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Standards across borders: crossborder diffusion of the arm's length standard in North America

Lorraine Eden *, M. Tina Dacin, William P. Wan

Department of Management, 423B Wehner, Lowry Mays College & Graduate School of Business, Texas A&M University,
College Station, TX 77843-4221, USA

Abstract

The arm's length standard is used by corporate income tax authorities to price international intracorporate transactions and allocate intracorporate income and expenses of multinational enterprises. In this paper, we examine the socio-historical evolution of transfer pricing regulation in North America. We develop a model of crossborder diffusion of standards, using institutional theory and the logic of embeddedness, that focuses on three components of crossborder diffusion: timing, motivation and form. Our model is then applied to the evolution and diffusion of the arm's length standard within North America from 1917 to the present. © 2000 Elsevier Science Ltd. All rights reserved.

Transfer pricing, the pricing of goods, services and intangibles transferred between affiliates of a multinational enterprise (MNE), is the single "most difficult area of international taxation" and "the biggest international tax issue MNEs will face over the next two years", according to a recent survey of more than 450 multinational parent and subsidiaries (Ernst & Young, 1997, pp. 1–2). There are three reasons why transfer pricing has become such an important international tax issue. First, globalization is creating integrated businesses with enormous crossborder transfers while corporate income tax systems remain nationally based. Second, governments argue that globalization provides MNEs with more opportunities to manipulate transfer prices and reduce taxes than in the past and therefore need tighter regulation. Third, the increased desire of tax authorities, faced

with tight fiscal situations, to protect and enhance their revenue base also encourages stricter regulation of MNEs. Thus, transfer pricing is a prime area for international conflict.

The most common solution that national tax authorities have adopted to reduce transfer price manipulation is to develop specific legislation as part of the federal corporate income tax code. Tax authorities require transfer prices to be set according to the *arm's length standard (ALS)*; that is, as if the transactions had taken place between unrelated parties acting at arm's length in competitive markets.

In this paper, we examine the socio-historical evolution of the ALS in North America over the twentieth century. Using the logic of embeddedness (Granovetter, 1985; Zukin & DiMaggio, 1990), institutional theory (DiMaggio & Powell, 1983; Scott, 1995) and transactional interdependence (Pfeffer & Salancik, 1978), we assess the forces that serve to diffuse national standards, that is, norms of behavior defined in terms of

* Corresponding author. Tel.: +1-409-862-4053; fax: +1-409-845-9641.

E-mail address: leden@tamu.edu (L. Eden).

rights and obligations, on a regional basis. We call this process — the adoption by country B of standards and practices developed in country A — *crossborder diffusion*. We are interested not only in which country is the standard setter, but also in the extent to which there is variation between the countries in their adoption patterns. Crossborder diffusion is seen as a three-part process: timing (who follows and when?), motivation (why follow?) and form of diffusion (is diffusion perfect or imperfect?). A paired case study (Yin, 1989) can help to identify the factors that account for differences in timing, motivation and form of crossborder diffusion. North America is an interesting context because political, economic and institutional forces suggest pressures for and against homogeneity. Because Canada and Mexico both border the United States and are closely linked to the US economy, one might expect diffusion patterns to be similar. On the other hand, because the three countries display different cultural heritages and stages of economic development, one might expect heterogeneous diffusion patterns.

The paper is structured as follows. We review the literature and develop a theoretical model of forces that can influence crossborder diffusion of standards. A brief description of the arm's length standard is followed by an historical survey of transfer pricing regulation in the United States, Canada and Mexico. A paired case study of the three countries allows us to isolate differences in timing, motivation and form, and to analyze these differences in terms of institutional theory and the logic of embeddedness.

1. Literature review

Crossborder diffusion does not occur in a vacuum. The diffusion of standards is motivated as well as constrained by a variety of economic, political, socio-historical and cultural forces. As a function of their embeddedness in a broader socio-cultural context, organizations face pressures to adopt a wide range of practices and beliefs and become isomorphic with this context and its changing nature (DiMaggio & Powell, 1983; Zucker, 1987). Bealing, Dirsmith and Fogarty

(1996) suggest that the process of institutionalization is subject to many political, cultural and societal forces.

Institutional theory highlights various mechanisms that induce organizations to respond to institutional forces (e.g. from broader socio-cultural norms, the state and other powerful agencies, uncertainty and professional norms) in a similar fashion (Dacin, 1997; DiMaggio & Powell, 1983; Tolbert & Zucker, 1983). Organizations that attend to these forces and incorporate institutional elements into their structures gain legitimacy, increased access to resources, and enhanced survival prospects. The process of isomorphism implies that organizations within the same field, or “recognized area of institutional life” (DiMaggio & Powell, p. 143), become increasingly homogeneous over time. Strang and Meyer (1993, p. 490) suggest that the presence of similar cultural understandings creates a tie across entities, resulting in greater diffusion of social practices. Organizations also tend to imitate the behaviors and actions of successful organizations as their presence in a new field signifies legitimacy (Haveman, 1993).

However, organizations do not always blindly conform to institutional forces. Even where pressures to conform are high, organizations can choose various ways to conform or comply (Oliver, 1991). Contextual forces may not be sufficiently strong to induce full conformity to existing practices but may also serve to enable action. For example, Goodrick and Salancik (1996) find that an organization's discretion in influencing practice is greatest when the institutional standards are most uncertain. Under these circumstances, institutional standards do not possess strong power to ensure homogeneity. Additionally, the motives for adoption can be either symbolic or substantive (Ashforth & Gibbs, 1990; Elsbach & Sutton, 1992). Institutional theorists have begun to explore both conformity and resistance to institutional forces (Covaleski & Dirsmith, 1988; Oliver, 1991).

Institutional isomorphism has been much less studied at the international level. The increasing homogenization of educational systems across-countries may demonstrate the presence of insti-

tutional forces at a global level. Meyer, Boli and Thomas (1987) suggest that if such institutions were simply the outcome of local political and/or economic processes, one would expect to see greater variance across societies. Despite the evidence of international linkages, the actions of organizations are primarily defined by the local infrastructure of a particular region (Romo & Schwartz, 1995). Empirical studies point to variation in the social structure of economies in Asia, Europe and Latin America (Evans, 1995; Hamilton & Biggart, 1988; Whitley, 1994), and to the role of unique political, cultural and social systems in generating features of these economies. Thus, the embeddedness of activity in local infrastructures shapes the boundaries of diffusion, providing both constraint and opportunity in the framing of strategic action (Jepperson & Meyer, 1991).

2. Theory development

We treat government entities as organizations interacting with institutional environments (North, 1990); that is, government entities are open systems engaged in interactions with each other. This openness makes them subject to each other's influence, as well as encouraging them to seek legitimacy and status in the eyes of other organizations. We define the concept of field to include all actors and stakeholders relevant to the particular issue area; the notion of field sets the boundaries for the arena in which crossborder diffusion occurs. Organizations in the same field interact with one another to a greater extent than actors outside the field, resulting in the diffusion and adoption of like practices (Scott, 1995).

We distinguish between standards and practices. A standard is a broad norm of behavior in terms of rights and obligations that are socially accepted as the proper way to handling a task (Goodrick & Salancik, 1996; Krasner, 1983). Practices are the regulations and guidelines used to interpret and implement the standard. Diffusion is the process by which the standards developed by one organization (the standard setter) are adopted by another organization; adoption is the outcome of the diffusion process.

Our overall research question asks "What explains why standards diffuse from one country to another?" We decompose this into three questions: (1) *timing*: Which country will be the standard setter, and, if one becomes the standard setter, which country(ies) will follow and when? (2) *motivation*: Why do some countries choose to adopt similar standards? (3) *form of adoption*: Is adoption complete or incomplete? We address each in turn below.

We identify three possible actors based on timing: standard setters, fast followers (early adopters) and latecomers (late adopters). International relations theorists argue that larger and economically more powerful countries are hegemon, that is, they develop and set standards which are adopted by their neighbors in the form of international regimes (Krasner, 1983). The advantages to being a standard setter are clear; e.g. the ability to tailor the standard to domestic competencies, goals and institutions; to avoid or minimize the costs of having to adapt to another's standards; and to reap the symbolic and real rewards of seeing one's legislation and policies adopted by other governments and countries. This suggests our first proposition: the greater the economic size and power of one country relative to another, the stronger the motivation for the larger and more powerful country to move first and be the standard setter.

The extent to which two countries share crossborder flows (e.g. trade, investment, labor, financial flows) creates transactional interdependence, increasing the need for harmonization of standards and practices in order to facilitate crossborder linkages and reduce crossborder transactions costs. For example, in a case study of the diffusion of US tax policies to less developed countries, Shoup (1980) finds that where the potential revenue losses from non-adoption of the standard are high, which is more likely the larger are crossborder linkages between countries, the probability of diffusion is high. This suggests our second proposition: the greater the volume and types of crossborder linkages between two countries in a particular issue area, the stronger the motivation for, and earlier the timing of, crossborder diffusion.

Institutional theory also suggests that voluntary diffusion is a function of the interconnections and

frequency of interaction among actors in a particular field. For example, at an organizational level, directorship ties among firms induce more interfirm imitation (Davis, 1991; Haunschild, 1993). Similarly, Shoup (1980) argues that a government is more likely to voluntarily replicate the standards of another country if the two governments interact regularly through tax missions, conferences and/or international organizations. Therefore, we propose that the greater the degree and frequency of interactions between two governments in a particular issue area, the stronger the motivation for, and earlier the timing of, crossborder diffusion (proposition 3).

Note that propositions 2 and 3 both suggest that more frequent interactions encourage crossborder diffusion. Proposition 2 focuses on macro, country-level forces for diffusion (e.g. trade and FDI flows) whereas proposition 3 emphasizes micro, individual-level interactions between government policy makers, departments, and agencies. These interactions can be bilateral (state-to-state) or intermediated through international organizations such as the United Nations or the OECD.

What provides the specific — as opposed to general — motivation for organizations to adopt standards set by other parties? Three different literatures provide some ideas. First, institutional theory suggests that organizations adopt a wide range of practices and beliefs and become isomorphic with their institutional context in order to gain legitimacy, increased access to resources, and enhance their survival (DiMaggio & Powell, 1983). Isomorphism can also result from pressures to reduce transactions costs under uncertainty, or from similar cultural understandings that create ties across entities and encourage diffusion of standards and practices. For example, Strang and Meyer (1993) point out that the closer the cultural understanding between organizations, the greater the propensity for diffusion.

The multinationals and technology transfer literature also provides some insights (Eden, Martinez & Levitas, 1997). Informal technology transfer from an MNE to host country firms occurs in at least three ways. First, local firms see the MNE's new practices and follow the leader by copying these practices (the demonstration or contagion

effect). As geographic and operational proximity increases the information flow among firms, the demonstration effect becomes stronger. And, as more and more producers adopt the standard, this can cause a bandwagon effect because latecomers fear being left behind. Second, backward and forward linkages between the MNE and local firms facilitate learning-by-doing of MNE best practices. In addition, interfirm linkages work more efficiently and transactions costs are reduced when upstream and downstream firms in the same industry employ the same standards and practices. Third, entry by a more efficient firm generates competition within an industry that puts pressure on existing firms, threatening their survival (the competition effect). Their response may be to more efficiently use existing technology or to upgrade, either following the entrant or pursuing their own technology paradigm.

Lastly, Shoup (1980) explicitly addresses crossborder diffusion of the US corporate income tax system to developing countries. He argues that there are two basic ways one government can respond to another's standards: (i) a reaction effect whereby one government directly and mechanically reacts to a tax change, and (ii) a replication effect whereby one government replicates another's on more general grounds (Shoup, p.182). The replication effect can be subdivided into a tradition effect (where former colonies retain the tax system imposed on them by the colonizer for hysteresis reasons) and an emulation effect (where countries voluntarily choose to adopt features of another country's tax system, possibly based on advice provided by tax missions or information shared at tax conferences). Shoup concludes that the US tax system has not significantly diffused to developing countries, but where it has occurred most crossborder adoption has been due to reaction, not replication, effects.

Based on these literatures, we argue that the motivation for crossborder adoption of standards can be seen as either replication or reaction effects. Motivations for replication of another organization's standards and practices are primarily affirmative, e.g. the search for legitimacy, learning-by-doing or demonstration effects, bandwagon effects, simple hysteresis, and the desire to enhance

performance or reduce transactions costs. Reaction effects, on the other hand, are primarily defensive where an organization directly or mechanically adopts the standard in order to protect its own resources or to ensure its survival.

Which effect (replication or reaction) dominates probably depends on the type and intensity of interactions and linkages between organizations. Crossborder linkages and interactions in a particular issue area can be either cooperative or conflictual. For example, pollution spillovers from one country to another (e.g. acid rain, polluted transboundary rivers) are negative forms of crossborder linkages which are likely to cause frequent, but conflictual, government interactions. This suggests our fourth proposition: If crossborder linkages and interactions are primarily cooperative, the adoption motive is more likely to be replication effects (e.g. legitimization, demonstration, performance); where linkages and interactions are primarily conflictual, the adoption motive is more likely to be reaction effects (e.g. defensive, automatic).

Timing may also be related to the specific replication motive for adoption of the standard. Institutional theory argues that early adopters value the practice as a means to improve internal functioning or performance (DiMaggio & Powell, 1983; Leblebichi, Salancik, Copay & King, 1991; Tolbert & Zucker, 1983), whereas late adopters adopt a practice primarily for its legitimization value (Fligstein, 1985). That is, our fifth proposition: fast followers adopt the standard for performance reasons whereas latecomers adopt for legitimization motives.

The form of crossborder diffusion, by which we mean the extent to which the standard is perfectly or imperfectly diffused across borders, should be affected by the embeddedness of decision-makers within broader sociocultural, political and economic contexts (Zukin & DiMaggio, 1990). We augment this idea by incorporating the concepts of greenfield and brownfield entry from the international entry mode literature (Dunning, 1993, Chapter 9). Greenfield (first-time) entry occurs when a standard is transferred from one country to another that does not have any pre-existing standard in this issue area. Brownfield entry

occurs when the adopting country already has pre-existing standards and practices. We propose that greenfield entry should be relatively easy and in most cases, the details of interpretation and implantation (i.e. practices) should be largely adopted without much resistance. This suggests that greenfield entry should lead to perfect crossborder diffusion of standards.

Brownfield entry, on the other hand, should meet with resistance because a pre-existing definition of how to approach an issue will have already taken root. Adoption of an institutional standard often has differing impacts on groups of stakeholders in different countries, so that the levels of resistance are correspondingly dissimilar. Moreover, when conformity to institutional standard requires changes in core values, rather than just peripheral characteristics, resistance to adopting the standard will be stronger (Oliver, 1991; Slack & Hinings, 1994). Therefore, the standard should go through diverse paths after it crosses national borders, implying that brownfield entry should lead to imperfect homogeneity.¹ In summary, perfect diffusion is more likely where the adopting country does not have a pre-existing domestic standard; imperfect homogeneity where there is a pre-existing standard (proposition 6).

Finally, once a standard is successfully diffused across countries and becomes institutionalized at the international level, the power of institutionalization in upholding and maintaining the standards should be strong. For example, if the standard setter is successful in having its standards and practices be adopted by an international organization as the model for other countries to follow, we argue that this institutionalization should increase the probability that subsequent diffusion to other countries will be homogeneous. That is, our seventh and last proposition is that institutionalization of the standard at the international level increases the likelihood of perfect (homogeneous) crossborder diffusion.

¹ One possible exception is Shoup's (1980) tradition effect where inertia, familiarity and vested interests lead to subsequent policy changes by colonizer being automatically copied by the host country.

3. The arm's length standard

The rationale for transfer pricing regulation derives from the fact that multinational enterprises are integrated businesses. The typical MNE consists of several affiliated firms that are located in different countries, under common control of the parent firm and sharing common resources and goals. Each multinational must declare income and pay taxes in the various countries where its affiliates do business. The need to declare taxable income means that the MNE must allocate its expenditures and revenues among its various affiliates and set transfer prices for all intrafirm transactions in goods, services and intangibles.

Because governments have the authority to tax entities on both the source principle (i.e. all income earned within a country's borders is taxable regardless of ownership) and the residence principle (i.e. all income earned by a country's residents is taxable regardless of where the income was earned), multinationals must follow the different and, most likely, conflicting corporate tax rules set down by both home and host governments. Thus, double taxation of MNE income is a real possibility. At the same time, MNEs can arbitrage the differences in national tax systems, through transfer price manipulation, to reduce their overall taxation burden. In order to prevent both double taxation and under taxation of MNE income, tax authorities have developed sophisticated transfer pricing and income allocation rules and procedures as part of their federal corporate income tax systems.

Transfer pricing legislation is normally based on the concept of the arm's length standard (ALS) which says that all MNEs' intra-corporate activities should be priced as if they took place between unrelated parties in competitive markets (Eden, 1998). Essentially, the ALS asks an MNE the question: What would the parties have done if they were unrelated? The answer can only be hypothetical since the affiliates of an MNE are by definition related to each other. The most feasible measure is a proxy done in either of two ways. The first approach is to make reference to a price for the same or similar product negotiated by two other unrelated parties under the same or similar

circumstances. The second approach is to use the price for the same or similar product traded between one of the related parties and an unrelated third party under the same or comparable circumstances. Both approaches together are called the comparable uncontrolled price (CUP) method; this is the method most highly recommended by tax officials. The problem is that often neither approach can be used in practice because there often are no really comparable transactions. In these cases, tax authorities must rely on other methods to determine the arm's length price.

Transfer pricing legislation is generally developed by national tax authorities and passed into legislation by national governments. In the United States, the Treasury has the responsibility for developing tax law, which is interpreted and applied by the Internal Revenue Service (IRS). In Canada, the Department of Finance and Revenue Canada play similar roles to the US Treasury and IRS. In Mexico, *Secretaria de Hacienda y Credito Publico* (the Ministry of Finance and Public Credit, known as *Hacienda* or *SHCP*) is responsible both for developing and for interpreting and applying tax law.

During each stage of the policy development and implementation process, non-governmental organizations (e.g. MNEs, legal and accounting professional associations) attempt to influence the outcome in various ways. National governments also solicit expert opinions, not only because transfer price law has great impact upon business operations, but also due to the technical intricacies involved. The regulation of transfer prices is particularly influenced by MNEs, which have the largest stake in the outcomes because it is their incomes that are most affected by tax policy changes.

At the international level, there is a long history, starting with the League of Nations, of national tax officials getting together to try to devise international standards in regulating transfer prices. [see Langbein (1986) and Picciotto (1992) for comprehensive reviews.] Since the late 1960s, tax authorities in the OECD countries have met regularly through the OECD's Committee on Fiscal Affairs (CFA) to discuss tax problems and develop common policy approaches such as a model corporate income tax treaty. Canada and the United

States have been long-time members of the CFA; Mexico joined in 1994 when it became an OECD member. The CFA has published two major transfer pricing reports (OECD, 1979, 1995) and a variety of smaller documents, designed as guidelines for its members.

4. The arm's length standard in North America²

4.1. The US approach to transfer price regulation

The US Treasury has been the world's most active innovator and developer of transfer pricing policy. US regulation began in 1917 when the IRS Commissioner was authorized to allocate income and deductions among affiliated firms. The 1928 Revenue Act added two rationales: to prevent tax avoidance and determine the true taxable liability of the parties. In 1935, Section 45-1(b), later renamed Section 482, was added to the US income tax code, stating that the ALS was to be used by the Commissioner in making a clear reflection of income and preventing tax evasion among related parties. The ALS was defined as that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

Until the mid-1960s, the US Treasury was primarily concerned with underinvoicing of outbound transfers, and the subsequent loss of US taxable income, as US multinationals shifted income to offshore tax havens. After a heated debate over US taxation of MNEs and FDI (Langbein, 1986, pp. 643–645), in 1962 Congress enacted Subpart F provisions to limit the use of tax havens, and authorized the Treasury to develop guidelines for taxing MNE income. In 1968, the US Treasury responded by issuing detailed transfer pricing regulations specifying a hierarchy of four methods: CUP, resale price, cost plus, and fourth methods.

The 1968 IRS regulations represent a watershed in the history of the ALS in North America. The

ALS was first developed in the United States as a general principle for ensuring that revenue and cost allocations between related parties were broadly fair. However, as Picciotto (1992, p.771) argues: "In 1968, the US approach set out on the deep slope of attempting to define rules for the pricing of specific transactions." That is, the US interpretation of the ALS changed from adoption of a broad norm to the specification of detailed rules designed to implement the standard.

As early as 1965, the US Treasury began to actively encourage other countries to adopt transfer pricing regulations similar to the 1968 IRS regulations. The Treasury pushed for the OECD's Committee on Fiscal Affairs to develop transfer pricing standards that would be adopted by all OECD member countries, on the grounds that a unilateral approach would not work. "For if our unilateral rules do not mesh with those of other countries the result will be double taxation" (Stanley Surrey, Assistant Secretary of the Treasury, quoted in Langbein, 1986, p. 647). The US Treasury was successful; when the CFA's 1979 transfer pricing guidelines were issued, they closely followed the Section 482 regulations.³

The 1986 Tax Reform Act significantly lowered corporate income tax rates, broadened the tax base, and tightened foreign source income provisions. In addition, Congress amended Section 482, adding a sentence requiring that intrafirm transfers of intangibles be priced commensurate with the income (CWI) earned from the intangibles. The intent of CWI was to ensure that the US Treasury would be able to capture a fair share of MNE worldwide income earned on "crown jewel" intangibles (blockbuster drugs) developed in the United States. Because the income from intangibles could not be fully anticipated, the Treasury argued that periodic adjustments of transfer prices would be required and that such adjustments were consistent with the ALS. Other governments disagreed on the grounds that the ALS should be based only on the information available to the

² See Boidman (1995), del Castillo et al. (1995), Eden (1998), Ernst and Young (1997), Pagan and Wilkie (1993) and Tang (1997) on transfer pricing regulation in Canada, Mexico and the United States.

³ Langbein (1986, p. 652) notes that the 1979 OECD report never once refers to the domestic law or practice of any member country except the UNITED States.

parties at the time of the license or sale. The CWI standard caused a great deal of controversy because it was seen as an US Treasury tax grab based on excessive licensing fees levied on foreign affiliates of US MNEs (Boidman, 1988).

In order to implement CWI, in 1992, the IRS issued proposed Section 482 regulations which were followed by temporary regulations in 1993 and final regulations in 1994. The draft regulations were very controversial (Eden, 1998, Chapter 8). The CFA, with Canada as an active participant, strongly criticized the US rules and was successful in its attempts to persuade the US government to place less weight on the most controversial change — the introduction of the Comparable Profits Method or CPM (OECD, 1993). In the final 1994 Section 482 regulations, the numbers of specified methods were increased by two (CPM was kept but reduced in importance, and a profit split method was added). The earlier hierarchy of acceptable methods was replaced by the best method rule, requiring the taxpayer to select the best method based on the facts and circumstances of the case. Periodic adjustments of intangible valuations were kept to ensure that the CWI standard was satisfied. Taxpayers were expected to document their transfer pricing policies; the documentation had to be contemporaneous and available to the IRS upon request. The final IRS regulations, when compared with the earlier proposed and temporary regulations, were seen as a substantial retreat by the United States from any potential departure from the ALS (Boidman, 1995).

With increased FDI into the United States in the mid-1980s, the nature of the US Treasury's concern with transfer price manipulation began to change. The new fear was that foreign MNEs, especially Japanese MNEs, were overinvoicing inbound transfers to their US affiliates and not paying US taxes (Eden, 1998, pp. 343–356). In response, Congress passed several pieces of legislation setting out new procedures for ensuring compliance with the ALS (Triplett, 1990). These included a variety of information and reporting requirements, an accuracy-related tax penalty for transfer pricing misvaluations, and an Advance Pricing Agreement (APA) procedure (a mechanism

whereby a taxpayer and the IRS can voluntarily negotiate an agreed transfer pricing methodology that is binding on both parties for three years). The transfer pricing penalty (Section 6662) provoked the most negative response from business and other tax authorities; it was widely perceived as a “big stick” designed to shift tax revenues from foreign tax authorities and MNEs to the IRS (Eden, 1998, pp. 460–469). Despite these criticisms, the inaccuracy penalty took effect in 1996. The APA has perhaps been the most successful of these procedural developments, and the one most widely adopted by other countries. Since 1991, the IRS has broadened the APA process, introduced a Small Business APA and is now moving to release texts of actual APAs to the public domain.

The US Treasury was actively involved throughout the period in trying to convince other tax authorities, particularly the OECD, that, first, the US changes were consistent with the arm's length standard and, second, the US changes should be adopted by other tax authorities. The CFA, after twice criticizing the US changes, spent three years rewriting its own transfer pricing guidelines. The new guidelines (OECD, 1995) clearly show the stamp of the US 482 regulations; for example, they include a version of CPM called the Transactional Net Margin Method (TNMM) (Eden, 1998, Chapter 14).

By 1996, the United States had totally rewritten its transfer pricing regulations so as to incorporate the commensurate with income standard adopted ten years previously. Since that time, there have been no major changes in the US regulations. It is clear from the above history that US policy changes were driven by US goals and circumstances as the major home country for FDI and as a world power. US policies were unilaterally derived throughout the whole period, and only partially modified when there was strong complaints from the OECD. Despite international criticism, the US Treasury retained the comparable profits method, the inaccuracy-related penalty and periodic adjustments for intangibles, the three most controversial changes in the US tax code in recent years. In addition, the Treasury took an active role in encouraging other countries to follow its example and adopt similar corporate income tax regulations

towards MNEs and transfer pricing. The 1995 OECD guidelines are witness to its success.

There is little evidence that trade policy played a role in the development of US transfer pricing regulations. For example, neither the 1989 Canada–US Free Trade Agreement (CUFTA) nor the 1994 North American Free Trade Agreement (NAFTA) factored into transfer pricing policy debates in the United States. Nor does either agreement deal directly with transfer pricing or international taxation matters (Eden, 1996a). The growing internationalization of the US economy, caused by the growth in the numbers and size of domestic and foreign MNEs and in their intrafirm trade activities, appears to be the primary motivation behind the US Treasury’s push for more sophisticated transfer pricing regulations in the 1980s and 1990s.

4.2. The Canadian approach to transfer price regulation

The Department of Finance in Canada first passed transfer pricing legislation as Section 23B of the 1939 Income Tax Act (ITA). Section 23B allowed Revenue Canada to adjust any payment made by a taxpayer to a nonresident related party which was “not in conformity with similar payments made by other persons in the same kind of business” (Vincent, 1996, p. 2). The legislation initially applied only to outbound transfers, but was broadened in 1949 to include inbound transfers. In response to the need for additional revenues to finance Canada’s role in the Korean War, tax rates were raised significantly (Gillespie, 1991; pp. 158–160), and, in 1952, the concept of the “reasonable amount” was introduced (Vincent).

The Department of Finance engaged in a major overhaul of Canadian income tax legislation in the early 1970s, following the landmark Royal Commission on Taxation. As part of the 1972 tax reform package, Section 69, arm’s length pricing, replaced the earlier legislation. If overinvoicing of inbound transfers [69(2)] or underinvoicing of outbound transfers [69(3)] occurs, the legislation says that Revenue Canada must substitute the price that is “reasonable under the circumstances”.

Note that IRC Section 482 and ITA Section 69(2,3) read quite differently. Section 482 authorizes

the IRS to reallocate income to prevent tax avoidance or more clearly reflect true taxable income. Section 69(2,3) authorizes Revenue Canada to adjust the transfer price only for an over-invoiced inbound, or an underinvoiced outbound, transaction. Therefore, US law focuses on allocating income (the arm’s length result) whereas the Canadian law focuses on pricing transactions (the arm’s length method). This difference in focus — results versus methods — has been a key difference between the two tax authorities’ approaches.

According to Peterson (1979, p. 458), transfer pricing issues first became a major concern for Canada in 1976 when the Canadian Institute of Chartered Accountants and the Tax Executive Institute criticized Revenue Canada for being either inactive or ineffective in policing transfer prices. In response, Revenue Canada introduced three auditing programs in 1997: the large file program of the top 200 MNEs in Canada, industry-wide audits, and simultaneous examinations (joint audits conducted by Revenue Canada and the IRS). Two years later, Revenue Canada conducted its first industry-wide audit of the pharmaceutical industry, which led to “heated discussion” with the drug MNEs and requests for published transfer pricing guidelines (Lawlor, 1987, p.1).⁴ In response, Revenue Canada set up its first internal Transfer Pricing group.

After four years of drafting transfer pricing guidelines, Revenue Canada released Information Circular 87-2 (IC 87-2). IC 87-2 did not have the same force of law as the IRC Section 482 regulations, but was meant to provide administrative guidance as to how Revenue Canada would interpret Section 69(2,3). IC 87-2 explicitly committed the Canadian tax authorities to the ALS. Rules were developed for transfers of tangibles, services and intangibles that roughly followed the 1968 US regulations. The same four methods (CUP, resale price, cost plus, fourth methods) were used, with CUP having priority but with no ranking among the other methods. The Revenue Canada auditor

⁴ Between 1977 and 1979, Revenue Canada and the IRS conducted three simultaneous audits of related Canadian and US companies (Peterson, 1979, p. 461). The IRS also helped develop Canadian industry-wide transfer pricing guidelines for oil and pharmaceuticals (Lanthier, 1986, p. 488).

was expected to look to the facts and circumstances of the case and find a price that was reasonable in the circumstances.

The adoption of transfer pricing rules in Canada in the 1980s did not take place in a vacuum, but can be seen as part of a broader response to rising international tax competition (Gillespie, 1991, pp. 202–205). In 1986, the US Tax Reform Act had reduced tax rates, tightened the foreign tax credit rules, and broadened the tax base. Canadian CIT rates were higher than US rates so that US tax reform meant Canadian taxes were not competitive. In 1988, Canada reduced its CIT rate and broadened the tax base, along the lines adopted by the US Treasury two years earlier. Fear of horizontal tax competition with the United States was therefore the key force underlying adoption of the US CIT changes by Canada.

The role of the OECD is also important in understanding IC 87-2. Canada and the United States were founding members of the CFA. The US Treasury played the key role in developing the 1979 OECD guidelines and OECD (1979) closely paralleled the 1968 IRS Section 482 regulations. As an OECD member, Canada's adoption of the US version of the ALS was facilitated by its OECD membership.

Canada, in the late 1980s, also adopted new transfer pricing procedures which paralleled those adopted earlier in the United States. For example, in 1988, ITA Section 233.1 was added, requiring all Canadian firms with non-arm's length transactions with nonresident persons to file a T106 information reporting form. Jack Calderwood, Director of the Revenue Canada International Audits Division, in discussing Section 233.1, noted that: "The concept and design of an information reporting form was based on a review of the IRS and Australian experiences" (Calderwood, 1991, p. 5); as a result, the T106 form was virtually copied from the IRS reporting forms 5471 and 5472. Another example is Section 231.6, foreign document request, which gives Revenue Canada the power to request documents from foreign firms; if not provided, the documents cannot subsequently be used in tax court. This legislation is almost identical to IRC Section 982, passed in 1982 in the United States, and the Technical Notes

refer specifically to Section 982 (Calderwood, 1990; p. 9; Vincent, 1996; p. 23). A third example is the Advance Pricing Agreement (APA) process. After initially expressing concern about the IRS's adoption of the APA because it would be "too costly and burdensome...[and] call for expertise that does not exist within the resources of taxpayers or treaty partners" (D'Aurelio, 1990, p. 44:3), Revenue Canada agreed to "test the new US Advance Pricing Arrangement" (Calderwood, 1991, p. 13). The IRS provided assistance with two pilot cases, each involving a US parent with a Canadian affiliate (Turro, 1993, p. 503). Since then, Revenue Canada has expanded its APA group, issued its own APA guidelines (Information Circular 94-4), and negotiated more bilateral APAs with the United States than any other tax authority.

While the US Treasury in 1986–1994 was overhauling its transfer pricing regulations, Revenue Canada watched the US upheaval and did little to modify Canadian rules. Revenue Canada strongly criticized the 1988 US Treasury's White Paper, arguing that "the commensurate with income standard and periodic adjustments may perhaps be in favor of the United States fisc and are not necessarily in accord with the traditionally accepted arm's length standard promoted by the OECD and used in income tax conventions" (Calderwood, 1990, p. 6). In addition, Canada was actively involved in developing the OECD report that strongly criticized the US proposed transfer pricing rules (OECD, 1993).

Interestingly, the 1989 CUFTA and 1994 NAFTA appear to have had little direct impact on Canada's transfer pricing regulations during this period. Neither Revenue Canada or the Department of Finance used CUFTA or NAFTA as rationales for modifying domestic transfer pricing rules or procedures (Eden, 1996a). For example, in January 1994, Revenue Canada and the Department of Finance issued a joint News Release on transfer pricing. The sole motivation for the release was the assessment by the Canadian tax authorities that CPM and periodic adjustments would "have significant potential to generate transfer prices that would not conform to the arm's length principle and, therefore, would not

be acceptable in many OECD countries, including Canada” (Government of Canada, 1994, p.2). The release stressed that Canadian taxpayers should follow Canadian tax law, avoid using CPM, and use the competent authority process (whereby US and Canadian tax authorities regularly meet to resolve bilateral transfer pricing disputes) under the Canada–US bilateral tax treaty. In effect, in the same month that Canada tied its trade future more closely to the United States in NAFTA, Canada’s tax authorities were drawing a line in the sand, distancing Canadian transfer pricing law from its US counterpart.

However, the line in the sand did not last. The OECD, after criticizing the IRS for its draft transfer pricing regulations, began issuing its own new guidelines closely paralleling the 1994 US regulations (OECD, 1995). The OECD guidelines recommended the addition of two new methods, profit splits and the transactional net margin method (TNMM), the latter a close cousin to the much maligned CPM. Many of the rules (e.g. best method rule, range of acceptable transfer prices) and procedures (e.g. APA, contemporaneous documentation) developed by the IRS in the 1990s were included in the OECD guidelines.

As a result, in February 1997, the Minister of Finance announced that Canada would review its transfer pricing regulations to order to harmonize them with the 1995 OECD guidelines. Draft legislation was issued in September 1997, revised and passed into law in June 1998. The Canadian government announced that the changes were necessary to bring Canadian regulations into conformity with the 1995 OECD guidelines and the transfer pricing rules of other OECD states, such as the United States, in order to “protect the Canadian tax base by encouraging taxpayers to observe the arm’s length principle” (Government of Canada, 1997). This was the first major change in Canadian transfer pricing legislation in ten years.

In the new legislation, Section 69(2,3) is replaced by Section 247. The Section applies to all transactions (arrangements or events) between Canadian taxpayers and nonresident persons with whom the taxpayer does not deal at arm’s length. The legislation is broadened to specifically include partners,

partnerships and qualified cost contribution arrangements. Instead of the old focus on under or overinvoicing of transactions, Section 247 is broader: non-arm’s length parties must conduct their transactions under terms and conditions that would have prevailed if the parties had been dealing at arm’s length with each other. Perhaps the most controversial change is the introduction of an inaccuracy penalty, broadly similar to its US cousin Section 6662, in Section 247(3). The penalty is seen as potentially more onerous than its US counterpart because the tax is payable as a percentage of the total income adjustment, rather than the payable tax (i.e. firms with losses would still face a penalty), and negative income adjustments can only under certain circumstances be deductible from positive adjustments. The penalty can be avoided if the taxpayer makes “reasonable efforts” to determine and use arm’s length transfer prices. Reasonable efforts include contemporaneous documentation of an acceptable transfer pricing method.

In the revised information circular, IC 87-2R, released in September 1999 (Government of Canada, 1999), the traditional transfer pricing methods (CUP, resale price, cost plus) are expanded to include profit splits and TNMM as methods of last resort. While Revenue Canada continues to view CPM as an unacceptable method, the new rules do recognize and accept profit-based analyses. The circular also adopts the IRS’s arm’s length range and, as does the 1994 US regulations, states that if the transfer price lies outside range, it will be adjusted to midpoint of interquartile range. The method used must produce the “most reliable result” based on the degree of comparability between controlled and uncontrolled transactions; although once a higher ranking method is satisfied, there is no need to review lower ranked methods. In terms of periodic adjustments, Revenue Canada continues to hold that hindsight is not appropriate for determining value of intangibles, but does give itself the ability to recharacterize transactions under certain circumstances. The transfer pricing penalty is also softened; downward adjustments can be subtracted from upward adjustments (reducing the overall penalty) if the taxpayer is deemed to have made reasonable

efforts to develop and document an acceptable transfer pricing methodology.

In summary, the Canadian approach to transfer price regulation is now very similar to that in the United States. The IRS and Revenue Canada have a long history of cooperative relations, developed through the bilateral tax treaty process and as members of the OECD. The purpose and scope of the legislation in both countries are similar. The definitions and interpretations of the ALS are also similar, although the Canadian approach focuses more on the pricing methods for transactions while the US focuses on the results of allocating income and expenses. Most Canadian administrative rules and procedures are based on US rules and procedures; there are differences, but these are primarily of degree. Overall, Canada's arm's length standard is closely related to, and based on, the US standard.

4.3. The Mexican approach to transfer price regulation

Since 1976, the Mexican tax system has required transactions between related parties to be conducted at arm's length (del Castillo, Fabregat, Solano & Pena, 1995, p. A-101). However, Hacienda did not enforce the law until after Mexico signed bilateral income tax treaties with Canada in 1991 and the United States in 1992.

The 1992 Income Tax Law (ITL) gave SHCP the authority to reallocate tax profits and losses of related parties, both domestic and foreign (Rendón, 1998). Since Mexico had no legal precedents or administrative decisions to guide its implementation of the ALS, SHCP looked elsewhere for advice. The most readily available regulations were those developed by the IRS. This was particularly appropriate as the United States was Mexico's largest trading partner and home to most of the foreign subsidiaries operating in Mexico. Having similar transfer pricing regulations to US regulations would be beneficial to US MNEs and help to attract US foreign direct investment into Mexico. SHCP began to study various US transfer pricing audits techniques and methods to determine their applicability to Mexico (del Castillo et al., 1995), and even hired and

trained its tax auditors with the assistance of the IRS (Matthews, 1993). SHCP also set up a new international affairs division in charge of conducting of transfer pricing audits, APAs and treaty negotiations, a unit somewhat similar to the Internal Revenue Service.

In 1994, Mexico joined the OECD and began to participate in the OECD's Committee on Fiscal Affairs. This had a major impact on Mexican transfer pricing policies. That same year, SHCP amended Article 64, enacted ITL Article 64-A, and collected Mexico's first transfer pricing adjustment. Under Article 64, SHCP can make transfer pricing adjustments in three types of situations: if intrafirm transactions are conducted at prices different from fair market value, sales of goods occur at cost or below cost, and for all export-import transactions and remittances abroad (del Castillo et al., 1995, p. A-109). Under Article 64-A, SHCP is granted specific authority for applying the ALS only if the transactions are between related parties and are not conducted at arm's length. The actual wording is very similar to the 1979 OECD guidelines. Four transfer pricing methods are permitted: CUP, resale price, cost plus, and profit splits (Perez de Acha, 1994).

Mexico's corporate income tax rules did not apply to the maquiladoras (in-bond processing plants along the US–Mexican border). In fact, the reverse was the case: the maquilas received substantial trade and tax breaks to encourage their growth, local employment and net exports. The Mexican government treated maquiladoras, not as permanent establishments (taxable entities in Mexico), but as cost centers for purposes of calculating the Mexican corporate income tax; they were also exempt from the business assets tax. As a result, maquiladoras profits were included in their US parents' income and taxed by the US government.

This situation did not last. The Mexican government's need for tax revenues coupled with the enormous growth and profitability of the maquiladoras, made their profits an inevitable target. The first active enforcement occurred in 1995 when Hacienda began applying the transfer pricing rules to the maquiladora sector (Gonzalez-Bendixsen, 1997, p. 459). Once SHCP began to

apply its new transfer price rules to the maquilas, this meant that maquila profits would now be shared between the IRS and SHCP, rather than being sent north to the IRS. SHCP, however, agreed to not audit a maquila if its taxable income met a five percent of asset value test. In March 1995, again pressed by the need for revenues, the government also eliminated the maquilas' exemption from the business assets tax. The maquilas could continue to avoid the business assets tax but only if (i) they paid taxes amounting to at least five percent of the value of assets employed in the maquila, or (ii) the firm obtained a ruling from SHCP that a lower transfer pricing would satisfy Mexico's transfer pricing regulations. Only 20 percent of the maquilas asked for a ruling from SHCP; most chose to pay the five percent of employed asset tax.

In December 1996, Mexico amended its tax law to conform with the new OECD guidelines and to extend these rules to all taxpayers engaged in non-arm's length transactions, effective in 1997. Rendón (1998, p. 1737) referred to this law as "the real watershed year for Mexican transfer pricing regulation. . . , in which the first comprehensive set of legal and regulatory modifications was enacted, expanding the reach of transfer pricing taxation beyond the maquiladora sector to encompass every transaction with a domestic or foreign related party". Article 65 specified several pricing methods: CUP, resale price, cost plus, profit splits and TNMM. The best method rule, based on reliability and accuracy of company information and comparables, and the arm's length range — US-based concepts — were also introduced in this legislation.

In December 1998, Hacienda tightened the rules on maquiladoras again, declaring that they would be treated as permanent establishments starting January 2000 and would have to pay Mexican corporate income taxes. The IRS protested vigorously because, under international tax law, Mexico (the source country) has the primary right to tax, while the United States (the residence country) would have to grant a tax deduction or credit for the source country taxes. After months of negotiations, in November 1999, the two tax authorities announced that, for the tax years 2000–2002,

maquiladoras would pay Mexican taxes based on 6.5 percent of costs and operating expenses or 6.9 percent of assets, whichever is higher. These taxes would be creditable against US taxes. Mexico's tax revenues from the maquiladoras are expected to rise from \$200 million to \$320 million, while US tax revenues will fall by \$120 million (Smith & Kraul, 1999).

In terms of transfer pricing procedures, Mexico continues to lag behind the United States and Canada. Mexico has no formal document request or record keeping requirements. Contemporaneous documentation of transfer pricing policies was introduced, in December 1996, for Mexican corporations with foreign related party transactions, but no failure-to-document penalties are attached (Rendón, 1998). Beginning in 1998, taxpayers must file an annual return on investments in tax havens, with possible incarceration penalties for failure to file (Gonzalez-Bendixsen, 1997, p. 462). Inaccuracy penalties also exist in Mexican tax law; the penalty is 50 to 100 percent of the adjusted tax, plus surcharges (Rendón, p. 1739).

In 1994, Mexico initiated an Advance Pricing Agreement process and encouraged firms to apply. Formal APA regulations, issued in July 1995, recommended the return on capital employed method to establish an arm's length price, in effect, treating the maquilas like contract manufacturers for their US parents. The first Mexican APA, using a cost plus methodology, was issued in November 1995. The 1996 APAs were in the form of private letter rulings valid for only one year, but the December 1996 reform authorized extension for up to four years before and after the tax year in question (Gonzalez-Bendixsen, 1997, p. 460; Rendón, 1998).

It is clear from the above that Mexico, while it started much later than Canada in terms of adopting the ALS, is now moving very quickly to catch up. Its transfer pricing regulations are more and more resembling the OECD guidelines and the US regulations. The general trend is toward a stricter application of the transfer pricing regulations and rules. In fact, Labrador, Chip, Sanchez and Gonzalez-Lugo (1997) characterize Mexico, the latecomer, as now having "one of the world's most detailed and sophisticated statutory transfer

pricing regimes". However, one perhaps unexpected (or undesirable) result for the IRS is that, having trained Hacienda in how to use the arm's length standard, the IRS now finds itself faced with new Mexican rules that, starting in the year 2000, will shift the maquiladora tax base to Mexico, reducing US taxes in the process.

In this section, we have provided a short historical summary of the ALS in the United States, Canada and Mexico. The initial development was long, slow and idiosyncratic, but a rush of activity in the 1990s has now created three very similar transfer pricing systems.

5. Crossborder diffusion: timing, motivation and form

It is clear from our case study that the United States was the standard-setting country, with Canada as an early adopter and Mexico a latecomer to transfer price regulation. The four basic components of the US approach to the ALS (purpose and scope, definition, pricing rules, and procedures) have all been adopted in varying forms by Canada and Mexico. US regulation was diffused to Canada and Mexico in two ways: directly, and indirectly US influence on OECD transfer pricing guidelines.

5.1. *The question of timing*

Why was the United States the first mover while Canada and Mexico followed? We argue that the reason is not openness (i.e. international linkages) per se, but power relations based on transactional interdependence within North America. While Canada and Mexico have been more open than the United States, in the sense that international trade and FDI have represented larger percentage shares of GDP, neither country initiated the regulation of transfer prices.⁵

5.1.1. *The United States as standard setter*

The United States has been the world's strongest power in the twentieth century, the largest exporter of foreign direct investment (FDI), and home to the greatest number of MNEs. Thus, the tax

implications of MNE activities have been of critical interest to the US government. As the world hegemon, there are large benefits from being a standard setter, such as the ability to tailor the standard closely to national interests, institutions and competencies, and to force competitors to adjust to your standards. The wider the adoption of the standard, the greater the potential benefit to the standard setter (and to its MNEs if their preferences are taken into account). We conclude that the United States became the standard setter for transfer pricing regulation globally (and thus also within North America) because of its hegemonic position and the dominance of its multinationals, providing support for proposition 1 (larger and powerful → standard setter).

5.1.2. *Canada as fast follower*

The adoption of the ALS by Canada was initially slow and gradual. Canada only adopted the ALS in 1952, and passed Section 69(2,3) into law in 1972 (four years after the IRS regulations). The "second wave" of transfer pricing regulation in Canada came 15 years later with the publication of Information Circular 87-2, based on OECD (1979) and the 1968 OECD regulations. In the 1980s, the pace of reform increased, first in the United States and then in Canada. Most Canadian procedural changes in this period came soon after, and mimicked, their US counterparts (e.g. APAs, document requests). However, Canada strongly resisted following the IRS's 1994 transfer pricing regulations, even after the OECD published its own guidelines in 1995. The "third wave" is now in progress with the 1998 replacement of Section 69(2,3) by Section 247 and IC 87-2R. Based on the historical data, the gap in time between US tax changes and Canadian responses fell over the period, both in terms of the specific rules and in terms of procedural changes. We conclude that Canada, after 1972 and particularly

⁵ In 1991, the ratios of total trade to GDP were 15% (US), 46% (Canada) and 30% (Mexico); while the ratios of inward plus outward stock of FDI to GDP were 14% (US), 37% (Canada) and 6% (Mexico). Canada and Mexico are significantly more open than the US. Mexico's low FDI percent is due to its longstanding policy of discouraging FDI and status as a developing country (See Eden, 1998, p. 176).

in the late 1980s and 1990s, was a fast follower in adopting the US version of the ALS. What explains this result?

Our second proposition suggests that the greater the volume and types of crossborder linkages between two countries, the stronger the motivation for, and earlier the timing of, crossborder diffusion. The diffusion of the ALS from the United States to Canada can be traced partly to the unguarded border shared by the two countries and the enormous amounts of crossborder trade and FDI linkages between them. Canada and the United States are each other's largest trading and investment partners.⁶ Thus, the potential for interjurisdictional conflict over transfer pricing is huge. It is therefore critical to Canada, as the smaller and transactionally more dependent partner, to have similar transfer pricing definitions, rules and procedures to its larger, more powerful neighbor. Given that Canada and the United States have had extensive crossborder linkages, generated by the activities of US and Canadian MNEs, and that these linkages have grown rapidly since the 1950s, it is not surprising that proposition 2 (linkages→timing) is supported by our case study.

On the other hand, we found no evidence that CUFTA or NAFTA directly affected the Canadian motivation or timing of transfer pricing changes over the late 1980s or early 1990s. One possible explanation is that linkages were already so high, a change in trade policy was expected to have little impact on crossborder income tax issues.

Second, linkages create interactions. Both the US Treasury and Revenue Canada have faced strong pressures from domestic stakeholders (MNEs, tax and accounting groups) to develop consistent tax policies in order to minimize the potential for double taxation. Given these inter-

actions, US and Canadian MNEs have had a vested interest in harmonizing international tax and transfer pricing regulations. At the same time, international tax policy has traditionally been influenced by briefs and lobbying by professional tax groups (Bird & Brean, 1985, p. 414). Tax officials in Revenue Canada and the Internal Revenue Service meet regularly, particularly through competent authority processes under the Canada–US tax treaty. International tax groups such as the OECD's CFA and the Pacific Association of Taxation Administrators also provide opportunities for valuable exchanges of information and ideas on areas such as tax havens, exchange of information, and international profit shifting (Calderwood, 1991, pp. 13–14). These interactions between Canada–US government officials and with stakeholders positively affected the motivation for and timing of crossborder diffusion of standards, as suggested by our third proposition (interactions→timing).

Crossborder diffusion occurred not only because Canada chose to emulate the US example, but also because the US Treasury actively encouraged the diffusion of its tax policies to its treaty partners. US membership in the OECD has been a factor encouraging diffusion of the US version of the ALS, according to Picciotto (1992). Tax authorities in the OECD share a commitment, on the grounds of fairness and neutrality, to preventing both underpayment of taxes and double taxation of foreign source income earned by multinational enterprises. By persuading the CFA to adopt significant portions of both the US 1968 and 1994 IRS transfer pricing regulations, the US tax authority achieved substantial international legitimization of its approach to the arm's length standard. This internationalization of the US standard encouraged other countries, as OECD members, to also adopt the standard. Since Canada was a founding OECD member, while Mexico did not join until 1994, this may partly explain why Canada was an early adopter and Mexico a latecomer. Thus, interactions at the international level appear to have facilitated the motivation for and speed of crossborder adoption, supporting our third proposition (interactions→timing).

⁶ In 1991, 75% of Canadian merchandise exports went to the US, representing 19% of US imports; 64% of Canadian imports came from the US, representing 15% of US outwards FDI. Almost 60% of Canadian outward FDI stock was held in the US, representing 9% of US inwards FDI. Both countries have diversified their FDI shares away from one another in the 1990s. In 1991, intrafirm transfers were about 45% of US–Canada merchandise trade and more than half of intrafirm business services (Eden, 1998, pp. 177–178, 206).

5.1.3. Mexico as latecomer

Mexico adopted the ALS in 1976 (much later than Canada) with formal legislation specifying types of transactions and transfer pricing methods only appearing in the mid-1990s, after Mexico joined NAFTA and the OECD. These new policies have been put into practice only recently. The pace of legislative and regulatory change in Mexico has also quickened with new changes now occurring yearly. Thus Mexico can be classified as a latecomer to the arm's length standard, although the rate at which Mexico has adopted transfer pricing rules and procedures has accelerated since the mid-1990s.

We propose that the reason for the historical lack of enforcement was that the Mexican economy, unlike the United States and Canada, was heavily regulated. Little inward FDI was allowed, foreign firms were limited to minority interests and heavily regulated in terms of trade-balancing requirements, domestic content regulations, export/import license requirements, etc. In addition, the business assets tax, which functioned as a minimum tax, guaranteed that foreign firms would pay some tax to Mexico. As a result, SHCP spent little time questioning the validity of the intra-corporate transactions (del Castillo et al., 1995, p. A-106). Shoup (1980) also suggests that developing countries suffer from a shortage of skilled tax administrators and are constrained in terms of available tax bases, making it difficult to adopt the regulatory framework of developed countries. This may also have been a factor for Mexico. Thus, low international linkages implied that the motivate for crossborder diffusion was weak, and to the extent that diffusion did occur, it would be later rather than earlier. This supports our second proposition (linkages→timing).

On the other hand, the growing numbers of US MNEs operating in Mexico and the increasing presence of maquiladora plants created a need for transfer price regulation in the 1980s. After Mexico joined the GATT in 1986, tariff and nontariff barriers were lowered and FDI rules substantially liberalized. Bilateral tax treaties were signed with Canada in 1991 and the United States in 1992. As a result, by the mid-1990s, crossborder economic linkages had risen significantly,⁷ and transfer pri-

cing had become more of a concern for Hacienda. In addition, Mexico's joining NAFTA in 1994 was widely expected to enormously strengthen US–Mexico trade and FDI linkages over the next decade. Thus, it is not surprising that SHCP began to adopt new regulations for crossborder intrafirm trade, and to enforce them, by the mid-1990s. This provides additional support for proposition 2 (linkages→timing).

As in the US–Canada case, linkages created interactions. When Mexico moved to introduce transfer pricing regulations, it turned to the IRS for assistance. As Mexico's largest trading partner and home to most of the foreign subsidiaries operating in Mexico, having US-based transfer pricing regulations would be beneficial to US MNEs and help to attract US foreign direct investment into Mexico. The 1994 tax law closely followed the 1968 IRS regulations, and SHCP hired and trained its tax auditors with IRS assistance. In response to these SHCP–IRS interactions and pressures from US MNEs, the diffusion of the ALS from the United States to Mexico proceeded rapidly in the early 1990s. Once Mexico joined the OECD in 1994, crossborder adoption proceeded even more quickly; by 1996, Mexico was ahead of Canada in terms of its adoption of the 1995 OECD guidelines. Thus, interactions between the US and Mexican tax authorities, at both the national and international levels, facilitated crossborder diffusion of the arm's length standard from the United States to Mexico. This provides support for our third proposition (interactions→timing).

We conclude that there were a several reasons why Canada was an early adopter and Mexico a latecomer. Canada had much closer economic linkages than Mexico with the United States. There were more vested interests in Canada (US and Canadian multinationals) anxious to have a common set of rules governing intrafirm trade and

⁷ In 1991, 66% of Mexican exports went to the US, representing 8% of US imports. At the same time, 68% of Mexican imports came from the US, representing 6% of US exports. In 1991, 63% of Mexico's inward FDI stock was controlled by US investors, representing 3% of US outward FDI. Mexico's outward FDI is negligible, representing less than 0.10% of US inward FDI (Knubley, Legault & Rao, 1994, pp. 153–154).

FDI flows. Canada also has stronger cultural linkages and ties with the United States (Hofstede, 1980). Canadian and US tax authorities regularly interacted at the bilateral (competent authority) and multilateral (OECD) levels, institutions in which Mexico did not participate until early 1990s.

5.2. *The question of motivation: comparing Canada and Mexico*

5.2.1. *Canada: from replication to reaction*

Until the late 1980s, our historical analysis suggests that linkages and interactions between Canada and the United States, in the transfer pricing arena, were primarily cooperative. The United States, as the world's largest and richest capital exporter, encouraged international capital export neutrality and supported its MNEs' penetration of world markets. The US Treasury was primarily concerned with transfer price manipulation by US MNEs in tax haven countries, not in Canada or Europe. Canada, on the other hand, as a small capital-importing country, wanted to encourage inward FDI from US investors and, until the mid-1980s, paid little attention to transfer pricing issues. In this period, Canada's motivations for adopting transfer pricing regulations appeared to be a simple demonstration effect, following the leader as a way to improve viability and performance in the international taxation arena. Once the OECD began issuing transfer pricing guidelines, Canada followed suit as part of its international commitments to the OECD. This suggests that the motivations for crossborder adoption were primarily replication effects based on cooperative linkages and interactions, providing support for our fourth proposition (cooperative → reaction).

However, starting with the 1986 US CWI standard, Canada has strongly resisted US regulatory changes, arguing that they were not in the spirit of the ALS. The US Treasury was widely perceived by most tax authorities, not just Revenue Canada, as engaged in a major tax grab designed to shift the tax base from high-tax locations like Canada and Europe to the United States. The fact that the OECD also condemned the US changes provided additional support to Revenue Canada's criti-

cisms. Thus, interactions between the two countries, and their tax authorities, have become more conflictual since the mid-1980s.

The recent overhaul of the Canadian regulations — eliminating the line in the sand — can be seen as both a replication effect [copying OECD (1995) because Canada is an OECD member] and a reaction effect (the threat of revenue losses from the 1994 US regulations). Perhaps the most controversial change is the introduction of an inaccuracy penalty, broadly similar to its US cousin Section 6662. The recent News Release (Government of Canada, 1997) makes it clear that the purpose of Section 247 is to protect the Canadian tax base. The implicit government objective is to counterbalance the Canadian income tax losses expected from the US inaccuracy penalty, as MNEs shifted income from Canada to the United States in order to avoid the US penalty. Fear of lost tax base, according to Shapiro, Dodge, Carsley and O'Connor, (1997, p. 1623), meant that “Canadian tax authorities felt compelled to level the playing field” in response to increased US enforcement efforts in the early 1990s.

Shoup (1980) argues that the diffusion of the US tax system to developing countries has primarily been in the form of reaction effects to potential tax losses. While Canada is not a developing country, it is enormously dependent on the United States in terms of trade and investment. In the 1990s, potential revenue losses appear to have been a significant influence behind most Canadian responses to US transfer pricing changes. The new Canadian legislation therefore clearly fits with the reaction effect, whereby a tax change in one country introduces a defensive response designed to minimize the second country's loss in tax base. This suggests that, since the mid-1980s, Canada's adoption has been primarily for defensive reasons in response to more conflictual US–Canada relations, as suggested by proposition 4 (conflictual → reaction).

In summary, Canada's adoption of the ALS over the twentieth century appears to be a mixture of reaction and replication effects, depending on whether relations were primarily cooperative or conflictual. This echoes Bird and Brean (1985, p. 414) who argue that: “Between no two coun-

tries have such international spillovers [of international taxation] been stronger than between the US and Canada, as Canada at time emulated and at times defensively reacted to US transfer pricing policy developments”.

5.2.2. *Mexico: from reaction to replication*

Compared to Canada, Mexico until the mid-1980s had fewer bilateral linkages and was more suspicious of and hostile to US investors and US government agencies. Mexico has long been wary of US hegemonic expansion and jealous of its own sovereignty. This history filled with tensions towards the United States and reluctance towards inward FDI meant that linkages and interactions were seen in Mexico as clearly conflictual, slowing adoption of the ALS and ensuring that Mexico’s adoption would be primarily defensive.

Only after 1986, when Mexico began to liberalize its economy and join international institutions (OECD, GATT, NAFTA) did Mexico drop its import substitution industrialization policies and begin to see international economic linkages as a positive means to economic development. As US–Mexico trade and FDI linkages grew, the adoption of US-based transfer pricing regulations was needed both to reduce crossborder transactions costs for US MNEs and to provide a signal to potential investors that Mexico was open to FDI under the NAFTA. The IRS was even invited in to train SHCP tax auditors and help write the Mexican transfer pricing regulations, suggesting that Hacienda perceived government-to-government interactions as beneficial. Thus, performance motivations can explain why SHCP began to introduce transfer pricing regulation parallel to its largest trading and FDI partner, the United States.

In addition, adopting the ALS, the accepted standard in transfer pricing policy among all OECD countries, was seen as a necessary requirement for Mexico to join the OECD and NAFTA. The desire for international legitimacy was high as Mexico’s goal was, and is, to become a member of the developed countries. The quest for international legitimacy, together with the desire to attract inward FDI, suggest replication effects dominate Mexico’s motives for adoption of the ALS. Thus, our fourth proposition (cooperative→

replication) can be seen as applying to Mexico after 1986.

Mexico’s adoption of ALS rules and procedures in the mid-1990s in order to satisfy its obligations as a new member of the OECD, GATT and NAFTA, and as part of its new bilateral tax treaty commitments, is also consistent with research in institutional theory that points to the fact that late adopters typically adopt a practice primarily for its legitimation value. In comparison, Canada, as a developed country and founding OECD member, had no legitimacy-seeking rationale for its 1990s tax changes. This comparison provides some support to our fifth proposition that latecomers adopt standards primarily for legitimation reasons while early movers are motivated by performance goals, although over the whole period of the 1990s Mexico’s motivations appear to be for both legitimation and performance.

In reviewing the history of crossborder diffusion of the ALS from the United States to its northern and southern neighbors, it is clear that both reaction effects and replication effects were motivations for diffusion. Canada and Mexico adopted US transfer pricing rules and procedures, albeit imperfectly, in order to offset expected revenue losses (reaction effect) and to voluntarily emulate policies they believed to be useful (replication effect). Crossborder adoption by Canada in the 1990s has primarily been in the form of reaction effects, as Revenue Canada sought to protect its revenue base from the (perceived) grasping hands of the US Treasury. Mexico’s responses in the 1990s, on the other hand, were replication effects, conditioned by its desire to achieve membership and legitimacy in its external relations and encourage inward FDI and economic growth. This somewhat paradoxical result — reaction effects for Canada, replication effects for Mexico — can be partly explained by Canada’s status as an early follower and Mexico as a latecomer.

5.3. *The question of form: perfect or imperfect diffusion?*

The United States was the developer of the ALS, but despite its hegemonic status, the United States has been unable to ensure perfect diffusion

to its northern and southern neighbors. Canada and Mexico have each taken a somewhat different regulatory approach to interpreting and implementing the standard.

5.3.1. Canada: from greenfield to brownfield entry

Canada can be regarded as a case of, first, greenfield and, later, brownfield entry. Since the IRS had the right to adjust intrafirm transactions long before Canada did (1917 versus 1939) and defined the ALS first (1935 versus 1952), Canada could have simply and wholly adopted the US standard. However, even as early as 1949, the purpose and scope of the US and Canadian legislation differed. In terms of specific rules and procedures, however, Canada closely followed US practices. IC 87-2 was based on the 1968 US Treasury regulations and Canadian information and record keeping requirements mimic their US antecedents. Therefore, while similar to the US approach, Revenue Canada fine-tuned the ALS in terms of Canadian goals, competencies and institutions. We therefore conclude that even with greenfield entry, crossborder diffusion was not perfect, contrary to proposition 6 (greenfield entry→perfect diffusion).

Since 1987, however, diffusion to Canada must be seen as a case of brownfield entry. As an early adopter, Canadian transfer pricing rules and procedures were already in place. When the US Treasury changed the rules to accommodate the controversial CWI standard, Canada was among the leaders to object the CWI standard and uphold the “correct” ALS. Clearly, the process of diffusion did not entail sufficient coercive isomorphic forces as the follower criticized the leader’s (perceived) violation of the standard. Later, Canada strongly resisted adopting the 1994 US transfer pricing regulations and was slow to adopt the 1995 OECD guidelines. Even the 1998 law and IC87-2, while close in spirit to the OECD and US regulations, differ in significant respects. This provides some support for proposition 6 (brownfield entry→imperfect diffusion). On the other hand, if the original standard came from the standard-setting country, hysteresis, familiarity and vested interests should lead to automatic adoption of subsequent changes by the standard setter, which

did not occur. It appears that once a standard begins to diffuse across borders, even the dominant player cannot dictate the form of its diffusion.

In addition, the form of diffusion in IC 87-2 and Section 247 was clearly dependent on Canada’s membership in the OECD. Institutionalization of the US approach to the ALS in terms of OECD (1979, 1995) was important for diffusion; in both cases, Revenue Canada referred specifically to and closely follow the OECD guidelines. In the absence of the CFA’s (albeit modified) approval and adoption of the 1994 IRS regulations in OECD (1995), Canada would most likely have remained a reluctant and defensive follower. Thus, crossborder diffusion of the US standard was facilitated by institutionalization of the standard at the international level, as proposed in proposition 7, although the form of diffusion was still imperfect.

5.3.2. Mexico: greenfield entry

In contrast, Mexico is an example of greenfield entry. Mexico was not concerned with transfer pricing until the 1990s. Because SHCP invited the IRS to help develop Mexico’s transfer pricing regulations and train its tax auditors, the US approach to the ALS largely diffused to Mexico without much resistance. Unlike Canada, Mexico did not hold any firm belief about what the ALS should mean. Without a pre-existing belief, the US standard could be more easily diffused to Mexico in a relatively homogeneous manner. This provides support for proposition 6 (greenfield entry→perfect diffusion). One somewhat amusing consequence of Mexico’s adoption of the US approach is that historically the maquiladoras had paid no corporate income tax in Mexico; their tax base was therefore transferred to the United States. Having taught SHCP auditors how to put the arm’s length standard into practice, turnabout becomes fair play; the IRS must now give a foreign tax credit for Mexican taxes levied on the maquiladoras, starting in 2000. Thus, crossborder diffusion can have negative as well as positive impacts on the standard setter.

The OECD was an important agent in crossborder diffusion after Mexico joined the OECD due to the Mexican government’s desire for legitimization

in international arenas. For example, Mexico, the late adopter, moved in December 1996 to introduce new regulations based on OECD (1995) while the equivalent Canadian changes did not occur until June 1998. For both countries, the internationalization of the US approach to the ALS through the OECD was a significant factor in the timing and form of their adoption, as suggested by propositions 3 (interactions→timing) and 7 (institutionalization→perfect diffusion).

6. Discussion and conclusions

In this paper, we have examined the socio-historical evolution of the arm's length standard in North America. Using insights from the logic of embeddedness, institutional theory and transactional interdependence, we developed a theory to explain the timing, motivation and form of cross-border diffusion.

We saw North America as an interesting case study because political, economic and institutional forces suggest pressures for and against diffusion. The three economies exhibit interdependence in the form of a *hub-and-spoke relationship*, with the US economy as the hub dominating trade and FDI patterns in the two spoke economies (Eden & Molot, 1992). This hub-and-spoke relationship has strengthened since Mexico joined the GATT in 1986 and began liberalizing its economy. CUFTA and NAFTA have further liberalized crossborder trade and FDI flows, deepening the integration process among the three countries (Eden, 1996b). The hub-and-spoke relationship suggests that the United States should be the standard setter, with Canada and Mexico as followers, in the issue area of transfer pricing regulation. The intensification of bilateral trade and FDI linkages implies that pressures for homogeneous adoption should grow stronger over time. On the other hand, because the three countries display different cultural heritages and stages of economic development, one might expect heterogeneous diffusion patterns. The deep cultural and developmental differences between the United States and Mexico, relative to Canada–US levels (Hofstede, 1980), together with traditional Mexican

animosity to the United States, suggest that Mexico should be less likely than Canada to adopt US transfer pricing standards.

Our theoretical model, based on institutional theory and the logic of embeddedness, suggested seven propositions about the timing, motivation and form of crossborder diffusion of standards. The paired case study of the arm's length standard in North America provided strong support for our propositions. Although the diffusion process was complex, we conclude that a clear *policy hub-and-spoke relationship* has emerged, paralleling the economic hub-and-spoke, with the United States as the standard setter (hub) and Canada and Mexico as adopters (spokes). However, once the ALS was diffused even the hub could not dictate the eventual form of its adoption by the spokes. The timing of adoption differed, with Canada as early follower and Mexico as latecomer. The motivations for adoption varied, depending on whether crossborder linkages and interactions with the United States were seen as conflictual or cooperative. Even where relations were cooperative, Canada and Mexico only partially adopted the US standard due to differences in their domestic institutional and socio-political situations. The OECD was an important international institution affecting the timing and form of diffusion of the US approach to Canada and Mexico. Thus the timing, motivation and form of crossborder diffusion were institutionally embedded in a broad set of forces, some favoring homogeneity and others heterogeneity.

Our analysis suffers from a variety of drawbacks. For example, our focus has been primarily at the national and international levels of analysis. We have not thoroughly explored the impacts of domestic stakeholders (e.g. MNEs, legal and accounting firms) nor looked very deeply inside the relevant bureaucracies (e.g. IRS, Revenue Canada, SHCP, CFA). A thorough examination of the arm's length standard would require detailed analysis of these actors and stakeholders. In addition, we have confined our study to the three countries in North America; however, diffusion of the ALS has occurred, and is occurring, on a global basis. A study of the role of the US Treasury and the OECD in diffusing the ALS

throughout Europe and Asia would be an important test of our propositions in another setting.

Our study may provide useful lessons for the crossborder diffusion of other standards. One example might be the diffusion of the national treatment and most favored nation standards in international trade, where England and France were early movers and the GATT played an important international institutional role. Another example might be the norms for international investment, where bilateral investment treaties have diffused the transparency, national treatment and right of establishment standards; the failure of the Multilateral Agreement on Investment, sponsored by the OECD, would provide an interesting counterpoint example to our study of the diffusion of the arm's length standard. Development of these other cases could also provide additional tests of our crossborder diffusion propositions.

We conclude that our analysis provides crucial insights to understanding the diffusion of the arm's length standard across national boundaries within North America. Crossborder diffusion is affected by multiple forces that can either promote or discourage this process. Even where institutions and transactional interdependence favor diffusion, as in the case of the North American hub-and-spoke relationship, outcomes will vary because — not surprisingly — history and institutions differ.

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