

CENTRE FOR TAX SYSTEM INTEGRITY



Comparing cross-cultural regulatory styles and processes in dealing with transfer pricing

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**COMPARING CROSS-CULTURAL
REGULATORY STYLES AND
PROCESSES IN DEALING WITH
TRANSFER PRICING**

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This series of working papers is designed to bring the research of the Centre for Tax System Integrity to as wide an audience as possible and to promote discussion among researchers, academics and practitioners both nationally and internationally on taxation compliance.

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Abstract

The aim of this paper is to find ways to reduce conflict between tax administrations and multinational corporations (MNCs) and between tax administrations in relation to transfer pricing. This paper examines cross-national differences in both management and regulatory styles between the US, the UK and Japan in relation to transfer pricing and evaluates Australia's transfer pricing regulatory strategy. Data were based on semi-structured interviews conducted in July 2000 to September 2001 with tax managers working for MNCs, tax advisors employed by the Big Five accounting firms, and revenue authorities from Australia, Japan, the UK and the US. The results suggest that cross-national differences in management styles do exist between Japanese MNCs and their Western counterparts. However, harmonisation of management styles is occurring. The results suggest that the different regulatory styles employed by US, UK and Japanese tax administrations have both merits and shortcomings for ensuring compliance with transfer pricing rules. The implications of this study are discussed in a global regulatory context.

Comparing cross-cultural regulatory styles and processes in dealing with transfer pricing

Yuka Sakurai

Transfer pricing is 100% grey - nothing white or nothing black (Tax advisor in Sydney).

Transfer pricing is like a work of art. A question of reasonableness (Tax advisor in Sydney).

Setting the transfer price is often a matter of judgment...there is usually no right or wrong answer, just a range of possible rational results' (Tax manager of UK MNC)

Introduction

With the rapid growth of multinational corporations (MNCs), the pricing of intra-company transactions (transfer pricing) undertaken by MNCs has become a major international taxation issue in recent years. A transfer price is the internal price at which a company of a multinational group undertakes transactions of tangible goods, intangible property, and services with its associated companies across national borders (intra-group foreign trade). MNCs have the ability to manipulate their transfer prices to shift profits in order to avoid tax. For example, low prices paid for transfers into a high tax nation will reduce the taxes paid in that country by shifting profits to the supporting nation. In short, transfer prices determine a significant proportion of the income and expenses of MNCs, and hence declared taxable profits of associated companies in each tax jurisdiction (Abdalla, 1989). A small alteration in transfer prices can result in significant revenue losses in some jurisdictions (Atkinson & Tyrrell, 1999). Consequently, a number of countries have recently tightened transfer pricing legislation¹ and have been increasingly engaging in

¹ For example, the US updated section 482 of the Internal Revenue Code of 1986 in 1994; the UK set up a new legislation is incorporated in the Income and Corporation Taxes Act 1988 and Schedule 28 AA was introduced in 1998.

transfer pricing audit and investigation (see Tan-Nygoyen, 2000; Hielscher & Kaneko, 1999; Lewis, 2001)².

With greater scrutiny by revenue authorities, MNCs therefore face an increased risk of transfer pricing audits. If an adjustment is made as a result of a transfer pricing audit, the amount of adjustment is generally large³. Accordingly, management of transfer pricing policies has become a growing concern for MNCs. In 1999 Ernst & Young International Ltd. conducted a global transfer pricing survey, which involved international tax directors from 582 multinational parents in 19 countries, and 124 foreign-owned subsidiaries in Europe and the North America. The survey found that 61% of parent companies and 97% of subsidiaries saw transfer pricing as the number one tax issue they would face in the next two years (Ernst & Young International Ltd., 1999). It is therefore not surprising that MNCs are devoting more time and spending more money on professional tax advice to ensure their transfer pricing compliance (The Economist, 2000).

Increasingly, there has been recognition for the idea of setting up commonly accepted ethical standards or principles in varied cultural settings to regulate MNCs' global activities. Given that transfer pricing involves more than one tax jurisdiction, international cooperation is needed to avoid double taxation problems as well as to counter tax avoidance by MNCs (Atkinson & Tyrrell, 1999). Responding to this demand, the Organisation for Economic Cooperation and Development (OECD) released transfer pricing guidelines (OECD1979, 1995) which provided the 'arm's length' principle and methodologies to evaluate the arm's length transfer price. The 'arm's length' principle means that a transfer price, at which a transaction is conducted between related companies, has to be equivalent to the price at which a comparable transaction is carried out by unrelated parties in the open market.

² For example, of the 271 deficiency assessments when was the law enacted on transfer pricing cases that were made since the enactment of the law in Japan, 185 audits were between 1996-1999 (Hielscher & Kaneko, 1990). In Australia, 47 transfer pricing audits were completed in respect of the 2000 income year.

³ For example, in 1998 the National Tax Administration (NTA) in Japan imposed the adjustment of 54.1 billion yen (US\$0.42 billion) for the period of 1992-1997 to Yamanouchi Pharmaceutical; in the same year, the NTA adjusted transfer pricing by 13.7 billion yen (0.11 billion US\$) to Murata Manufacturing (PWC, 2001).

The OECD guidelines on transfer pricing in theory should ‘build a consensus on international taxation principles, thereby avoiding unilateral responses to multilateral problems’. However, in reality the application and interpretation of the arm’s length standard varies among member countries. Picciotto (1992; 1993) argues that the international framework for corporate taxation lacks political legitimacy, specifically it lacks adequate principles, transparency and procedural fairness. Despite the fact that more detailed transfer regulations have been set up in a number of countries, transfer pricing is highly subject to interpretation and judgment, making it hard to find the ‘right’ answer. Given that the absence of uniform practices among tax administrations, transfer pricing ‘has become a real bone of contention between MNCs and tax authorities’ (Mehadi, 2000) and also has become ‘a prime area for international conflict’ between tax administrations (Eden et al., 2001).

The aims of this paper are to provide an indication of how tax authorities can improve regulatory strategies for increasing the level of MNCs’ compliance with transfer pricing regulations, and find ways to reduce conflicts between tax administrations and MNCs and between tax administrations. To achieve these objectives, this paper focuses on the dynamics of cross-cultural relationships surrounding transfer pricing. Specifically, cross-national differences in management and regulatory styles between the United States of America (the US), the United Kingdom (the UK) and Japan are examined. This paper begins with a brief review of relevant literature on transfer pricing, and of comparative management and regulatory styles. Following this, the research questions are outlined and the methodology employed in the present study is discussed. Findings in relation to US, UK, and Japanese management and regulatory styles are then presented followed by an evaluation of Australia’s transfer pricing regulatory strategy. Finally the implications of the findings are discussed in a global regulatory context.

A brief overview of the transfer pricing literature

Transfer pricing has received substantial attention in recent years from both academics and practitioners, and the amount of research on transfer pricing is on the increase (for a review see Anne, 2002). To meet this demand, several journals have been forwarded to focus

solely on transfer pricing issues. They include: *Global Transfer Pricing*; *Tax Management Transfer Pricing Report*; *Transfer Pricing Report*; *International Transfer Pricing Journal*. In these journals, tax practitioners provide updated information on the technical aspects of transfer pricing and they also provide detailed interpretations of transfer pricing legislation and its requirements in various countries.

In the economic and management accounting literature, transfer pricing is studied as a strategic device to increase the competitive advantage of an organisation (Gox, 2000; Vidal & Goetschalckx, 2001) or to shift profits (Harris, 1993; Klassen et al., 1993; Jacob, 1996; Conover & Nichols, 2000). Factors such as tax minimisation, trade policy, foreign direct investment inducements and foreign exchange are considered to affect transfer pricing strategies of MNCs (Anne, 2002). Some research draws attention to the internal decision-making and negotiation process within MNCs in determining their transfer prices. For instance, the extent to which the responsibility of pricing decisions is delegated to divisional managers, the performance evaluation of divisional managers and the interdependence of sourcing decisions⁴ have been linked to transfer price outcomes (Eccles, 1985; Spicer, 1988; Colbert & Spicer, 1995, Ghosh, 2000). Thus, transfer pricing is regarded as an integral part of the organisation's functioning that is closely linked with its overall corporate strategy and performance (Cravens, 1996). Mehafdi (2000, p. 366) claims that '[transfer pricing] problems are not just about transfer prices per se. As they are mostly determined inside companies, transfer prices are delimited by and inseparable from the wider organisational, managerial and cultural characteristics of [MNCs]'. This suggests that in order to understand transfer pricing policies and strategies, the broader characteristics of MNCs should be taken into account.

Management styles and tax compliance

The cross-cultural management literature suggests that national context and culture have an impact upon the establishment of strategic management styles and financial approaches (Carr & Tomkins, 1998). The management policies employed by Japanese MNCs are

⁴ Sourcing decision refers to 'the selection of a supplier by a buyer' and 'customer selection by the seller (see Gosh, 2000, p. 661).

characterised by long-term profitability and market expansion (Carr & Tomkins, 1998) and parent companies play active roles in the formation of long-term plans and strategies for subsidiaries (Goold, Campbell & Alexander, 1994). In contrast, American and British MNCs often employ short-term profit oriented management policies (Carr & Tomkins, 1998). Subsidiaries enjoy freedom from the control of their parents, but at the same time, are required to meet short-term financial targets. Japanese MNCs' close relationships with banks, along with mutual cross-ownership and an interlocking stockholding system, allow for pursuit of long-term profits that are not too affected by stock-market pressures or threats from acquisition (Aoki, 1990). British and American firms, on the other hand, are under stock-market pressure, so that their management policies focus upon earnings per share for their stockholders (Carr & Tomkins, 1998).

Some researchers show that the Japanese culture has contributed to the development of a unique costing structure within Japanese manufacturing firms (Kato, 1993). Buckley and Hughes (1998) argue that Japanese MNCs operate as one entity, and the role of their subsidiaries is to act as operational agents whose primary purpose is to generate a central profit in their home base while accepting low profitability in the host country. Thus, it is suggested that taxpaying behaviour of MNCs in host country jurisdictions and transfer pricing policies may be explained by cross-national differences in their management policies.

Regulatory styles and tax compliance

Kagan (2000, p. 227) acknowledges that 'national legal traditions, political structures, industrial organization, and cultural attitudes- all of which shape regulatory rules and institutions-*resist* homogenization'. Moreover, Kagan continues that 'even when national laws articulate similar norms, domestic regulatory styles often differ, producing cross-national variation in regulatory outcomes' (2000, p. 227). Cross-national differences in regulatory style are well documented. A number of studies have been conducted to compare the regulatory cultures of the US and Japan in various contexts such as environmental (Aoki, 2000; Kitamura, 2000), financial services (Milhaupt & Miller, 2000) and labour market regulation (Wokutch & Vansandt, 2000). Many have observed that the

US takes a legal and adversarial approach, while Japan takes an informal and cooperative approach (Kagan, 2000; Aoki, 2000; Milhaupt & Miller, 2000). As a result, the regulatory relationship in the US is characterised as formal, distant, adversarial, rigid and suspicious, whereas in Japan it is informal, close, cooperative, flexible and reciprocal (Kagan, 2000; Aoki, 2000; Milhaupt & Miller, 2000).

Studies comparing US and UK regulatory styles have also led to similar conclusions (Hawkins, 1984; Vogel, 1986; Braithwaite & Braithwaite, 1995). For example, according to Vogel (1986), the US approach to environmental regulation is very rigid and rule-oriented, and business-government relations are characterised as tense and adversarial. On the other hand, the UK approach is very flexible and informal and encourages self-regulation and cooperation between governmental officials and industry representatives. Braithwaite and Braithwaite (1995) examined nursing-home regulation and regulatory practices in the UK and the US. They conclude that while American law is more substantive and less formal than British law, British regulatory practice is more discretionary and less formal than American regulatory practice.

Few empirical studies have been undertaken comparing regulatory styles in a context of taxation, but there is a suggestion the differences do in fact exist. According to Picciotto (1993, p. 399), 'British authorities have been very successful apparently in resolving cases by confidential negotiations with the representatives and advisors of enterprises', while 'in the USA the procedures have become increasingly juridified'. Picciotto's observation raises the question of the extent to which national regulatory culture shapes the tax compliance behaviour of MNCs.

The present study

Given that transfer pricing is more than a tax issue, revenue authorities should take a broader approach to transfer pricing before they undertake functional and comparable analyses in evaluating or assessing transfer prices of MNCs. Comparative management studies show the linkage between national cultures and management styles on the one hand, and the management accounting literature suggests the linkage between

organisational strategies, cultures and transfer pricing on the other. However, little attention has been paid to the effect of management styles that have their origins in cultural traditions and practices upon their transfer pricing policies of MNCs. Moreover, in the burgeoning transfer pricing literature, the dynamics of cross-cultural relationships and a regulatory culture that is shaped by the larger sovereignty of which it is part have been understudied. Thus, this paper takes a broader approach to transfer pricing by focusing on 1) the dynamics of cross-cultural relationships and the possible role they may play in shaping the transfer pricing environment, and 2) the differences in cross-cultural regulatory styles. Specifically, the present study:

- Examines differences in management policies and their effects upon tax policies held by Japanese, American and British MNCs;
- Analyses differences in regulatory style and process between Japan, the US and the UK in the taxation context;
- Examines the advantages and disadvantages of each regulatory style in transfer pricing compliance; and
- Evaluates the Australian Taxation Office's (Tax Office's) transfer pricing regulatory strategy.

The implications of the findings of this study will be discussed in a global regulatory context.

Research method and sample

Between July 2000 and September 2001, 55 interviews were conducted with:

- Tax managers working for MNCs (32 firms including automotive, electronic & electrical goods, medical devices, pharmaceutical goods, transport & storage, trading, and telecommunications);
- Tax advisors who specialised in transfer pricing issues employed by the international taxation division of international public accounting firms (the Big Five)⁵; and;

⁵ The Big Five refers to Deloitte & Touche, Arthur Andersen; Ernst & Young; Pricewaterhouse Coopers; and KPMG.

- Revenue authorities from Japan (National Tax Administration/NTA), United Kingdom (Inland Revenue/IR), United States of America (Internal Revenue Service/IRS), and Australia (Australian Tax Office/ATO).

The breakdown of firms and organizations visited in the four jurisdictions (Japan, US, UK and Australia) are listed in Table 1.

Table 1: The breakdown of the interviews with MNCs, tax advisors and revenue officials in each tax jurisdiction

Jurisdiction	Japanese MNCs	American MNCs	British MNCs	Tax advisor	Revenue officials
Japan	6	2	N/A	4	2
US	2	3	N/A	2	3
UK	2	N/A	3	2	2
Australia	10	3	1	4	5
Total	20	8	4	12	12

Initial contact was made by letter, in some cases by e-mail. The letter explained the research objectives and asked for a face-to-face interview with tax managers, tax advisors, and revenue officials respectively. Nineteen of the companies approached refused to be interviewed. The main reasons given were that: a) managers were too busy to engage in extra non-business activities, b) their firms did not see themselves obtaining any direct benefits from participation, or c) they did not feel qualified to talk about the issues because they did not have transfer pricing disputes with revenue authorities or they lack experience of advance pricing arrangements (APAs).

All interviews were conducted face to face with the exception of two: One was conducted as a telephone conference, the other via e-mail. Interviews took one and two hours. Interviews were tape-recorded where interviewees consented. Indented quotes and italics in this paper are direct quotes from the interview transcripts unless otherwise indicated. Interviews with Japanese managers were mostly conducted in Japanese, which were

transcribed and later translated into English by the researcher. The interviews were semi-structured with participants being given ample opportunity to raise questions and problems.

The findings of this paper are presented below in relation to: 1) the management policies held by Japanese, American and British MNCs and their effects upon the tax policies of the firms; 2) the regulatory styles and processes employed by Japanese, American and British tax administrations, as perceived by participants in this study; and 3) the evaluation of the Tax Office's transfer pricing regulatory strategies.

Research findings:

1. Comparison in management policies and their effects upon tax policies between Japanese and Western MNCs

In the course of conducting the interviews, it was suggested by several interviewees that tax compliance behaviour and tax planning of MNCs were influenced by management policies and accounting practices. The majority of interviewees supported the notion that there were significant differences in attitude towards tax between Japanese MNCs and their British and American counterparts. Most tax advisors and host national tax managers of Japanese MNCs agreed that Japanese companies were less motivated by tax minimisation than their Western counterparts. They stressed that Japanese companies were far more conservative in tax planning compared to MNCs of other nationals in which they had previously worked. As expected, most interviewees regarded management policies as one of the factors to contribute to such differences.

Long-term vs short-term profitability

Consistent with past research, it was found that Japanese MNCs 'traditionally' tended to have management policies which pursued longer term profits and put more emphasis on market expansion than Western MNCs. This resulted in lower profitability in the overseas subsidiaries of Japanese MNCs. A few tax advisors stated that non-Japanese revenue authorities should not have looked at the performance of overseas subsidiaries of Japanese companies within such a narrow compliance framework, but should have taken a broader

perspective that acknowledged economic and business practices. They argued that small margins or low profitability in overseas subsidiaries of Japanese MNCs resulted from management policies or the nature of their business, not from tax avoidance. This sentiment is highlighted in the following quote:

Japan has always been volume-driven, building factories first, getting the volume through, as a result they always work on fine margins.

Tax managers from Japanese trading houses, in particular, felt that foreign revenue authorities did not understand the unique nature of their business and applied inappropriate transfer pricing methods. This often led to unfair outcomes from the perspective of Japanese MNCs:

Foreign revenue authorities should realise that the way Japanese MNCs operate is different from Western MNCs. Japanese MNCs, especially trading houses, generally work on small margins. Applying a certain transfer pricing methodology, such as CPM⁶, to Japanese MNCs would produce unfair outcomes.

If management policies are geared toward long-term profitability, it is not unreasonable to discount poor economic performance in overseas subsidiaries. However, if management policies are oriented to short-term profitability, it does not make sense from an economic point of view to keep foreign subsidiaries which make excessive losses for a few years. According to one Australian tax advisor, this fundamental disagreement occurs between Japanese and Anglo-American revenue authorities when they negotiate transfer pricing cases involving overseas subsidiaries of Japanese MNCs. Anglo-American revenue authorities may impose transfer pricing adjustments upon overseas subsidiaries of Japanese MNCs, believing that poor economic performance of Japanese MNCs in their countries are not economically justifiable.

One Australian revenue official said that Japanese culture has contributed to the costing structure of Japanese MNCs, but , their outcome behaviours are not always in kept at arm's length:

⁶ CPM refers to the Comparable Profits Method, which 'compares the overall profitability of controlled and uncontrolled companies rather than the profitability of transactions' (Atkinson, 1999, p. 140).

It [Japanese company's taxpaying behaviour] is not necessarily an arm's length behaviour, particularly when, what we have seen, a lot of them do undertake, or try to build market. Quite a few of them are driving out competitors and other companies. Basically making sure that they can be in a position to supply the Japanese market. I think we accept all of that [their management strategies], but I would question that whether this is the arm's length behaviour.

On the other hand, the Japanese revenue authority may try to justify the low profitability of overseas subsidiaries of Japanese MNCs from the standpoint of long-term profitability. The above examples demonstrate difficulties associating with the determination of the arm's length behaviour. It is important to take differences in management policy into account in assessing transfer pricing, but only to the extent that it does not undermine the arm's length principle. Tax authorities are not concerned with the motivations behind MNCs' transfer pricing strategies, but are concerned with the consequence of their behaviour if it results in reduction of tax liabilities. This suggests that there is discrepancy between motivation, action and outcome concerning transfer pricing.

Accounting standard and practices

Some interviewees stressed that accounting standards and practices drove tax planning of Japanese MNCs, whereas capital markets drove tax planning of American and British firms. Historically, the majority of Japanese MNCs have used an individual company-basis financial statement under Japan's Commercial Code, whereas American and British firms have been using a consolidated-basis financial statement. According to Yoost & Kerley (2001, p. 68), a single entity based financial statement 'had enabled the concealment of loss-making deals and activities from the investment community by simply transferring them to subsidiary undertakings'. As a result, only details of the parent company have been disclosed in Japan. Thus, this suggests that the single entity based accounting standard may have contributed to Japan lacking a concept of 'global' tax planning.

One NTA officer stated that American or British MNCs made tax policies at the global level, whereas Japanese MNCs did so at a more regional level. Tax managers of American and British MNCs commonly agreed that tax planning was coordinated and planned by the

headquarters and that subsidiaries were supposed to report all transfer pricing matters to the centre. When asked about their tax planning policies, one tax manager of an American MNC said:

Yes, it is global tax planning. The tax department in our headquarters does plan globally, particularly in regard to how much tax may be lodged in countries which do not have tax treaties with US.

The US and UK headquarters in this study generally had in-house specialists such as lawyers and accountants to manage and coordinate their transfer prices and execute global tax planning. A Japanese manager in the US subsidiary of a Japanese firm said that tax managers seemed to be more highly regarded in the US firms than in Japanese headquarters.

In contrast, when asked about their tax planning, only one Japanese MNC entailed to have a concept of global tax planning. Even in this case, the tax manager felt that his company lagged behind Western MNCs in the effectiveness of their tax planning.

One Japanese tax advisor stated that it was more common for Japanese MNCs to have lines of divisional responsibility. For example, transactions of the machinery division (and transfer prices) were decided by the divisional managers of headquarters and its subsidiary, rather than by the corporate general manager. The following quotes illustrate a lack of coordination in tax planning at the global level in Japanese MNCs:

Japanese companies tend to be organised by commodities. It is the division that sets its own arrangement. So overall, coordination is not particularly strong.

No, not really [global tax planning]. We evaluate each case (transaction) to make sure that we do not pay taxes more than necessary. After all, our business is based on stacks of small transactions or small investments.

Some of the Japanese MNCs employed local managers who were accountants to assist Japanese tax managers, but there were far fewer specialists in Japanese MNCs, as was indicated in the following quote:

There are some large Japanese firms which have in-house tax teams led by tax experts. But the tax teams in Japanese firms consist of only a few experts, in contrast to several dozen in American or European MNCs. I have not yet encountered Japanese firms which manage to control risks associated with taxation globally.

Recent changes in Japan

It should be noted that most Japanese tax managers expressed the view that their management policies were moving away from market-focused to more financial-focused strategies. A tax manager of one Japanese MNC stated that although financial matters in his company were still controlled by the regional financial director, sales and marketing had been gearing toward 'global' purchasing. Simultaneously, more and more overseas subsidiaries of Japanese MNCs are now employing host national tax specialists in order to assist expatriate managers to cope with local regulatory policies.

The above transformation resulted from recent transformations in accounting standards (from an individual entity-basis to consolidated-basis financial statements) in Japan, and severe recessions and the downfall of financial institutions over last 10 years.⁷ Japanese companies' attitudinal changes to tax and tax planning are suggested by the following statistics. In 1990, Japan's corporate income tax consisted of 6.6% of its GDP, which was the highest among the OECD countries (for example, 2.1% in US, 4.2% in UK and 4.2% in Australia). However, the ratio continued decreasing in Japan, and dropped to 3.4% in 1999, which was lower than that of the UK (3.8%) and Australia (4.9%) (Source: OECD, 2001).

Summary

Findings in this section suggest that there are differences in management policies between Japanese MNCs and their British and American counterparts, which go on to affect the tax compliance behaviour of MNCs. However, because of a continuing economic downturn, Japanese companies have been forced to undergo massive structural changes. Consequently, the management policies of Japanese MNCs are becoming similar to those

of British or American MNCs, focusing more on the profitability of a MNC group as a whole. Combined with management policies, the accounting standard employed in Japanese MNCs made Japanese MNCs place greater emphasis upon the organisational performance of headquarters than that of a group as a whole.

In this section, findings are summarised as follows:

- Management policies of Japanese MNCs are traditionally characterised as a long-term, market expansion oriented management strategy.
- Coupled with a single-entity based accounting standard, such management policies contributed to generating profits in the parent firm, thereby discounting losses in overseas subsidiaries.
- This resulted in less coordinated and centralised tax planning in Japanese MNCs than their Western counterparts.

On the contrary,

- Management policies of the US and UK MNCs are characterised by short-term profitability and earnings per share for shareholders.
- Such management policies and a consolidated financial statement led to the importance of global tax planning and centralised financial control.

In addition,

- With recent massive structural changes in Japan and the adoption of a consolidated financial statement by Japanese MNCs, Japanese MNCs are likely to reduce their focus on long-term profits and focus on more global management policies.

2. Cross-national differences in regulatory style and process among the US, the UK and Japan in relation to transfer pricing

Section 1 above highlights differences in management policies and accounting practices among Japanese, British and American MNCs that shape their tax compliance behaviour. This section examines cross-national differences in regulatory style and process and their

⁷ Reporting periods commencing on or after April 1999, financial statements should be a consolidated basis.

impact upon both the relationship between revenue authorities and businesses, and the tax compliance behaviour of MNCs. Differences in regulatory process among the US, UK, and Japan emerged from the interviews. I refer to the regulatory styles as:

- Adversarial legalism in the US;
- Non-confrontational negotiation in the UK; and
- Hierarchical consultation in Japan

Adversarial legalism in USA

The legalistic and adversarial relationship between the Internal Revenue Services (IRS) and MNCs is exemplified by the number of court cases on transfer pricing disputes. Between 1996 and 2000, 13 transfer pricing cases were concluded by the Tax Court (O'Brien & Oates, 2000). In comparison, only a few transfer cases have ever been disputed in court in the UK, and there has never been a legal case on transfer pricing legislation in Japan (PricewaterhouseCoopers, 2001). Most interviewees agreed that the US had a very strict codified tax system and that the IRS took a litigious approach toward taxation matters. One tax manager stated that a possible explanation for the IRS's greater reliance on the courts as the final arbiter was that the IRS needed uniform practice to manage the large size of the market and number of taxpayers. Another tax manager of a British firm observed that adversarial legalism in the US could be derived from a structural deficiency existing in the IRS. He noted that:

In the US, inspectors at the local level are evaluated according to the adjustment they propose, not according to the adjustment that is finally agreed upon. The agent writes up an adjustment, and it goes to the appeal officers. The appeal officers are evaluated according to how many cases they settle. All they want is to get a case off from their desk, and get someone else to do the job. So the first reasonable person you may meet is a judge. It is a ridiculous system.

Tax managers of American MNCs were generally supportive of the IRS regulatory practices, by saying that the IRS came up with more flexible and creative approaches than other tax administrations. It appeared that frequent disputes led to innovative new practices for transfer pricing, which in some cases favoured taxpayers. For example, the

establishment of the Advance Pricing Arrangement (APA), the simultaneous involvement of the Competent Authority and Appeals⁸ in resolving double taxation disputes (Rev. Proc.96-13, §8), and a ruling inviting Customs to participate in the APA process⁹ are seen as positive products of the litigious culture. The former allows taxpayers to pursue two different dispute resolution methods and the latter allows taxpayers to prevent disputes with two separate regulatory agents. Perhaps, the most positive product of the IRS's litigious approach is the abolishment of secret comparables by the IRS, which was accompanied by the adaptation of the Comparable Profits Method (CPM) in 1992. Using secret third party comparables means that when making assessments, the tax administration uses non-public third party transactional data obtained from other taxpayers (often a competitor of the taxpayer being investigated). As the third party data are treated as strictly confidential, the source of the information will not be disclosed to the taxpayer. Disclosure of the information in the court would also conflict with taxpayer confidentiality in the case of transfer pricing disputes (Hayuka, 1999).

All interviewees agreed that litigious solutions were costly and time consuming. According to O'Brien & Oates (2000), litigation is costly and time-consuming for both taxpayers and revenue authorities. The IRS' litigation costs incurred as a result of two recent transfer pricing cases in the US Tax Court were \$2.4 million and \$5.2 million. It was estimated that litigation costs incurred by taxpayers would be at least three to four times the IRS's costs (O'Brien & Oates, 1999). A tax manager of a Japanese company which had relied on litigation to resolve a transfer pricing dispute with the IRS in the past said:

The motivation to use the court as a final arbitrator was that there would be some merit to us. We expected that the court would give us a speedy solution to put an end to the prolonged audit. This was wrong. The litigation takes a long time. When we had a transfer pricing dispute with the IRS for the second time, we did not think about litigation at all.

⁸ Competent authority procedures for the relief of double taxation, resulting from a tax authority proposing an adjustment to transfer prices, are typically established in bilateral tax treaties. The goal of combining Appeals and Competent Authority Procedures is 'to expedite the resolution of issues by enabling Appeals to participate actively in the competent authority process' (Levey & Wrappe, 2001, p. 311).

⁹ 'An APA is an agreement negotiated between the MNC and one (unilateral) or more (bilateral or multilateral) tax authorities which governs the arm's length prices, returns and methods that the MNC will use during a specific future period' (Atkinson, 1999, p. 101).

The above manager stated that there would be no merit in taxpayers using litigation unless taxpayers could not use the competent authorities because of the absence of tax treaties between the countries.

Negative opinions toward the IRS's regulatory style were generally expressed by British MNCs and UK-based tax advisors who were more or less satisfied with the non-confrontational approach taken by their own revenue authority:

American companies have great respect or even fear for the IRS. Culturally the IRS is aggressive, sending people to jail for tax evasion. So it is built into the psyche of American taxpayers to take taxes seriously. At the corporate level, American companies are more pushed to the edge of the law, not to transgress the law, but to the edge.

British MNCs are used to talking to inspectors in a polite manner. It comes as a surprise to encounter the aggressiveness and sophistication of their related companies in the US, where tax inspectors can also be aggressive and rude to taxpayers.

Kagan & Scholz (1984) argue that the non-compliance act of corporations is not always motivated by rational calculation of costs and opportunities. Instead, non-compliance may result from corporations' incompetence or disagreement with the principles of regulation, or their perceptions that regulations are unreasonable and unfair. Given that British tax managers showed dissatisfaction with the adversarial approach taken by the IRS, it is possible that this approach could push them into game playing tactics to counter tax administrator's aggressiveness (see McBarnet, 2001). In fact, research conducted on individual taxpayers in Australia has shown that the Tax Office's use of threat and coercion has created active resistance to its regulatory strategy (Murphy, 2003).

Non-confrontational negotiation in UK

The UK regulatory style is similar to Japan's in the sense that it is non-confrontational. In the US, business and government accuse each other of acting in bad faith, while in the UK, both sectors believe that acting in good faith fosters industry self-regulation. In the course

of the interviews it was found that the UK's cooperative regulatory style also applied to tax regulation. British MNCs in this study all expressed support for such a flexible approach. According to some UK tax advisors, solving transfer pricing issues in the UK largely relied on informal agreements with individual inspectors that were founded on negotiations and discussions. Hence, there had been few legal disputes on transfer pricing cases.

A review of the Inland Revenue (IR) relationship with large business, *Review of Links with Business*, was undertaken by the Inland Revenue in 2001. One of the recommendations relating to transfer pricing illustrates the characteristics of the IR's negotiation based approach. The recommendation said, 'to allay concerns over the requirement for transfer pricing documentation', and 'inspectors should be ready to discuss with groups the application of the record-keeping requirement in their particular circumstances' (R34 in page 13).

One British tax manager stressed the importance of maintaining a good relationship with the IR:

We have made an effort to approach the Inland Revenue. Our audit inspectors had issues with us that came up unexpectedly, but we had a good relationship that definitely helped us resolving things.

The company this tax manager worked for recently adopted a new transfer pricing methodology to evaluate their transfer pricing throughout the world (that is, the profit-split method). The company tried to work cooperatively with the IR by giving a presentation of their new transfer pricing strategy. The presentation was for:

Not really getting an agreement to it, but just getting their understanding of why we get into it.

There are some disadvantages, however, in the UK approach. For example, a tax advisor pointed out that this system could be distressing to small companies due to their lack of resources and experience in negotiating with the IR on a regular basis. Another UK-based tax advisor believed that the use of a consulting approach to transfer pricing issues would

become less frequent as the burden of proof recently has shifted onto taxpayers.¹⁰ Moreover, given that a lot of agreements are made behind the closed door, the UK approach is perceived as lacking transparency.

Although both the British and Japanese regulatory approaches were non-confrontational, differences were observed by some interviewees. One tax manager in a Japanese company in the UK observed that field inspectors of the IR enjoyed relatively greater autonomy than field inspectors with the NTA:

There is a tremendous amount of latitude among individual inspectors in the UK.

This suggests that the internal structure of IR is less hierarchical than that of the NTA.

Another difference in regulatory approach between British and Japanese tax administrations pointed out by a few tax managers of Japanese MNCs was that there were less ‘direct’ contacts with revenue officers in the UK compared with their experiences in Japan. In the UK, correspondence between the IR and large businesses was generally mediated by external tax advisors in a written form. More direct approaches were undertaken by the Japanese tax administration. This point will be discussed in more detail below.

Hierarchical consultation in Japan

Some interviewees stated there were differences in revenue-business relationships between Japan and other countries. One tax advisor stated:

There are not so many differences between Japanese MNCs and MNCs of other nationalities in the way they look at international tax laws, but there are cultural differences in the way they interact with their respective revenue authorities. For example, there are more direct interactions between Japanese MNCs and the NTA.

The relationship between the NTA and large business is characterised by frequent informal interactions regardless of existing disputes:

¹⁰ The new transfer pricing rules apply to all accounting periods ending on or after July 1999.

Occasionally, we visit the NTA just to show our face and greet NTA officials we know. In this way, we can maintain a good relationship with the NTA.

The merit of direct contacts with the NTA was described by a Japanese tax manager:

I visited the competent authority officers in the late afternoon, and we had discussions till midnight. It was good, because it helped us in having a good understanding of each other, and they took us seriously.

Some tax advisors and tax managers interviewed indicated that the governance-by-consensus approach taken by the NTA was not based on a horizontal relationship between the NTA and regulated enterprises, but rather a vertical or hierarchical relationship. One tax advisor said:

In the US, the IRS and taxpayers are considered as equal, and try to have discussions to support each other's stance. In Japan, the relationship between NTA and taxpayers is more hierarchical. The NTA officers hold a higher position to 'guide' taxpayers, and taxpayers are in a position to receive the guidance gratefully.

A number of tax managers of Japanese MNCs in this study referred to regulatory agents at a national level as *Okami* (a feudal lord) or *Kokka kenryoku* (symbol of national authorities). In contrast, none of the tax managers of American and British companies referred to revenue officials in their own countries as their superiors. Kanda (1991) argues that industries do not challenge the ministry rulings in Japan, because industries have participated in the formation of the rulings. Japanese tax managers in the interviews had a common view that it was not worth taking any legal actions against the NTA. They felt that given that there was a hierarchical relationship between the regulatory agency and regulated enterprises, there was no chance of getting favourable outcomes by challenging *Okami*. It was also found that disbelief in the fairness of the system made them reluctant to even use the National Tax Tribunal, where the majority of judges were appointed from the NTA.

The reluctance of MNCs to take appeal or judicial action against an adverse determination by the NTA relates to their fear of damaging their reputation or image, or losing face. One Japanese tax advisor explained that when the media reports on transfer pricing adjustments

being made in relation to large corporations, the general public (who do not usually know what transfer prices are) tend to form the impression that the company has engaged in tax evasion. Two tax advisors in Tokyo further stated that the NTA occasionally implied to taxpayers that their disputes might be released to the media. These findings suggest that since the NTA's legitimacy is so well established in taxpayers' minds, this kind of emotional sanction can be effectively used in informal negotiations.

Given that taxpayers are concerned about maintaining a good relationship with the NTA, it is common for Japanese MNCs to employ retired ex-NTA senior officials as corporate tax advisors (*Komon Kaikeishi or Zeirishi*) in order to provide an important linkage between the host firm and the NTA. This practice is called *amakudari* (decent from heaven) 'in which bureaucrats parachute into lucrative private-sector positions at the end of their careers in public service' (Milhaupt & Miller, 2000, p. 253). A few interviewees stated that when an NTA officer was causing trouble for a company, their corporate tax advisors sometimes assured the company that they could persuade the NTA officer to make things easier for the company. This likely to be expected if the advisors once supervised the NTA officer. Tax advisors agreed that the practice of *amakudari* had an overall positive effect upon maintaining good relationships between regulated enterprises and the NTA.

Two tax managers working for the headquarters of two British MNCs said that their Japanese subsidiaries followed this practice, because:

The important thing in Japan is to not get into the dispute in the first place.

From the interviews with Japanese and non-Japanese informants, it seems that frequent informal consultation and the practice of *amakudari* helped to maintain a good relationship between the NTA and individual corporations, and hence increased voluntary compliance.

However, there are disadvantages in the Japanese hierarchical consultation approach. The informal consultation style lacks legal accountability in nature:

When we, as listed companies, are going to start something new, we usually consult NTA officials in advance. The NTA do not give us any written promises or rulings,

but they give us informal opinions. The NTA official will write an internal report to his supervisor about our meeting. Sometimes their informal opinions can be altered later on and, without any formal documentation, it is hard for us to complain.

Kagan (2000, p. 241) argues that ‘the informal Japanese approach is less effective than adversarial legalism whenever regulation, if it is to be effective, requires *significant changes* in the attitudes of business and governmental elites’. Lincoln (1999, p. 173) states that ‘the long history of privileged status, deference, and delegation of authority to bureaucrats makes changing the system difficult’. Consistent with the above arguments, both Japanese and non-Japanese tax managers in this study criticised the NTA for being too slow to implement change. One American tax manager stated that Japanese law was too far behind business practices:

The law is very slow to be established. The process for evolving laws, for rectifying them, everything is too slow.

For example, there was recognition among the NTA that domestic law should be changed to accept the Transactional Net Margin Method (TNMM)¹¹, one of the methodologies endorsed in the OECD guidelines. However, as notified by Hielscher & Kaneko (1999), the law has never been changed.

The NTA was also criticised for its slowness in decision-making by tax managers. One tax manager of an American company who recently renewed an APA with Australia stated that they would not consider entering into an APA with Japan, because it was too time consuming, and the initial compliance costs would exceed the benefit of the APA. Some tax advisors and tax managers perceived that the slow process might derive from the internal hierarchical structure existing within the NTA.

In comparison to the Tax Office or IR examiners, the discretion held by individual field examiners of the NTA was also seen to be limited. Field examiners in Japan need to

¹¹ The NTA has given a priority to the traditional transactional methods which require high levels of comparison with third party transactions. TNMM is a non-transactional method, which ‘compares the net margin resulting from a group of related party transactions with the net profit margins of independent companies which are engaged in broadly comparable transactions’ (Atkinson, 1999, p. 43).

consult with their seniors before making any judgments on cases. Delays in making a decision may relate to a decision-making practice called *ringi*. The *ringi* practice is based on a decision proposal being prepared and circulated through the organisation. This process ensures that a consensus and consultation exist (Yoshikawa, 1994). Thus, this approach ‘involves many steps prior to the final decision by top management’ (Yoshikawa, 1994, p. 286).

A few Japanese interviewees pointed out a lack of internal coordination within the NTA—among *zeimu-sho* (a district tax office), *kokuzei-kyoku* (a regional taxation bureau) and *kokuzei-cho* (the National Taxation Office):

Administrative procedures required by the NTA are so onerous. The organisational structure of the NTA is so complex. Our tax returns should be submitted to *zeimu-sho* (a district tax office). When we want to apply for an APA, we go and consult with the competent authority officers in *kokuzei-cho* (the National Taxation Office), but the evaluation of an APA application is conducted by *kokuzei-kyoku* (a regional taxation bureau). When we applied for an APA, I felt as if we had to deal with three completely different regulatory agencies. We had to repeatedly give the same explanations over and over to the persons in charge of *sho*, *cho* and *kyoku*. Sometimes, I felt there was no communication between them, because they gave us conflicting opinions. It was easier to deal with the ATO, because we only needed to talk to one person!¹²

The quote below from another Japanese tax manager who was involved in a bilateral APA with the US, contrasted the NTA approach with the IRS approach:

The IRS asked key or relevant questions in relation to the information we initially provided to them. But in Japan, I wondered why on earth *Kokuzei-kyoku* (a regional tax bureau) needed such ridiculous amounts of documentation? ... It seemed to be the case that *Koyoku* needed to gather as many documents as possible,

¹² The general APA procedure in Japan is as follows: Taxpayers put an application to the Regional Tax Bureau that conducts a detailed examination of the transfer pricing method proposed by the taxpayer. The regional tax bureau reports the results to the NTA’s examination division. After the examination division reviews and approves the results, is referred to the case to the NTA’s competent authority division. The competent authority division then advises taxpayers to file a request for competent authority proceedings (Miyamoto, Yoost & Noble; 1999).

needed to have enough evidence, to demonstrate that they had conducted thorough examinations to Kokuzei-cho.

A few non-Japanese interviewees also made the criticism that Japanese tax law lacked depth and clarity, which allowed matters to be subjected to the judgment of the NTA officers. Moreover, they stated that what was not endorsed in the Japanese law was interpreted as what you were not permitted to do, whereas in the US what was not endorsed in the law was interpreted as a loophole to be taken advantage of. One American tax manager commenting on the Japanese regulatory system said:

The way in which power is distributed [in Japan] is such that people are in power to make decisions rather than the law itself, decisions are handed down in a form of bureaucratic permissions rather than visible law.

Some tax advisors believed that using former NTA officers had little effect upon solving transfer pricing disputes. In their view, given that transfer pricing is a highly specialised area, few ex-NTA officers have enough knowledge to negotiate with the NTA transfer pricing examiners. There is a risk that relying on hierarchical relationships rather than on expert state-of-the art knowledge can backfire on the company.

The recent arrest of the former Japanese regional taxation bureau chief, Hamada, on suspicion of massive tax evasion, reveals vulnerabilities inherited in Japan's hierarchical regulatory practices, in particular the practice of *amakudari*. Hamada is suspected of concealing 730 million yen in income over a four period, which were mostly commissions he received as a corporate tax advisor. Hamada was the advisor for a talent agency, who was accused of tax evasion of 250 million yen in income tax. Two media reports covering the story (Asahi, 2002) state that it is customary for high ranking tax officials to retire about two years prior to mandatory retirement. By doing this it allows younger people to be promoted. Further, tax officials who have worked in tax administration for more than 23 years can also obtain a tax accountant license without passing the national exam. Then they can work as tax advisors for a number of private companies which they dealt with while employed with the NTA. The media reports blamed this institutional practice for making Hamada believe that he was immune to prosecution (Asahi, 2002). The Hamada incident is

a case of the regulatory actor being captured by the regulatory practice itself (see Ayres and Braithwaite, 1992).

Conflicting views were presented by interviewees on the effectiveness of non-confrontational versus litigious regulatory styles in gaining compliance with transfer pricing laws. Most interviewees generally agreed that the litigious regulatory style and legal disputes costly and exhausting experiences, but that provided more transparency and legal accountability than non-confrontational regulatory styles.

Summary

While the US and UK regimes manifest a rule of formal law, Japan is a 'rule of men'.¹³ Findings suggest that in Japan that while tax law is primitive, the norms of administrative guidance are elaborate.¹⁴ In the US, it is the law that is elaborate and the norms of administrative guidance primitive. The practice of *amakudari* reinforces informal monitoring and control, hence reducing law-based regulation and legalistic control. Some Japanese interviewees including one NTA officer claimed a need for more written precedents from rulings and judicial decisions to increase transparency and legal accountability concerning transfer pricing disputes. They claimed that the competent authority procedure was like a black box; what was discussed and agreed upon was invisible to the public. The US, it was thought that extensive written precedents would reduce the degree of discretion exercised by individual examiners. These opinions suggest that advantages and disadvantages of Japanese, British and American regulatory styles are well recognised by interviewees. Synthesis of tax law and the norms of administrative guidance thereby should be pursued by revenue authorities.

¹³ Special thanks to Prof. John Braithwaite for making valuable comment on this issue.

¹⁴ US law is more formal than UK law in the sense of being more detailed. On the other hand, the interpretations of English courts are more formalistic than those of the American courts. This is a more general contrast between US and UK regulation than with tax (Braithwaite & Braithwaite, 1995).

Findings of this section are summarised as follows:

The US regulatory style

- Adversarial legalism in the US is characterised by a highly codified tax system and reliance on litigious resolution for transfer pricing disputes.
- American tax managers are generally supportive of this approach, because it led to some innovative practices and flexible solutions to transfer pricing issues.
- Legal transparency provided by adversarial legalism is well regarded by most interviewees.
- British tax managers who are used to a non-confrontational approach taken by the Inland Revenue were critical of adversarial legalism.
- This suggests that adversarial legalism may push taxpayers into a game-playing posture or creative compliance (see McBarnet, 2001).

The UK regulatory style

- Non-confrontational negotiation in the UK is characterised by informal agreements with individual inspectors.
- British tax managers generally appreciate this flexible approach, and they are making efforts to maintain a good relationship with the Inland Revenue.
- Japanese tax managers perceive that there are less direct contacts between revenue and business in the UK than in Japan.
- The non-confrontational negotiation approach can be distressing to smaller companies due to their lack of resources and their infrequent dealings with the IR and lacks transparency.

The Japanese regulatory style

- The Japanese hierarchical consultation approach is characterised by frequent informal interactions and a close revenue-business relationship.
- The disbelief in the fairness of the system and the close revenue-business relationship both contribute to more reliance on voluntary compliance than legalistic solutions.
- The hierarchical consultation approach is inefficient in bringing about legal changes.

- The practice of *amakudari* reinforces the close revenue-business tie, but decreases accountability and transparency of the system.
- More written precedents are required to increase transparency in solving transfer pricing disputes.

3. How do small nations like Australia develop their regulatory cultures?

Braithwaite (1984, p. 573) states that small nations like Australia ‘piggyback on the fruits of American conflict and openness’ and ‘can dispassionately observe all of the blood-letting that occurs in the United States’, so that they are able to make consensual decisions in their own countries. These nations are therefore able to get information without the cost of conflict, and may adopt better regulatory systems than the US. As a result, as for transfer pricing regulation, smaller countries like Canada and Mexico have been motivated to follow the standard set by the US in order to improve viability and performance in the international taxation arena and hence to minimise their potential tax losses (Eden et al., 2001). The question of interest to the present paper is how successfully has Australia learnt from the US and/or other countries to improve its own regulatory style and practices in relation to transfer pricing?

Australia has not adopted the litigious US approach to solve transfer pricing disputes, as it is evident that very few transfer cases ended up in court in Australia. According to one Tax Officer, transfer pricing law involves looking at the economic substance of transactions rather than legal form, increasingly the risks involved in litigation for the Tax Office. In contrast, the US has a substantial case law history which limits the room for novel judicial interpretation, thus lowering the risk to the tax authority if it chooses to pursue litigation.

One Tax Officer stated that the Tax Office practice in resolving transfer pricing disputes in 1970s and 80s was similar to the UK approach. At the time, agreements with MNCs were made behind closed doors and thereby lacked transparency. However, he believed that the introduction of the self-assessment system in 1986 has significantly increased transparency in their practice.

One Tax Officer who oversees transfer pricing audits said the revenue-taxpayer relationships were culturally quite different between Australia and Japan. The following quote is an excerpt from his interview.

Australian companies seem to regard any arms of government as quite foreign to them. They tend not to become involved with the bureaucracy. They see it as an interference in their life. They in fact, many of them, I guess, see no legitimate role for the ATO.

This is in stark contrast to the Japanese experience. In Japan, the relationship between the NTA and taxpayers is much more important. The same Tax Officer stated that the Tax Office had learnt how to deal with taxpayers from the NTA:

Senior ATO officers dealing with senior NTA officers learned that the issue of trust building is important.

In their search of best practice in resolving transfer pricing difficulties, it can be seen from the quotes presented above that Australia has been willing to learn from other tax authorities.

Several interviewees expressed appreciation of the significant changes in the Tax Office's attitude toward taxpayers in the last 10 years from hostile to cooperative. One Australian tax advisor stated that such changes were initiated at the top by senior officers who were implementing the APA program:

In the 80s, we had a very aggressive commissioner, who wanted to take on big companies, follow the US, audit the hell out of them, it had been going on for years, screw them down and get every cent you could get. In the early 90s, the relationship between the ATO and the corporations was bad, really bad. A new commissioner came in and said we've got to do something about this... a lot of their new thinking was eventually applied with APAs.

According to Job and Honaker (2002), the Tax Office moved from the command-and-control regulatory style to a more flexible and cooperative regulatory style in the late

1990s. In the early 1980s, there were growing demands to public administrations including taxation agencies to become more market-focused and service-oriented. This was followed by a series of press allegations against the Tax Office's excessive use of power and poor use of penalties. Responding to these criticisms and demands to change the Tax Office's regulatory approach, new concepts and enforcement strategies were adopted in the form of the ATO Compliance Model in 1998. The ATO Compliance Model emphasises assisting and educating taxpayers to encourage self-regulation and creating a cooperative relationship between the Tax Office and taxpayers (see Job & Honaker, 2002, for more in-depth discussion of this topic). The Compliance Model is based on a regulatory approach known as responsive regulation. The principle of responsive regulation is that regulators should consider cooperative strategies first and encourage taxpayers to comply voluntarily. More enforcement-oriented and punitive strategies should be used progressively only when cooperative strategies fail to deliver compliance (see Ayres & Braithwaite, 1992; Braithwaite & Wirth, 2001).

Responsive regulation has been applied to enhance transfer pricing compliance. Braithwaite and Williams (2001) examined the Transfer Pricing Record Review and Improvement Project (TPRR & I) commenced by the Tax Office in 1998. TPRR & I was designed to identify whether taxpayers were complying with the Tax Office's documentation requirements. TPRR & I is a good example of simultaneously implementing monitored self-regulation and transparency which is ensured by the rulings and supplementary booklets. As a result of TPRR & I, the Tax Office successfully increased the total net tax of companies by intensifying taxpayers' self-scrutiny through improved risk-assessment methodologies.

A recent survey conducted by PricewaterhouseCoopers (PWC) (23 April, 2002, PWC website), however, revealed that there were some negative outcomes of the Tax Office's transfer pricing strategy. From the survey, 97% of companies believed that the burden of complying with the Tax Office's transfer pricing regulations had increased in the past five years. Moreover, given that companies, especially small to medium companies, are already struggling to comply with the Tax Office's stringent requirements, 59% of the surveyed companies believed that the Tax Office's transfer pricing regime would discourage foreign

investment in Australia. Commenting on the results of this survey, a partner of PWC stated that the Tax Office encourages small to medium size firms to enter into short-term unilateral APAs as an alternative solution for reducing their transfer pricing burdens. However, a short-term unilateral APA might be detrimental to these firms in the long run, if the agreement is not commercially achievable (PWC website).

In fact, the Tax Office, has been actively promoting the APA process and encouraging more high-risk taxpayers to enter the agreement as an outcome of the Transfer Pricing Record Review or as the alternative to an audit (see Braithwaite & Williams, 2001; Lewis, 2001). As can be seen in the following quote, this initiative has been seen by some senior Tax Office staff to be particularly valuable for maintaining the integrity of the Australian revenue base:

Australia is a small economy, so making the APA program attractive to companies is a strategy to ensure our revenue base.

The Tax Office's success in promoting the APA program is evident from a significant increase in the number of APAs concluded recently.¹⁵ One tax manager of an American company who currently has a unilateral APA with the Tax Office said that it was a relatively quick, and consequently relatively inexpensive, process to have a unilateral APA with the Tax Office, and he was pleased with the outcome.

One tax advisor, while acknowledging that unilateral APAs were faster and more efficient to conclude than bilateral or multilateral APAs, believed that the unilateral APAs breach the Tax Office's obligation to their treaty partners. If a unilateral APA resulted in limiting the rights of other revenue authorities to have a fair share of the pie, and allowed the possibility of double taxation, it contradicted the purpose of the treaty. It was perceived that while the Tax Office and IRS accepted unilateral APAs, the NTA and IR had a stance that APAs should be bilateral. This criticism suggests that greater international cooperation would be required to ensure the integrity of the APA system.

¹⁵ In 1991-1999, 18 APAs had been completed, by January 2001, this increased to 41 (Lewis, 2001).

Summary

- Taxpayers perceived that the Tax Office's attitude toward taxpayers has significantly improved in the last 10 years from hostile to cooperative.
- The Tax Office's attitudinal changes were initiated at senior levels.
- In dealing with Japanese revenue officials and Japanese MNCs, the Tax Office learned the importance of building a long-term trusting relationship with taxpayers to improve levels of taxpayer compliance.
- The Tax Office's Transfer Pricing Record Review and Improvement Project proved that it is possible to create a regulatory strategy to encourage self-regulation as well as providing transparency.
- The Tax Office has been successful in promoting unilateral APAs to ensure its revenue basis.
- However, unilateral APAs are not well received by some tax advisors.

Discussion and conclusion

This paper attempted to provide an indication of how tax authorities can improve regulatory strategies for increasing the level of MNCs' compliance with transfer pricing regulations. By focusing upon cross-cultural differences and emphasising cross-cultural understanding, the study found that different regulatory styles and practices do exist within each tax jurisdiction. American regulation tends to be more adversarial and litigious in nature, British regulation tends to involve non-confrontational negotiation, and Japanese regulation tends to be based around hierarchical negotiation.

The findings of this paper show that attitudes toward tax and taxpaying behaviour of MNCs are shaped by different management policies and accounting practices. American and British MNCs take a pro-active approach to managing transfer pricing policies and Japanese MNCs lag behind American and British MNCs in terms of global tax planning. However, with gradual changes in management policies and organisational structures, differences between Japanese MNCs and their Western counterparts are becoming less prominent.

This paper suggests that there are both disadvantages and advantages of each regulatory style. It also suggests that the close relationship between the tax authority and industry in Japan is not necessarily the best way to increase transfer pricing compliance. Adversarial legalism provides greater transparency and accountability than non-confrontational regulatory approaches, but the US bears the costs of these true consuming and expensive conflicts. Moreover, the adversarial approach poses an additional risk of encouraging *creative compliance* among disgruntled companies. According to McBarnet (2001, pp. 2-3), creative compliance is not illegal-it could be perfectly legal- but it escapes the intended impact of the law. As McBarnet argues that in order to prevent creative compliance, changes are required not just in the actual law, but also in taxpayers' attitudes toward tax and to the law. The law should be seen 'as an instrument of legitimate policy to be respected' rather than 'material to work on'. In achieving this, it first requires changes in revenue authorities' attitudes towards taking a more cooperative approach to taxpayers. This may help taxpayers change their attitudes to revenue authorities. They may regard them as legitimate agents of the law, rather than as players of perpetual tax games. In fact, all tax managers, regardless of the nationality of MNCs interviewed, expressed the view that creating a trusting relationship with revenue authorities was an essential part of transfer pricing management policies. Thus, building trust between tax administrations and taxpayers and showing respect for legitimate players in the tax system should be incorporated into the regulatory framework (Tyler, 2001; Braithwaite & Wirth, 2001).

British and Japanese approaches are efficient in increasing voluntary compliance of taxpayers in general, because of the close relationship between revenue and industry. Informal consultations and the practice of *amakudari* in Japan in particular, enables monitoring of taxpayers' behaviour to prevent them from getting into trouble in the first place. However, the practice of *amakudari* seems to be far less effective in ensuring compliance with transfer pricing laws. In dealing with transfer pricing that is subjective in its nature, accountability and transparency are important. The absence of transparency does not encourage litigation to resolve transfer pricing disputes. However, the cooperative and consultative regulatory approach should not be pursued at the cost of transparency and accountability.

Interviewees claimed that tightening up transfer pricing regulation does not necessarily increase tax revenues, but definitely increases taxpayers' compliance burdens. Moreover, if one country strengthens transfer rules, other countries are likely to follow. This only escalates tax competition among tax jurisdictions. This paper argues that when implementing effective transfer pricing strategies, revenue authorities should be familiar with different regulatory styles in order to facilitate bilateral negotiation processes. No regulatory style is perfect; all involve both benefits and vulnerabilities. Australia is a good example of how countries can learn from each other to improve their regulatory style. Adapting to the hybridity of regulatory styles and practices appears to have done Australia well and is an inevitable fact of globalisation.

With respect to management styles, findings of this study show that differences in management styles derived from national cultures do exist among MNCs, however these differences are becoming significantly less obvious. It may be argued that as the rapid expansion of e-commerce and advancement in technology has facilitated economic integration, it is no longer effective for MNCs to cling to cultural relativism in their management styles. Although business norms and principles may still be conditioned by local cultures where MNCs operate, the synthesis of varied management styles employed by MNCs is gradually occurring. Given this view, management strategies and policies of MNCs are increasingly dominated by fundamental economic ideas commonly shared among MNCs rather than by culture-specific norms. This gradual phenomenon I refer to as the harmonisation of management styles.

My argument is that given that the harmonisation of management styles is taking place, there is a need for a supranational regulatory framework to create more uniformity in transfer pricing regulation across diverse regulatory cultures. Mutual cooperation and coordination between tax administrations in international tax enforcement is being increasingly seen in the context of economic integration; for example, through the North American Free Trade Agreement (NAFTA) and the European Union (EU), international agencies such as the OECD, and tax administration forums such as the Pacific Association of Tax Administrators (PATA) (Zagaris, 1998). One example is that the Pacific Association of Tax Administrators (PATA) has recently proposed to standardise transfer

pricing documentation requirements (that is, taxpayers prepare one set of documentation) among the four member countries (Australia, Canada, Japan and the United States). It is a first step to overcome difficulties that MNCs face in complying with the law and requirements of multiple jurisdictions by lowering taxpayer compliance burden and penalty risks (Tax Office, 2002). In addition, harmonisation of corporate taxation systems within the EU countries has been actively discussed (see Genser, 2001).

In contrast, the polarization of transfer pricing policies is occurring with increased international cooperation on the one hand, and increased unilateral extraterritorial tax enforcement¹⁶ on the other (Zagaris, 1998). While more and more detailed transfer pricing legislation and documentation requirements are enacted by each nation, a lack of consistency among tax administrations adds another layer of complexity and uncertainty to transfer pricing issues. This creates opportunities for non-compliance and increases tax competition between jurisdictions.

Braithwaite (2002) argues that in complex and dynamic areas of tax law, combining specific rules and general principles is likely to foster superior regulatory conversations between industry and revenue, reduce uncertainty and hence increase prospects of voluntary compliance. Given that transfer pricing is a highly complex and dynamic taxation area which involves multiple jurisdictions, an integration of rules and principles in the transfer pricing law at the global level would be prudent. While the OECD provides commonly accepted principles, it is evident from the present study that interpretations and applications of the principles are subject to national regulatory cultures. What is required more is a supranational regulator that provides precise translation of the OECD guidelines and makes more concrete arrangements. The OECD guidelines can be used as a basis of globally enacted rules that govern each tax jurisdiction. Picciotto (1992) argues that international coordination based on secret and bureaucratic administrative arrangements lacks political legitimacy. Thus, once rules are established at the global level, overarching principles are commonly recognised and integrated through the 'superior regulatory conversations' at the regional level. Within regional economic forums such as the EU and the NAFTA, superior regulatory conversations should take place in various forms between

tax administrations from different jurisdictions and interactions between tax administrations and stakeholders (MNCs and tax and accounting groups). In this way, political legitimacy can be achieved.

These days MNCs are becoming increasingly reliant on external tax advisors in resolving transfer pricing disputes and ensuring compliance. While it is acknowledged that it is difficult to bring divergent regulatory styles together in international taxation enforcement to create a single hybrid regulatory style, it might be particularly helpful if tax advisors act not only as mediators for dispute resolutions between tax administration and MNC, but also as cultural translators between tax administrations. The communication networks and resources and skills available to international accounting and legal firms means that it is possible for them to foster a professional skill that bridges the gap between different regulatory approaches. Whatever the case, in order to minimise conflicts between MNCs and tax administration and between tax administrations, cooperation between tax administrations, tax advisors and taxpayers is becoming increasingly important.

¹⁶ For example, penalisation of non-compliance with transfer pricing reporting requirements.

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