Transfer Pricing: the double-edged sword in AEC

by

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1. Introduction

A. Objectives of This Article

This Article provides the readers not only an introductory principle of international taxation, but also the major tax issues that AEC member countries must confront with theirs trading partners. In this era of globalization and increased cross-border activity, multinational enterprises (MNEs) by their very nature have advantages and disadvantages. A major advantage (and thus major motivation) is that operation in other countries provides the ability to take advantage of market imperfections and so gain a competitive advantage. Whether a large MNE or small, closely held business, the use of transfer pricing is necessary to appropriately manage costs and risks.

Generally speaking, Transfer Pricing which could be used as 'tax avoidance' or 'tax shelters' by the multinational enterprises is the centre of a storm of controversy on among AEC member countries. The Association of Southeast Asian Nations (ASEAN) which was founded on August 8, 1967 by Indonesia, Malaysia, the Philippines, Singapore and Thailand has emphasized regional cooperation on the three pillars of security and sociocultural and economic integration. It has made most progress in economic integration and aimed to create the ASEAN Economic Community (AEC) by December 2015.[1] The foundation of the AEC is the ASEAN Free Trade Area (AFTA), a common external preferential tariff scheme to promote the free flow of goods within ASEAN. Particularly, the important elements of economic integration are free flow of investment and services which involve international taxation. In virtue of agreements such as the ASEAN Charter, signed in November 2007, ASEAN's leaders are attempting to build a 'Single Market', without either a strong central executive (comparable to the European Commission in the European Union) or a well-developed body of laws and dispute settlement mechanisms.

The rapid growth of international trade has made international enterprises Transfer Pricing an everyday necessity for the vast majority of business. Some tax authorities of the AEC member countries have issued regulations and enforcement of the arm's length standard as a prime priority for commentary on the audit approach to pricing matters. Since there is no absolute rule for determining the right transfer price for any kind of international transaction within associated enterprises, whether it involves tangibles, intangibles, services, financing or cost allocation, this is the main point for disagreement on the correct amount of taxable income reported in a particular member jurisdiction, whilst the existence of tax treaties between AEC member countries might lead the casual observer to conclude that international transfer pricing is a 'Zero Sum Plan' where an adjustment in one jurisdiction will be matched by the granting of corresponding relief at the other end of the transaction. These important issues are within the scope of this article, which reveals the person who benefits from multinational tax transfer pricing rules.

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[1] Devonshire, C., "*Understanding ASEAN's Free Trade Agreements*," p.1 Retrieved from http://www.aseanbriefing.com/news/2014/02/13/undersatnding-aseans-free-trade-agreements.

B. What Is International Tax?

International tax is the study or practice of tax on individuals, businesses or government agencies subject to the law of different countries or the international aspects of an individual country's tax law as the case may be. They are actually the customary practice of sovereign states or from the actions of some international body such as the United Nations (UN) or the Organisation for Economic Co-operation and Development (OECD).

Many governments tax individuals or businesses enterprises based on their income. Varieties of systems of taxation create possibilities for double taxation (which the same income is taxes by different countries).

The international tax law of a country has two broad measures:

- 'Taxation of Foreign Income' - the taxation of resident individuals and corporations on income arising in foreign countries. For example, wages from working abroad, foreign investments and saving interest, rental income on oversea property, income from pensions held oversea etc., (foreign income is anything from outside country).

- 'Taxation of non-residents', the taxation of nonresidents on income arising domestically, e.g. pension, rental income, savings interest, wages etc.,

If there has a 'Double Taxation Agreement' between the countries involved, it is possible to claim tax relief in those countries to avoid being taxed twice.[2]

C. Goals of International Tax in AEC's Member Countries.

With regard to the taxation according to the AEC, apart from free flow of goods (non-tariffs), the AEC Blueprint divides taxation in two parts :

1. Enhance withholding tax structure, where possible, to promote the broadening of investor base in ASEAN debt issuances. (Item 31 Action IV., AEC Blueprint)

2. ASEAN member countries should complete the network of bilateral agreements on avoidance of double taxation among all member countries by 2010. (Item 58, AEC Blueprint)[3]

Currently (2015), there is no single taxation regime for ASEAN member countries under the AEC Blueprint. In particular, the integration among the ASEAN is only for economics, but not for the taxation. Government of each member country needs to reform tax systems in order to promote competition among ASEAN members. For example, Thailand and Vietnam have entered into DTAs with over sixty countries and most of these DTAs provide the initiation of a Mutual Agreement Procedure (MAP) in the event of double taxation as a result of transfer pricing adjustments, whilst Singapore has the most extensive regional tax treaty network. . On the other hand, Brunei, Cambodia, Myanmar and Laos have no specific transfer pricing rules or guidelines. It is, therefore, possible to conclude that the intra-ASEAN treaty network is far from completion comparing with the European Union

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[2] Arnold, B.J. & M.J.McIntyre, *International Tax Primer*, (The Hague: Kluwer Law International , 2002) p.3

[3] Loh, A.V., "*Taxation of AEC,*" The Taxation Accounting Committee, p.4 Retrieved from http://www.fap.or.th/images/column_1359012960/TAXATION%20of%20AEC.pdf.

countries, although there are tax treaties signed by all ASEAN countries except for Cambodia which has not concluded a treaty with any other countries, either ASEAN or non-ASEAN.

2. Jurisdiction to tax

A. Principal Residence Rule

The definition of 'residence rule' for tax purposes varies considerably from jurisdiction to jurisdiction. For individuals, physical presence in a jurisdiction is the main factor. Some jurisdictions also determine residency of an individual by reference to a variety of other factors, such as the ownership of a home or availability of accommodation, family, and financial interests. The following presumptions might be used:

- Individuals present in a country for 183 days or more in a taxable year are residents for that year unless they establish that they do not have a dwelling in the country and are not citizens of the country.

- Individuals having a dwelling in the country are residents unless they also have a dwelling in another country.

- Citizens of a country are residents unless they have established a dwelling abroad and are regularly outside the country for more than 183 days per year.

- Individuals who have established residence in a country cannot relinquish residence status until they have established residence status in another country.

- Individuals who have either resident or non-resident status for visa or immigration purposes might be presumed to have the same status for income tax purposes, although that presumption might be rebuttable.[4]

Looking at companies, some jurisdictions determine the residence of a corporation based on its place of incorporation. Other jurisdictions determine the residence of a corporation by reference to its place of management. Some jurisdictions use both a place of incorporation test and a place of management test.

Any 'business' activity carried out in a country which results in 'revenue' being generated (which can either be revenue generated directly in the country or where the activity in the country contributes to the 'group' entity's revenue), is likely to be deemed (by local authorities) as having created a 'PE'. What this means is that the local country tax authorities will assess corporate tax on a 'deemed revenue' arising in-country. In most countries in order to 'recognize' a PE, it needs be formally registered under some corporate identity, typically a branch, representative office, or a subsidiary entity. Three forms (3A) of permanent establishment (PE), in terms of the provisions of Article 5[5] of a Typical Tax Treaty are possible as follows:

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[4] *Supra*. n.2 p.18

[5] Article 5. Permanent Establishment OECD MC Commentary 1. (*Purpose of the rule*) - The main use of the concept of a permanent establishment is to determine the right of a Contracting State to tax the profits of

- Permanent Establishment due to fixed place i.e., office, branch, site etc. (Basic rule PE: Asset PE)

- Permanent Establishment due to presence employees i.e., service etc. (Activity PE)

- Permanent Establishment due to existence of dependent agent i.e., agency. (Agent PE)

B. Principal Source Rule

In theory, a country has the primary right to tax income that has its source in that country. Normally, there is a provision in the domestic law of a country or in a tax treaty defines the concept of source for a particular type of income. Determining the source of income is of critical importance in a territorial system, as source often determines whether or not the income is taxed. Source of income is also important in residency systems that grant credits for taxes of other jurisdictions. Such credit is often limited either by jurisdiction or to the local tax on overall income from other jurisdictions.

Source of incomes is where the income is considered to arise under the relevant tax system. The manner of determining the source of income generally depends on the nature of income. Income from the performance of services is generally treated as arising where the services are performed. Financing income is generally treated as arising where the user of the financing resides. Income related to use of tangible property is generally treated as arising where the property is situated. Income related to use of intangible property is generally treated as arising where the property is used. Gains on sale of realty are generally treated as arising where the property is situated.

Most countries have only sketchy rules for determining the source of income, especially income derived from business activities. Many tax treaties include source rules for some categories of investment income, but most do not include explicit source rules applicable to business income.

3. Double Taxation Relief

Most countries tax on the basis of both the residence status of the taxpayer and the source of income. Consequently, foreign-source income earned by a resident of a country may be taxed by both countries of source and the country of residence if there is no relief provisions designed to prevent double taxation.

International double taxation can arise from a variety of causes. In particular, ,the following three types of double taxation arise from conflicts over jurisdiction.

- Source-source conflict: Two or more countries assert the right to tax the same income of a taxpayer because they all claim that the income is source in their country.

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an enterprise of the other Contracting State. Under Article 7a Contracting State cannot tax the profits of an enterprise of the other Contracting State unless it carries on its business through a permanent establishment situated therein.

- Residence-residence conflict: Two or more countries assert the right to tax the same income of a taxpayer because they claim that the taxpayers is a resident of their country. A taxpayer that is a resident of two countries is commonly referred to as a 'dual-resident taxpayer'.

- Residence-source conflict: One country asserts the right to tax foreign-source income of a taxpayer because the taxpayer is a resident of that country, and another country assert the right to tax the same income because the source of the income is in that country.[6]

Based on these three types of international double taxation residence-source conflicts are the most likely to occur in the absence of measures to relieve double taxation. Residence-source conflicts are very difficult for a taxpayer to avoid through tax planning. Most of the attempts of the international tax community to deal with international double taxation have focused on the elimination of residence-source conflicts.

A. Relief Mechanisms

Tax relief is a generic term to describe all methods used to reduce tax liability without regard to the particular way it is accomplished. The following three methods are in common use. A country may use only one of these methods, or it may use some combination of methods.

- Deduction method: The residence country allows its taxpayer to claim a deduction for taxes, including income taxes, paid to a foreign government in respect of foreign-source income.

- Exemption method: The residence country provides its taxpayers with an exemption for foreign-source income.

- Credit method: The residence country provides its taxpayers with a credit against taxes otherwise payable for income taxes paid to a foreign country. In some circumstances, the credit also extends to income taxes paid to foreign sub-national governments.[7]

B. Allocation of Expenses

The apportionment or assignment of income or expense between permanent establishments in various jurisdictions is one of tax planning mechanisms. Whether a country uses an exemption method or a credit method for providing relief from international double taxation, it should have rules for allocating a proper of the expenses incurred by its taxpayers between their foreign-source gross income and their domestic-source gross income. But most countries lack specific rules for attributing expenses to foreign-source income. However, two approaches that might be used for that purpose are:

- Tracing approach involves a factual inquiry into the connection between the expenses and the foreign-source income.

- Apportionment approach involves the allocation of expenses by formula, either on the basis of either the proportion of the taxpayer's foreign assets to its total assets or the proportion of its foreign-gross income to its total gross income. Unlike tracing,

[6] *Supra*. n.2 p.27
[7] *Ibid*. p.30

apportionment is based on an assumption that the relevant expenses were incurred to support all of the taxpayer's assets or income-earning equally.

C. Tax Sparing

Tax sparing is a provision where a country applies a tax credit against taxes owned on foreign income which is equivalent to the tax exemption provided by the foreign country. A tax sparing credit is a credit granted by the residence country for foreign taxes that for some reason were not actually paid to the source country but that would have been paid under the country's normal tax rules. The usual reason for the tax not being paid is that the source country has provided a tax holiday or other tax incentive to foreign investors as an encouragement to invest or conduct business in the country. In the absence of tax sparing, the actual beneficiary of a tax incentive provided by a source country to attract foreign investment may be the residence country rather than the foreign investor. This result occurs whenever the reduction in source-country tax is replaced by an increase in residence-country tax. Therefore, tax sparing policies are especially important to developing countries in their effort to attract investment.[8]

4. Transfer Pricing

Transfer pricing is the setting of the price goods sold and services provided between controlled or related to legal entities within an enterprise. Transfer pricing policy is generally aimed at

- Evaluating financial performance of different business units (profit centers) of a conglomerate, and/or

- Shifting earnings from a high tax jurisdiction to a low-tax jurisdiction

In principle a transfer price should match either what the seller would charge an independent, arm's length custom, or what the buyer would pay an independent, arm's length supplier. While unrealistic transfer prices do not affect the overall enterprise directly, they become a concern when they are misused to lower profits in a division of an enterprise that is located in a country which levies high taxes and raise profits in a country that is a tax haven that levies no or low taxes. Accordingly, transfer pricing is the major tool for corporate tax avoidance also referred to as Base Erosion and Profit Shifting (BEPS).

In recent years, some countries have sought to reach agreement with their taxpayers on methodologies used in setting transfer prices before a transfer pricing dispute has actually arisen. A major object of the advance approval system is to reduce the high costs that taxpayers and the tax authorities incur in litigating disputes over transfer prices. A taxpayer wanting prospective approval of its pricing methodology with respect to one or more transactions typically submits a request to the tax authorities for an 'Advance Pricing Agreement' or APA. The taxpayer must give details concerning the pricing methodology that it intends to apply to the transactions covered by the APA and must explain why that methodology would produce an appropriate result. In some instance, two or more government may use the dispute resolution mechanism in their tax treaties to agree jointly on the pricing

[8] *Ibid.*, p.50

methodology to be used by a taxpayer. In 1999, the OECD issued guidelines for countries in developing joint APAs.

As ASEAN increasing flew their economic might around the world, they will look to computation their tax nets wider and restrict to what that see as abusive practices. All AEC member countries express on their demand for the rules to be rewritten and will be more aggressive in pursuing the revenue they believe is owing to them. AECs government adhere on their traditions in taxation and transfer pricing, they must adopt to a rapidly developing global environment.

A. OECD or UN Transfer Pricing Methods

The OECD and UN have been adopting Transfer Pricing guidance for members. Precisely, the goal of transfer pricing, for tax purposes, is to allocate and prevent income shifting through inter-multinational companies' transactions. The OECD and UN have been adopting Transfer Pricing guidance for members. The goal of transfer pricing, for tax purposes, is to allocate and prevent income shifting through inter-multinational companies' transactions.

B. Arm's Length Method

The arm's length principle was initiated by the U.S. regulations which is adopted by the organization of Economic Cooperation and Developments (OECD). This standard was also accepted by the United Nations (UN) Model convention. The OECD Guidelines on transfer pricing strongly endorse the arm's length standard and are better at highlighting the problems of establishing the comparability of controlled and uncontrolled transactions on how to cope with these problems.

B.1 Tangible Property

There are five methods to be used for determining the arm's length price on sales of tangible person property. The first three methods are known as traditional methods. They are as follows:

Traditional Methods:

- Comparable Uncontrolled Price (CUP) Method; the comparable uncontrolled price (CUP) method establishes an arm's length price by reference to sales of similar products made between unrelated persons in similar circumstances. It is the preferred method if such comparable sale exists. This method is widely used for pricing goods sold on public commodity markets and also useful for pricing manufactured goods that do not depend substantially for their value on special know- how or brand names.

- Resale Price Method ; The resale price method sets the arm's length price for the sale of goods between related parties by subtracting an appropriate markup from the price at which the goods are ultimately sold to unrelated parties.

- Cost Plus Method; The cost plus method uses the manufacturing and other costs of the related seller as the starting point in establishing arm's length price. An appropriate amount of profit is added to these costs by multiplying the seller's costs by an appropriate profit percentage. This percentage is determined by reference to the gross profit percentage earned by the seller in transactions with unrelated parties or by comparable unrelated parties in transactions with unrelated parties.[9]

Additional Methods:

- Profit-Split Methods; Under the profit-split method, the worldwide taxable income of related parties engaging in a common line of business is computed. The taxable income is then allocated among the related parties in proportion to the contribution they are considered to have made in earning the income. This method typically is employed when none of the three traditional methods can be applied. If a group of affiliated companies has more than one product line, the profit spit method might be applied separately to each product line.

- Transactional Net Margin Method (TNMM) and Comparable Profit Method (CPM); This method is may used under certain circumstances in determining transfer prices for sales of tangible and intangible property. Under TNMM, the payer must establish, for itself or a related party (the test party), an arm's length range of profits on a set of transactions. If the tested party's reported profits on those transactions fall within that range, then its transfer price will be accepted by the tax authorities. If its profits fall outside that range, the tax authorities may adjust transfer prices so that profits fall within the range, typically at the midpoint.[10]

B.2 Intangible Property

If a group of corporations intends to develop valuable intangible property and share the benefits among two or more of its members, it can avoid transfer pricing issues by having all of the prospective users of the intangible property jointly develop it through a cost sharing arrangement. In that event, all of the users are owners of the property from the beginning, and no transfer of the property between members of the corporate group is required.

In 1996, the US government issued regulations governing the use of ***cost contribution arrangements***, and the OECD issued guidance on their use in 1998. In general, both set of rules are designed to give tax significance to bona fide cost contribution arrangements and to place some limits in the use of these arrangements for tax avoidances purposes.

In order to make the Cost Contribution Arrangements to be consistent with the arm's length standard, it should have the following characteristics:

- The arrangement should be embodied in a written contract that is legally enforceable. It was entered into when the arrangement was initially established, and that sets forth clearly the nature of the arrangement, its duration, and the terms for its enforcement and amendment.

- Only persons with a legitimate expectation of benefiting under the arrangement should be permitted to be participants.

- The contract should require the participants to the arrangement to contribute to the costs of development of the intangible property in proportion to the benefits that they might reasonably be anticipated to derive from the use of that property.

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[9] *Supra*. n.2 pp.62,63
[10] *Ibid*. p.65,66

- The participants to the arrangement should be required to keep adequate records documenting their costs and explaining how their anticipated benefits were calculated.[11]

The governing cost contribution arrangements among related persons should permit the participants to modify an arrangement to reflect changed economic circumstances. To confirm to the arm's length standard, however, those rules should require that the participants receive a payment equal to the fair market value of any rights that they may have relinquished and that they pay a fair market fee for any new rights obtained. If a new participant is brought into the cost contribution arrangement, that participant should be required to compensate the other participants for the fair market value of the dilution of their interests in the arrangement. Any revision of a qualifying cost contribution arrangement should be in writing and otherwise should conform to the requirement for an initial arrangement. Practically, to prevent tax avoidance, a government should have the authority to treat related persons as if they had entered into a cost contribution arrangement when their economic behaviour is consistent with such an arrangement.

5. The comparison of EU and AEC

A. EC Tax Law and ASEAN Tax Treaties

The commitment of ASEAN member countries to complete the intra-ASEAN network of bilateral tax treaties is certainly significant progress towards tax. In the context of economic integration, the EU experience demonstrates that bilateral tax treaties may in fact not be the best mechanism for achieving a single market. The bilateral tax treaties of EU countries have been the subject of much ECJ Jurisprudence, creating uncertainty for the taxpayers and tax authorities. This approach to tax matters vis-a-vis regional economic cooperation has been strongly criticized and it has been suggested that a multilateral tax treaty is in fact the only feasible mechanism of achieving the goal of creating common market conditions. The substantial consistency between bilateral tax treaties, as based on either the OECD Model or UN Model, should also mean that a multilateral tax treaty may in fact be an achievable goal.

ASEAN is at a crucial stage in its quest to establish a single market, and rather than perpetuate existing problem, it should be bold and strive for best practice and the conclusion of a multilateral tax treaty. A multilateral tax treaty removes the administrative burden of having to negotiate and conclude separate bilateral tax treaties with other member countries and also establishes certainty and consistency of tax treatment in the region. Given the disparities in member countries' tax systems and economies, a multilateral tax treaty does not have to be concluded between all member countries.

B. Background of the EC and ASEAN work.

The European Union is more than just a confederation of countries, but it is not a federal state. In fact, its structure does not fall into any traditional legal category. It is historically unique, and its decision making system has been constantly evolving for the past 60 years or so.

[11] *Ibid*. p.71

- 1951 : The European Coal and Steel Community is set up by the six founding members.

- 1957 : The same six countries sign the Treaties of Rome, setting up the European Economic Community (EEC) and the European Atomic Energy Community (Euratom)

- 1973 : The Communities expand to nine Member States and introduce more common policies

- 1979 : The first direct elections to the European Parliament (EP)

- 1981 : The first Mediterranean enlargement

- 1992 : The European single market becomes a reality

- 1993 : The Treaty of Maastricht establishes the European Union (EU)

- 2002 : The euro comes into circulation

- 2007 : The EU has 27 Member States

- 2009 : The Lisbon Treaty comes into force, changing the way the EU works[12]

The Association of Southeast Asian Nations, or ASEAN, was established on 8 August 1967 in Bangkok, Thailand, with the signing of the ASEAN Declaration (Bangkok Declaration) by the Founding Fathers of ASEAN, namely Indonesia, Malaysia, Philippines, Singapore and Thailand.

Brunei Darussalam then joined on 7 January 1984, Viet Nam on 28 July 1995, Lao PDR and Myanmar on 23 July 1997, and Cambodia on 30 April 1999, making up what is today the ten Member States of ASEAN.

As set out in the ASEAN Declaration, the aims and purposes of ASEAN are:

1. To accelerate the economic growth, social progress and cultural development in the region through joint endeavours in the spirit of equality and partnership in order to strengthen the foundation for a prosperous and peaceful community of Southeast Asian Nations;

2. To promote regional peace and stability through abiding respect for justice and the rule of law in the relationship among countries of the region and adherence to the principles of the United Nations Charter;

3. To promote active collaboration and mutual assistance on matters of common interest in the economic, social, cultural, technical, scientific and administrative fields;

4. To provide assistance to each other in the form of training and research facilities in the educational, professional, technical and administrative spheres;

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[12] European Union, "*How The European Union Works*," Retrieved from http://www.gr2014parliament.eu/poetals/6/PDFFILES/NA0113090ENC_002.pdf

Wikipedia, "*History of the European Coal and Steel Community (1945-57)*," Retrieved from https://en.wikipedia.org/wiki/History_of_the_European_Coal_and_Steel_Community_(1945%E2%80%9357)

5. To collaborate more effectively for the greater utilisation of their agriculture and industries, the expansion of their trade, including the study of the problems of international commodity trade, the improvement of their transportation and communications facilities and the raising of the living standards of their peoples;

6. To promote Southeast Asian studies; and

7. To maintain close and beneficial cooperation with existing international and regional organisations with similar aims and purposes, and explore all avenues for even closer cooperation among themselves.[13]

ASEAN Summits

- Twenty-sixth ASEAN Summit, Kuala Lumpur & Langkawi, Malaysia, 26-28 April 2015.
- Twenty-fifth ASEAN Summit, Nay Pyi Taw, Myanmar, 11-13 November 2014
- Twenty-fourth ASEAN Summit, Nay Pyi Taw, Myanmar, 10-11 May 2014
- Twenty-third ASEAN Summit, Bandar Seri Begawan, Brunei Darussalam, 9-10 October 2013
- Twenty-second ASEAN Summit, Bandar Seri Begawan, Brunei Darussalam, 24-25 April 2013
- Twenty-first ASEAN Summit, Phnom Penh, Cambodia, 18 November 2012
- Twentieth ASEAN Summit, Phnom Penh, Cambodia, 03-04 April 2012
- Nineteenth ASEAN Summit, Bali, Indonesia, 14-19 November 2011
- Eighteenth ASEAN Summit, Jakarta, 7-8 May 2011
- Seventeenth ASEAN Summit, Ha Noi, 28-30 October 2010
- Sixteenth ASEAN Summit, Ha Noi, 8-9 April 2010
- Fifteenth ASEAN Summit, Cha-Am Hua Hin, Thailand, 23-25 October 2009
- Fourteenth ASEAN Summit, Cha-am, Thailand, 26 February - 1 March 2009
- Thirteenth ASEAN Summit, Singapore, 18-22 November 2007
- Twelfth ASEAN Summit, Cebu, Philippines, 9-15 January 2007
- Eleventh ASEAN Summit, Kuala Lumpur, 12-14 December 2005
- Tenth ASEAN Summit, Vientiane, 29-30 November 2004

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[13] ASEAN, "*The Asean Declaration (Bangkok Declaration)*," Retrieved from http://www.asean.org/news/item/the-asean-declaration-bangkok-declaration.

- Ninth ASEAN Summit, Bali, 7-8 October 2003
- Eighth ASEAN Summit, Phnom Penh, 4-5 November 2002
- Seventh ASEAN Summit, Bandar Seri Begawan, 5-6 November 2001
- Fourth Informal Summit, Singapore, 22-25 November 2000
- Third Informal Summit, Manila, 27-28 November 1999
- Sixth ASEAN Summit, Ha Noi, 15-16 December 1998
- Second Informal Summit, Kuala Lumpur, 14-16 December 1997
- First Informal Summit, Jakarta, 30 November 1996
- Fifth ASEAN Summit, Bangkok, 14-15 December 1995
- Fourth ASEAN Summit, Singapore, 27-29 January 1992
- Third ASEAN Summit, Manila, 14-15 December 1987
- Second ASEAN Summit, Kuala Lumpur, 4-5 August 1977
- First ASEAN Summit, Bali, 23-24 February 1976[14]

B. How responsibilities are shared between the AEC and its member countries?

The AEC was born out of the ASEAN Vision 2020 adopted on the 30th anniversary of ASEAN in 1997. The goal is to produce one market and production base by 2020 with a free movement of services, goods, capital, investments and skills labor. When ASEAN leaders met in 2003, they signed the Declaration of ASEAN Concord II and agreed to establish the AEC by 2020.[15] Among their members, the ASEAN way of not interfering with domestic political affairs may cause the non-recognition of joint economic interest. Some critics have noted that several AEC implementation deadlines have passed and several key initiatives have yet to begin. For instance, due to financial shortcomings, corruption, poor governance and the inability for governments to manage interdepartmental and international coordination (just 50 percent of the Master Plan on ASEAN Connectivity has been put into action. The large concern, however, is ASEAN's lack of structure to pull the AEC along.

The AEC scorecard was developed to track the progress being made, based upon the EU Internal Market Scorecard. Since its inception, there were two published scores (2010 and 2012). The skepticism is not too hard to understand that the AEC formation is right on the track, which begs the question why as many people do not expect it to occur by 2020

[14] ASEAN, "*ASEAN Summit*," Retrieved from http://www.asean.org/asean/asean-structure/asean-summit

[15] Hutabarat, B., "*Asean Economic Community 2015: Will it happen?*," the Jakarta Post, Mon 24 November 2014. Retrieved from http://www.thejakartapost.com/news/2014/11/24/asean-economic-community-2015-will-it-happen.html

6. Tax Treaties among Member Countries of AEC

Due to there is no single taxation regime for AEC member countries, each country has adopted for defining his jurisdiction to tax. The mechanisms are available to mitigate the risks to taxpayers of international double taxation.

International jurisdiction double taxation generally defined as the imposition of comparable taxes in two or all member countries of AEC on the same taxpayer in respect of the same subject matter and for identical periods has harmful effects on the international exchange goods and services and cross border movements of capital, technology and persons. In recognition of the need to move this obstacle to the development of economic relations between countries, as well as of the importance of clarifying and standardising the fiscal situation of taxpayers who are engaged in activities in other countries, the OECD Model Tax Convention on Income and on Capital provides a means to settle on a uniform basis the common problems that arise in the field of international juridical double taxation.

A. Content of a Typical Tax Treaty

The OECD Model requires constant review to address the new tax issues that arise in connection with the evolution of the global economy. Working Party No.1 of the OECD's Committee on Fiscal Affairs meets this need and its work results in regular changes to the Model. Updates were published in 1994, 1995, 1997, 2000,, 2003, 2005, 2008, 2010 and 2014.

The OECD and UN Treaty models, as well as many of the treaties in force, describe the scope of the treaty, summarizes the rules governing its ratification, termination and amendment which mainly includes provision for relieving or mitigating double taxation. (See the illustrate outline of Model Convention is organized in seven chapters at *Appendix*.)

B. Special Treaty Issues

In general, there are no significant legal restrictions on a country's jurisdiction to tax. Consequently, a country might well consider taxing nonresidents more harshly than residents. In fact, however, most countries generally treat nonresidents in the same way as residents for tax purpose. Probably the most important constraints on the unequal treatment of nonresidents are the possibilities of retaliation and of discouragement of investment by nonresidents.

Most tax treaties provide a mutual agreement procedure for resolving disputes that arise under a tax treaty. The dispute resolution mechanism of the OECD and UN Model Treaties is set forth in Article 25 (Mutual Agreement Procedure). This article contemplates that the competent authorities will attempt to resolve matters that have been referred to them. They are not required, however, to reach an agreement, even if the result is that a taxpayer is subject to double taxation.[16]

A variety of different types of disputes may be referred to the competent authorities. Some of these disputes involve the proper interpretation of treaty language, and some involve disputes over the facts on which a taxpayer's tax liability is based. Perhaps the most complex disputes commonly referred to the competent authorities involve the proper application of the

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[16] *Supra*. n.2 p.128.

arm's length standard to cross-border transactions. These disputes are sometimes difficult to resolve for a variety of reasons, including the large amounts of tax revenue frequently at stake. Article 9(2) of the OECD and UN Model Treaties provides that if one country adjusts the transfer prices used by related corporations in accordance with the arm's length standard, the other country must make a corresponding adjustment to the profits of the related corporation in order to avoid double taxation if it agrees with the adjustment made by the first country.[17]

7. Who Benefits from Inconsistent Multinational Tax Transfer Pricing Rules

The increased cross border activity, transfer pricing has become an increasingly hot topic and area of concern for both multinational enterprises (MNEs) and tax authorities in AEC. As six countries (Indonesia, Malaysia, the Philippines, Singapore, Thailand and Vietnam) adopt transfer pricing legislation and increase enforcement efforts, enterprises are concerned that they will face a greater risk of double taxation (the same amount will be taxes in more than one jurisdiction). All AEC member countries are thus being strongly encourage to increase international cooperation in transfer pricing to avoid double taxation. Moreover, the inconsistent multinational tax transfer pricing rules among AEC members on enterprises' reporting strategies and expected tax liabilities, as well as on the taxing authorities' audit strategies and expected tax revenue in 'a tax compliance game'. Enterprises may able to reduce their taxes by shifting income from a high tax rate country to a low tax rate country. However, they may face double taxation when taxing authorities apply transfer pricing rules inconsistently and attempt to tax the same income. Result in this article suggest that, contrary to popular thought, the risk of double taxation due to transfer pricing rule consistency is not necessarily a 'tax hell' for taxpayers and revenue authorities; that is, the prospect of double taxation does not necessarily lead to higher expected tax liabilities for enterprises or to higher expected audit costs for governments.[18]

In the multinational enterprises and taxing authorities, there are two taxing countries, Myanmar with 35 percent on corporate income tax rate which higher than Singapore with 17 percent on corporate income tax rate. The multinational enterprises operating in these two countries must choose where to report their income so as to minimize their expected tax liabilities, taking into account the probability that their reports will be audited. The multinational enterprises have an incentive to shift part of their income to Singapore through transfer pricing. However, if either country audits, Myanmar or Singapore may not agree on the transfer pricing and, thus on the income that should be taxed by a particular country. When both countries disagree because they apply transfer pricing rules inconsistently, the multinational enterprises face the potential for double taxation. The multinational enterprises have to decide whether or not to audit in consistent transfer pricing rule country or in inconsistent transfer pricing rule country:

Consistent transfer pricing rule country, the multinational enterprise chooses transfer pricing.

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[17] *Ibid*. p.133.

[18] De Waegenaere, A., R.C. Sansing, and J.L. Wielhouwer (*2006),* "*Who Benefits from Inconsistent Multinational Tax Transfer Pricing Rules? Contemporary Accounting Research*," 23(1), 103-139., p.133

- Myanmar taxing authority audits and Singapore taxing authority does not audit.

  If audit reveal income shifting

  - Myanmar (auditing country) collect tax and penalty

  - Tax refunded by Singapore

  Inconsistent transfer pricing rule country, the multinational enterprise chooses transfer pricing.

- Myanmar taxing authority audits and Singapore taxing authority does not audit.

  - Myanmar (auditing country) succeeds in collecting tax with probability.

  - No refunded by Singapore

  - No penalty

In this setting, an increase in transfer pricing rule inconsistency can be good for taxing authorities [and, thus, bad for the multinational enterprises (MNEs)] as the multinational enterprises report higher income and audits are lower. This would normally occur when the tax rate differential is fairly low and the probability that the auditing country prevails in taxing the income is relatively high. The probability of double taxation would normally be higher and the level of coordination between countries would vary. There exists one case in which the probability of double taxation is zero, when the multinational enterprises operate in two Organisation for Economic Cooperation and Development (OECD) countries. In this case, although the probability of transfer pricing rule inconsistency is low, the multinational enterprises always report a high level of income to the high tax rate country when they observe that the transfer pricing rules are inconsistent.[19] This case would occur when the probability that the auditing country prevails in taxing the income is high.

The multinational enterprises (MNEs) must make many strategic and tactical decisions in order to coordinate their intra-organizational value chain activities among AEC member countries. Strategic decisions include but are not limited to what product to produce, where to produce it, and how to get the most out of limited resources. Tactical decisions include but are not limited to how to create incentives to coordinate the value chain, how to control quality across the value chain, how to limit transaction risks, and how to distribute income among divisions to fairly evaluate and motivate managers in a decentralized organization. Transfer pricing policy is used by MNEs to mediate these activities, affecting both strategic and tactical decisions. Transfer pricing policy is affected by the nature of the value chain, including the products and services that are produced, markets, environmental factors, including taxes and regulations, power and dependence dynamics, resources, and governance structure including divisional relationships. Transfer pricing policy affects the coordination of value chain activities, opportunistic behavior, the location of resources, risks, and motivation. For these reasons transfer pricing decisions are of paramount importance to an MNE. Moreover, in addition to these factors, there are often multiple objectives to consider, which make MNE transfer pricing policy decisions especially complex.

[19] *Ibid*. p.103

8. Conclusion

The traditional concepts of residence and source rules were used on the basis that taxing rights if a state; or the infrastructure and legal systems provided by the state enabled income to be earned (and hence sourced) within the state. The tiebreaker rules used in DTAs in the case of transnationals that have links to numerous jurisdictions are unlikely to lead to states being correctly granted residence taxing rights when taxpayers are benefiting from them. This may also lead to tax avoidance behaviour on behalf of transnationals, who organize their affairs in such a way as to be a resident of a low-tax jurisdiction. The traditional methods to allocate profits between countries when multinational enterprises are involved are also not without their problems, particularly when individual nation states adopt their own rules regarding transfer pricing methodologies.

The problem that occurs as a result of a tax system which is based on individual nation states is exacerbated in a region such as South East Asia, where individuals and businesses frequently have connections which cross borders. Further, 'multinational enterprises (MNEs)' in such a region are not necessarily the large type of business thought of when transer uther, 'multinational enterprises' in such a region are not necessarily the large type of business thought of when transfer pricing methodologies are being developed and implemented. With the OECD also serious about addressing the issue of transfer pricing through its Base Erosion and Profit Shifting (BEPS) Action Plan, plus the increased exchange of information between taxing authorities due to greater transfer pricing compliance activity in the region, there is going to be more demand for tax, finance and transfer pricing staff.

This Article provides a very interest point for understanding how inconsistent transfer pricing rules can affect the multinational enterprises (MNEs) and AEC member countries' strategies and payoffs. The issue of compliance and transfer pricing has attracted a lot of attention to invest in the ASEAN. An increase in transfer pricing rule inconsistency may not detrimental for the multinational enterprises (MNEs) in some circumstances, MNEs may have incentives to do business in AEC member countries where the tax rate differential is high and the probability of double taxation is low (for instance, tax haven countries or countries where the competent authority process is working well). Finally, all AEC member countries have to cooperate in addressing the potential effects of the prospect of double taxation on expected tax liabilities and government revenues require, that they consider all costs of compliance and enforcement.[20] In practice, due to not only MNEs but AEC member countries may gain or may lost on inconsistent transfer pricing, both MNEs and AEC member countries' taxing authorities incur compliance and enforcement costs at various stages in the transfer pricing process. For example, MNEs encounter costs associated with being audited with being audited, preparing supporting documentation to avoid penalties, obtaining an advance pricing agreement (APA), appealing a decision and litigation. AEC member countries, on the other hand, incur costs associated with auditing, resolving disputes and litigation on resolution of transfer pricing disputes.

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[20] According to The Asean Summit, to be Consistent Multinational Tax Transfer Pricing Rules (Taxation impact-Business Trends and Taxation-Transfer Pricing Trends), all AEC member countries should follow step by step :

- Single market and production base will create and support more cross-border intercompany transactions
- Statutory requirement on transfer pricing documentation in the region
- Restructure of business model and supply chain management to maximize benefits to be received from AEC
- AEC may create AEC Joint Transfer Pricing Forum (similar to EU Joint Transfer Pricing Forum).

Appendix

Summary of the Convention

Title and Preamble

Chapter1

Scope of the Convention

Article 1 Persons covered

Article 2 Taxes covered

Chapter 2

Definitions

Article 3 General definitions

Article 4 Resident

Article 5 Permanent establishment

Chapter 3

Taxation of Income

Article 6 Income from immovable property

Article 7 Business profits

Article 8 Shipping, inland waterways transport and air transport

Article 9 Associated enterprises

Article 10 Dividends

Article 11 Interest

Article 12 Royalties

Article 13 Capital gains

Article 14 [Deleted]

Article 15 Income from employment

Article 16 Directors' fees

Article 17 Entertainers and sportspersons

Chapter 4

Taxation of Capital

Chapter 5

Methods for Elimination of Double Taxation

Chapter 6

Special Provisions

Chapter 7

Final Provisions

Terminal Clause

The terminal clause concerning the signing shall be drafted in accordance with the constitutional procedure of both Contracting States.

Glossary of International Tax Terms

Advance pricing agreement (APA)

An agreement between a multinational enterprise and the tax authorities of one or more countries approving the transfer pricing method to be used by the enterprise in future tax years.

Arm's length method

The establishment of transfer prices in transactions between related parties based on the prices charged (or sometimes the profits derived) in similar transactions between unrelated parties.

Arm's length price

A price set on a transfer of goods, services, or intangible property between related persons that corresponds to the price that would be set in the marketplace on a similar transfer between unrelated persons.

ASEAN (Association of South East Asian Nations)

The UN Association of South East Asian Nations (ASEAN) was established at Bangkok Thailand through the ASEAN/Bangkok Declaration 1967 in order to accelerate economic progress and increase the stability of the South East Asia region. At present the ASEAN, whose headquarters are in Jakarta Indonesia, incorporates all ten countries in the sub-region, i.e. Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Vietnam.

ASEAN Economic Community (AEC)

A single market and production base planned for 2020. Its goal is to create a stable, prosperous and highly competitive ASEAN economic region in which there is a free flow of goods, services and investment, a freer flow of capital, equitable economic development and reduced poverty and socio-economic disparities within ASEAN.

ASEAN Free Trade Area (AFTA)

Initially a comprehensive programme of regional tariff reductions established in 1992 by the ASEAN member states, AFTA was extended to cover other areas of trade cooperation such as the elimination of non-tariff barriers, harmonization of customs nomenclature, valuation and procedures.

Comparable profit method (CPM)

The US name for what the OECD calls the transactional net margin method (TNMM).

Controlled foreign corporation (CFC)

Rules that require the passive income and certain other tainted income of foreign corporations controlled by resident shareholders to be included in the income of those shareholders, whether or not such income is distributed (i.e., deferral is eliminated).

OECD

Organization for Economic Co-operation and Development. An organization of the major development countries of the world, with its headquarters in Paris.

Permanent establishment (PE)

A concept used to determine when an enterprise has sufficient connection with a country to subject it to tax on its income attributable to the PE.

Tax avoidance

The deferral, avoidance, or reduction of tax by lawful means.

Tax evasion

The reduction of tax by illegal means, usually involving fraudulent nondisclosure or willful deceit.

Tax havens

A tax haven is a country or also just part of the country that offers low tax rates or even no taxes at all for foreign investors.

The OECD in any case defines four criteria that a tax haven fundamentally fulfils.

- The tax system in the respective country provides for zero or low nominal tax rates.
- There is no effective information exchange with other countries.
- There is a lack of or inadequate transparency with regard to disclosure requirement. (Basic regulations and their implementation are not clearly defined are regulated.)
- Economic activity is not a necessary precondition. (This results in the conclusion that investments or transactions are carried out purely for taxation reasons only.)

Tax holiday

Fiscal policy measure often found in developing countries. A tax holiday offers a period of exemption from income tax for new industries in order to develop or diversify domestic, etc.,.

Tax planning

Exercise undertaken to minimize tax liability through the best use of all available allowances, deductions, exclusions, exemptions, etc., to reduce income and/or capital gains.

Tax sparing

The allowance of a credit for the amount of foreign taxes that were not paid become of a tax incentive or holiday in the foreign country.

Thin capitalization rules

Restrictions on the deductibility of interest payments made by corporations with excessive debt to equity ratios to their substantial nonresident shareholders.

Transfer pricing rules

Rules that limit the ability of related parties to set prices on transfers of property or services that are different from the prices that would be set in similar transfers involving unrelated parties.

Zero rate

The term is used in relation to VAT, where the rate of tax which is in principle levied but at a rate of 0% so that in effect no tax is payable, but will result in refunds of input tax credits.

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