Kluwer International Tax Blog

International Taxation, Epistemologies of the South, and Institutional Capacities: Transfer Pricing and the Universalization of the OECD Standards

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1. **Introduction**

As the General Reporter for the Subject 2 (The Future of Transfer Pricing) of the 2017 IFA Congress in Rio de Janeiro, I joined the plenary session on August 29 in a panel chaired by Luís Eduardo Schoueri and composed of Isabel Verlinden, Jefferson Vanderwolk, Mateus Calicchio Barbosa, Natalia Quiñones, Richard Vann, and Yariv Brauner.

After a morning of fantastic debates and all considerations about whether developing and emerging economies should incorporate the OECD transfer pricing standards – or pursue a different path, following Brazil's lead – in my concluding remarks I stated that "Developing countries should stop importing solutions for tax problems that they do not have".

To some extent, this seems to be the case with the BEPS Project in general. BEPS problems and the present solutions are presented in a OECD-centric perspective, that more often than not disregard the tax positions of developing and emerging countries as well as their institutional capacities.

This universalization of the OECD world is a mere reflection of what is found in social theory in general. In the first part of this post, I will comment on the theory of Portuguese Professor Boaventura de Souza Santos, who argues the need for the development of "Epistemologies of the South", which would be a social theory that considers the specific situations and views of the developing world.[1] My previous position, supporting a developing and emerging countries' international tax regime, is in line with the theory of the Portuguese Professor.[2]

The second part of this post will comment on the theory of institutional capacities, based primarily on an article written by Cass R. Sunstein and Adrian Vermeule.[3] These authors' article considers the theory of interpretation and how it should be shaped taking into account not only theoretical aspects, but also the capacities of the institutions that will apply the theory in practice. My goal is to use Sunstein's and Vermeule's theory in the context of international taxation – notably transfer pricing –, arguing that the best theory might prove itself inadequate in view of each country's actual institutional capacities.

2. **Epistemologies of the South**

I have been claiming that international taxation is driven by the interests of developed countries, which have been successful in turning international tax principles and standards that favor their positions into universal and general principles of international taxation. This state of affairs results in what I have named "International Tax Imperialism", which means "the transformation of certain tax criteria that favor the interests of developed economies in international tax standards that become considered as basic principles of international taxation".[4] My position was recently supported by Tarcisio Magalhaes.[5]

A similar position was supported by Tsilly Dagan, professor of the Bar-Ilan University in Israel, in her book "International Policy and Cooperation". This book is a must read for all those who can perceive that there is something out of place with the dogmas surrounding international taxation for almost one century. It is worth quoting the following paragraphs from her study.

"For almost a century, the impressive multinational cooperative campaigns in the international tax arena have been led primarily by OECD countries, some more successfully than others. In this period, OECD countries have relentlessly advanced cooperative initiatives, in line with the premise (or at least rhetoric) that cooperation is beneficial for all of its participants. This assertion is consistent with the classic collective-action rationale that everyone stands to lose if every state-actor promote its own self-interests and rejects cooperation. We see here the problematic strategic dynamics of the game that cause some state-actors to choose an action (defection) that conflicts with their best interests. However, the pro-cooperation narrative misses the converse alternative: that for some states the fact that cooperate does not necessarily mean that this is their best option. As I have sought to show in this chapter, sometimes states cooperate *despite* this not being in their best interests. That is not to say, of course, that *any* cooperation is bad but, rather, that instead of assuming that a country's cooperation is proof per se that the initiative is beneficial to it, we must look more closely at the interests at stake.

[…]

The chapter illuminated the mechanisms n which international tax game can be constructed to benefit some (that is, developed) countries at the expense of other (that is, developing) states. I would not go so far as to suggest that developed countries cooperated in a premeditated manner so as to deliberately create negative externalities on developing countries. But even assuming the current international tax system was not intentionally designed to impose these externalities on developing countries, by pursuing the interests of OECD countries in limiting tax competition and increasing their tax revenues while disregarding the interests of developing countries, it has de facto led to a reality in which the latter face a very narrow range of choices."[6]

This situation leads to the tax colonization of minds from developing and emerging economies, who are likely to think their own countries' international tax policies from the perspective of the "international" framework.[7]

The line of thought we have been developing in the field of international taxation overlaps the arguments presented by the Portuguese Sociology Professor Boaventura Souza Santos, who has been criticizing how the "social theory of the global North" presents itself as a universal theory, ignoring the contributions of the global South. In his words, "After five centuries of 'teaching' the

world, the global North seems to have lost the capacity to learn from the experiences of the world. In other words, it looks as if colonialism has disabled the global North from learning in noncolonial terms, that is, in terms that allow for the existence of histories other than the universal history of the West”.[8]

Among the difficulties of “confronting Eurocentric emancipatory imagination”, Boaventura Souza Santos mentions colonialism. According to the Portuguese professor, “It is difficult to imagine the end of colonialism as it is to imagine that colonialism has no end. Postcolonial or decolonial studies and struggles in the past three decades has shown how entrenched colonialism is in both private and public life, even many decades after the end of historical colonialism. On the other hand, as in the case of the capitalism without end, it is hard to believe that colonialism will escape the fate of other social phenomena and have no end. In this case as well, Eurocentric emancipatory imagination and politics have been split into two main responses. A first strand is blocked by the first difficulty; incapable of imagining the end of colonialism, it denies the existence of colonialism itself. According to this strand, the political independence of the colonies meant the end of colonialism; since then, anticapitalism has been the only political objective of emancipatory politics. This line of Eurocentric critical thinking focuses on class struggle and hence does not acknowledge the validity of the ethno-cultural-racial struggles. On the contrary, it valorizes hybridity (*mestizaje*) – which, for instance, it identifies as a key failure of Iberian colonialism – as extra proof that colonialism has been overcome. **Accordingly, the idea of racial democracy, rather than being defended as a legitimate aspiration, is celebrated as being already fully accomplished**.”[9] (Emphasis added)

This final part of Souza Santos’s comments seems entirely applicable to the debates in the area of international taxation. Whenever one argues that there are legitimacy deficits in this field, there is always a counterpart to support the opposite view. In other words, that inclusion has already been achieved or all countries are on the same side or have the same voice. Positions in this sense are reinforced by initiatives such as the Global Forum on Transparency and Exchange of Information for Tax Purposes and the inclusive approach in the BEPS Project.[10]

This same view of how social sciences have developed over time is also supported by Raewyn Connell. In his opinion, “Social science is, at best, ambiguously democratic. **Its dominant genres picture the world as it is seen by men, by capitalists, by the educated and affluent. Most important, they picture the world as seen from the rich capital-exporting countries of Europe and North America – the global metropole**. To ground knowledge of society in other experiences remains a fragile project.”[11] (Emphasis added)

This author also highlighted the attempt to present the views of the dominant countries of the world as universal. According to this author, “Modern social science embed the viewpoints, perspectives and problems of metropolitan society, while presenting itself as universal knowledge.”[12]

The resemblance between these positions regarding social sciences and the OECD-centric international taxation approach is evident.

In fields like transfer pricing, attribution of profits for permanent establishments, BEPS, etc., OECD’s view is presented as universally valid and applicable, regardless of the characteristics of each country – economic profile, legal system, and, most importantly, institutional capacities.

3. **The Importance of Institutional Capacities**

It is not unusual that theories and models are created and defended disconnected from the actual institutional capacities of countries, entities, etc. This topic was analyzed by Cass R. Sunstein and Adrian Vermeule in a study that focused on the theory of interpretation. Their starting point is that legal interpretation theories often focus on “how, in principle, should a text be interpreted”, while the real question should be “how should certain institutions, with their distinctive abilities and limitations, interpret certain texts”.[13]

Sunstein and Vermeule’s point is quite convincing: legal interpretation theorists argue their positions **disregarding the actual institutions that will interpret and apply the law in concrete cases**. A theory that does not take institutional capacities into account is likely to fail in the real world.

These authors’ comments can be expanded to several areas and fit perfectly in the field of international taxation.

Indeed, the OECD-centric approach to international taxation and the view that it can be universally applied fails to consider the institutional capacities of each country.

Tsilly Dagan’s comment quoted previously applies in this context. There is an awkward tendency of some developing and emerging countries acting against their own domestic tax interests under the banner of cooperation. It is as if the interest in belonging, the chance of joining the club, is stronger than the country’s own interests.

One area in which a country’s institutional capacities is especially relevant is transfer pricing. The crusade to apply the arm’s length principle – or OECD’s take on the arm’s length principle – requires the application of resources and infrastructure that many countries just do not have. However, even though the adoption of the OECD transfer pricing standards by some developing and emerging countries would seem unlikely and unproductive, most of them seen to be going in this direction.[14] Therefore, it is worth questioning: should developing countries adopt the OECD transfer pricing standards as their primary transfer pricing control methodology?

4. **The Arm’s Length Principle and Countries’ Institutional Capacities**

Even though there is no consensus regarding whether the arm’s length principle is the best criteria to assess transfer pricing in transactions between related parties, it remains as the go-to standard in the OECD’s perspective. According the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax

Administrations (“OECD TP Guidelines”), “**The view of OECD member countries continues to be that the arm’s length principle should govern the evaluation of transfer prices among associated enterprises**. The arm’s length principle is sound in theory since it provides the closest approximation of the workings of the open market in cases where property (such as goods, other types of tangible assets, or intangible assets) is transferred or services are rendered between associated enterprises. **While it may not always be straightforward to apply in practice, it does generally produce appropriate levels of income between members of MNE groups, acceptable to tax administrations**. This reflects the economic realities of the controlled taxpayer’s particular

facts and circumstances and adopts as a benchmark the normal operation of the market."[15] (Emphasis added)

Despite its popularity within the OECD, one cannot disregard the complexities surrounding the application of the arm's length principle.[16]

Even though the starting point of the arm's length principle is its capacity to prevent double taxation, it might be just the other way around. In our general report of the Subject 2 of the 2017 IFA Congress, the assessment was quite the opposite: post-BEPS transfer pricing based on value creation and substance-over-form approaches tend to create double taxation and transfer pricing litigation.[17]

In summary, applying the arm's length principle, as formulated by the OECD in the TP Guidelines is a complex endeavor, which might lead to double taxation and significant transfer pricing litigation. Notwithstanding, not only has it been presented as a universally applicable standard, surprisingly enough it has been generally accepted by developing and emerging economies – even those that do not have the institutions to apply it. On the other hand, simplified methodologies, such as the Brazilian fixed margin approach, have proven to be unsuccessful in gaining international acceptance.

The attempt to export the OECD TP Guidelines as a global transfer pricing standard fits the OECD-centric international taxation approach mentioned at the beginning of this text, especially when it disregards entirely the institutional capacities of each country.

There are countries that just do not have the manpower and the infrastructure to apply the complex OECD TP Guidelines. In the case of some countries, it does not even make sense from a tax collection standpoint to invest in creating such capacities because there are other areas of tax administration that are significantly more relevant.

Nevertheless, there is little or no effort from the OECD to develop – or to accept – transfer pricing methodologies that would fit better the needs and institutional capacities of developing and emerging economies. It is quite the opposite; the request is for the adoption of the OECD standards.

It is surprising that Brazil's simplified system has not become the role model for a large number of developing and emerging economies. This is not to say that the Brazilian rules are free from criticism, **which they definitely are not**. However, the rationale of the rules seems to be in the right place: the development of simplified methodologies that can be easily applied by the tax administration and taxpayers. If the current Brazilian rules deliver on this promise is a question for debate. Notwithstanding, this does not invalidate its end goal: simplification of the application of transfer pricing rules.

If there is another way to control transactions between related parties, why are developing and emerging countries moving in the direction of the OECD TP Guidelines? Is this proof of Tsilly Dagan's commentary that these countries sometimes act against their own interests?

It is impossible to answer this question without empirical research. Risking the shortcomings of an intuitive answer it seems that being closer to the OECD is somewhat attractive to some developing and emerging countries, which might explain why some of them are seeking a spot as effective

member of the organization.

Note that the position we have defended above is not the same as saying that developing countries and emerging economies should never use OECD's arm's length standards. Indeed, as I pointed out elsewhere, the concept of developing countries and emerging economies is too broad,[18] including some of the most underdeveloped regions of the globe as well as some of the world's economic dynamos, such as China and India. Therefore, our point is not that the OECD TP Guidelines are only for developed nations.

The core of our argument is that it is unthinkable to imagine that the same obligations required from a German taxpayer, which will be applied by German tax authorities, could also be required from a taxpayer from a poor developing country and be applied by that country's tax authorities. Hence, it is clear that an alternative methodology is more than necessary for developing countries and emerging economies. This alternative methodology would most likely follow in Brazil's footsteps, using a mix of fixed profit margins and safe harbors that would make it easier for the rules to be applied.[19]

5. **Conclusion**

Considering our previous comments, it is possible to conclude that there is a core problem in the international taxation discourse, which is the OECD-centric perspective that ignores the institutional capacities of each country, as if it were possible to apply the same criteria globally. Transfer pricing provides us with a great example of the attempt to universalize a standard that clearly cannot be applied universally.

It is time to reassess the dogmas of international taxation. This is why books like Tsilly Dagan's "International Tax Policy: Between Competition and Cooperation" are so important. Developing countries and emerging economies must be active in defending a new international tax regime, which will help balance international tax relations. If those that will benefit the most from change remain simply aspirants waiting for a chance to join the club, words won't be enough to defend their interests.

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1 See: B. Souza Santos, *Epistemologies of the South: Justice Against Epistemicide* (Routledge 2016).

2 See: S. A. Rocha, *The Other Side of BEPS: "Imperial Taxation" and "International Tax Imperialism"*, in *Tax Sovereignty in the BEPS Era* pp. 188-198 (S. A. Rocha & A. Christians eds., Wolters Kluwer, 2017).

3 See: C. R. Sunstein and A. Vermeule, *Interpretation and Institutions*, Coase-Sandor Working Paper Series in Law and Economics, pp. 2-54 (2002).

4 S. A. Rocha, *The Other Side of BEPS: "Imperial Taxation" and "International Tax Imperialism"*, in *Tax Sovereignty in the BEPS Era* p. 188 (S. A. Rocha & A. Christians eds., Wolters Kluwer, 2017).

5 T. Magalhaes, *International Taxation Without International Representation? Legality and*

Legitimacy in Global Tax Governance, in *Building Trust in Taxation* p. 273 (B. Peeters, H. Gribnau & J. Badisco eds, Intersentia, 2017).

6 T. Dagan, *International Tax Policy: Between Competition and Cooperation* pp. 183-184 (Cambridge University Press 2018).

7 S. A. Rocha, *The Other Side of BEPS: "Imperial Taxation" and "International Tax Imperialism"*, in *Tax Sovereignty in the BEPS Era* p. 190 (S. A. Rocha & A. Christians eds., Wolters Kluwer, 2017).

8 B. Souza Santos, *Epistemologies of the South: Justice Against Epistemicide* pp. 19-20 (Routledge 2016).

9 B. Souza Santos, *Epistemologies of the South: Justice Against Epistemicide* p. 26 (Routledge 2016).

10 See: S. A. Rocha, *Brazil's International Tax Policy* pp. 204-205 (Lumen Juris, 2017).

11 R. Connell, *Southern Theory* p. vii (Polity Press 2009) p. vii.

12 R. Connell, *Southern Theory* p. vii (Polity Press 2009) p. vii-viii.

13 C. R. Sunstein and A. Vermeule, *Interpretation and Institutions*, Coase-Sandor Working Paper Series in Law and Economics, p. 2 (2002).

14 S. A. Rocha, *General Report* p. 204 (IFA, *Cahiers de Droit Fiscal International*, 2017).

15 OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* p. 38 (OECD 2017).

16 See: OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* pp. 37-38 (OECD 2017).

17 S. A. Rocha, *General Report* pp. 241-242 (IFA, *Cahiers de Droit Fiscal International*, 2017).

18 S. A. Rocha, *General Report* p. 204 (IFA, *Cahiers de Droit Fiscal International*, 2017).

19 For an overview of Brazil's transfer pricing policy see: S. A. Rocha, *Brazil's International Tax Policy* pp. 155-162 (Lumen Juris, 2017).

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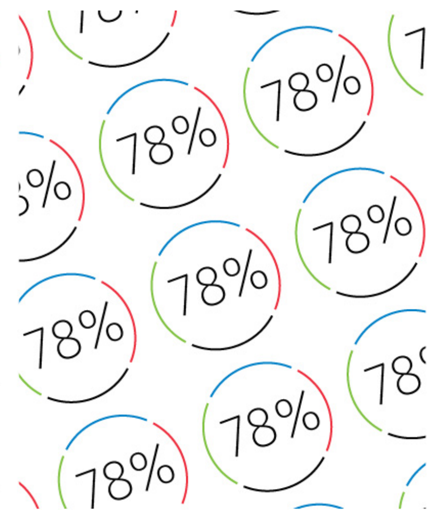

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This entry was posted on Monday, May 7th, 2018 at 8:44 am and is filed under BEPS, OECD, Tax Policy, Transfer Pricing
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