favored nation principles apply.	