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Transfer Pricing

Jeffrey Owens of the Institute for Austrian and International Tax Law, (WU) Vienna University of Economics and Business, writes about the need for international principles governing transfer pricing, but says there is no ''silver bullet'' to resolve the related issues of tax base erosion and multinational enterprises shifting their profits to low-tax jurisdictions. Aggressive behavior is not limited solely to MNEs, he argues, but also to governments that misuse their tax regimes to erode the tax base of other countries. Owens urges that any code of conduct for MNEs should be accompanied by a code of conduct for governments that would distinguish between acceptable and unacceptable forms of tax competition.

Myths and Misconceptions About Transfer Pricing And the Taxation of Multinational Enterprises

BY JEFFREY OWENS

Developed countries and emerging economies have for many years recognized the importance of transfer pricing. They have adopted comprehensive rules in line with the arm's-length principle and have built up the skills and administrative processes needed to implement them. Over the past five years we have also seen an increasing number of developing countries putting in place transfer pricing legislation based on the arm's-length principle. All of these countries see these rules as a way to protect their tax base and also to provide a business environment conducive to foreign direct investment.

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The Transfer Pricing Concept

Transfer pricing is important because it influences the amount of profit that multinational enterprises report and amount of tax paid in each of the jurisdictions in which they conduct business. Intracompany transactions are an integrated part of global business and multinationals accept that these transactions must be conducted at a price (a transfer price) that is consistent with the arm's-length approach and that they must comply with the regulations of each country. There is nothing intrinsically abusive about transfer prices for intracompany transactions and reporting tax profits. The internationally agreed principles are set out in Article 9 of the Organization for Economic Cooperation and Development and United Nations Model Tax Conventions and supplemented by the 1995 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the OECD guidelines) and the U.N. *Practical Manual on Transfer Pricing for Develop-*

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ing Countries agreed in October 2012. Regional organizations such as the Inter-American Center of Tax Administrations (CIAT) have also issued guidance to their members on how this principle can be applied.

The arm's-length principle aims to fulfill the dual objectives of:

- protecting countries against the erosion of their tax base due to over- or underpricing of intercompany transactions by multinational enterprises; and

- providing multinational enterprises with a reasonable certainty of treatment and thereby reducing the risk of double taxation, which could act as a potential barrier to cross border activities.

Need for Broad International Consensus

Avoiding double taxation or double non-taxation requires a broad international consensus on both the principles that underlie transfer pricing and their implementation. These principles should guide governments in the tax treatment of these intracompany transactions. It also requires robust dispute resolution mechanisms so that any differences of view between tax administrations are resolved in a timely and principled fashion.

The increased dominance of MNEs in world trade and the budgetary pressures faced by governments have led to growing pressure on the transfer pricing rules. This, in part, explains why we have seen so much political and media attention to what was, until recently, considered an archaic, dry, technical topic.

Multinationals increasingly operate on a global basis and it is not unusual to find a large multinational with a presence in more than 100 countries. Multinationals want globally agreed rules that are consistently applied, since this minimizes the risk of double taxation and provides them with tax certainty, which is particularly important in today's uncertain economic environment.

Governments also want globally accepted principles applied in a consistent fashion since this minimizes disputes, guards against multinationals playing one tax administration against another, reduces the scope for harmful tax practices, and reduces the opportunities for transfer pricing manipulation. Having an international consensus is particularly important for developing countries, which tend to have tax administrations with less technical capacity and experience with international transactions. Such countries also tend to have less leverage in their negotiations with multinational enterprises, as they are often simultaneously seeking increased foreign investment into their economies.

OECD and the United Nations have consistently supported the arm's-length principle as being the appropriate standard to divide up the tax base of multinational enterprises, and they have spent considerable resources in helping countries to implement it in a consistent manner.

Recent Criticisms of Arm's-Length Principle

Over the past 12 months there has been an unprecedented public debate on whether multinationals are using their transfer pricing practices to shift profits from high- to low-tax jurisdictions. We have seen a series of public hearings in the United Kingdom, France, Australia, and the United States. The Group of 20 has asked OECD to look at base erosion and profit shifting, recognizing that this goes way beyond transfer pricing. The United Kingdom has made tax evasion and avoidance one of the priorities of its presidency of the Group of Eight. Non-governmental organizations have pushed forward a tougher campaign to replace the arm's-length principle with global formulary apportionment, or consider some form of hybrid system.

The media has picked up this debate and with both the tabloids and the more serious press making an effort to present to their readers what they admit is a very complex issue but one that is very much at the center of the debate on whether MNEs are paying their ''fair'' share of taxes.

Nevertheless, there remain many misconceptions in the public debate. The real question should not be whether MNEs are paying their fair share of taxes, but whether they are complying with the laws and international rules put in place by the governments of the countries in which they operate. Concepts of fairness may and should influence governments in the design of these rules (although they will be balanced against the concepts of efficiency and simplicity), but in judging MNEs' tax behavior the issue is: are they paying the right amount of tax, in the right place, and at the right time. The majority of MNEs when trying to answer this question will not adopt a narrow legalistic approach; they will try to conform to both the letter and the spirit of the law (an approach endorsed by both governments and business in the 2012 revised OECD Guidelines for Multinational Enterprises). Their boards will strive to achieve tax strategies that are transparent, defensible not just before the courts but also before public opinion, and broadly in line with what the legislators intended, although in some cases legislative intent may not be easy to ascertain. Generally this will lead them to adopt transfer pricing policies which reflect the economic realities of their business and where the allocation of profits reflects the allocation of the underlying economic activities and risks.

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In making these decisions they will not only weigh the impact on their effective tax rates, but also how capital markets will react. Very aggressive tax planning generally leads to increased uncertainty and increased reserve provisions in the accounts, which in turn can have negative effects on capital market valuations and on how their investors will react. This latter consideration is growing in importance as the proportion of shares held by pension funds has increased. Boards will also consider how consumers will react and how an overly aggressive approach will influence their commercial relationships with government.

When corporate boards take account of these broader considerations in their tax planning, they are more likely to reject tax schemes which though legal would be contrary to the spirit of the law and which have no economic rationale other than to reduce tax. Like in any community there will be a minority of MNEs that will pursue an aggressive approach based on a narrow legalistic interpretation of the law and which will see minimizing their effective tax rate as a way to improve their competitiveness and as their duty to maximize shareholder value, especially where the performance packages of the top executives are based on post-tax profits. The behavior of this minority should not tarnish the reputation of those MNEs which recognize that taxes cannot be treated as just another cost of doing business. This is not to suggest that paying tax should be seen as a voluntary act or one where MNEs should be making one-off payments when subject to public criticism. Taxes must always be based on clear rules and decisions on how much should be paid are decisions for governments, not MNEs.

The public debate has also focused on effective tax rates on MNEs being too low in comparison to the nominal corporate tax rates. Again this is a concept that in practice is easily open to misconception. Nominal corporate tax rates in the 34 OECD countries range from a low of 12.5 percent in Ireland to a high of almost 40 percent in the United States when federal and state taxes are taken into account. Effective tax rates are well below these nominal rates because in part governments provide different types of incentives in the form of tax relief, special regimes, or reduced rates either that apply across the board or to particular sectors or types of activities. A recent study by the Oxford Center for Business Taxation[1] showed that the difference between the nominal and the effective average tax rates for the G-20 countries was between 1 and 7 percentage points in 2012, with the United Kingdom having one of the lowest differences (26 percent versus 24.8 percent) and Italy one of the largest differences (30.3 percent versus 23 percent). But even these comparisons do not tell the complete picture because they fail to take into account the different tax planning opportunities available to MNEs, which can lead to even lower effective rates (the OECD is currently examining this issue).

Another problem with these types of comparisons is that the global effective tax rate for an MNE may be relatively high but its effective tax rate in a particular jurisdiction may be low—a situation that often arises where the home country of the MNE has a very high corporate tax rate. Also, within the boardroom there may be a fourth rate, which may be called the ''ethical tax rate,'' defined by what the company feels it must pay to avoid social stigmatization. The policy debate must clearly distinguish between these different rates.

Despite the perception that corporate tax payments are falling, the data produced by the OECD show that when expressed as a percentage of total tax revenues, this percentage has remained near 8 percent since 1965 (in 1965 it was 8.8 percent and in 2010 it was 8.4 percent, reaching a high of 10.6 percent in 2007)[2]. There is, of course, a wide variation, with some countries (e.g., Australia, South Korea, Norway, and Luxembourg) at or above 15 percent and others (e.g., Austria, Finland, France, and Germany) at 5 percent or lower. Japan and the United States, two of the countries that had the highest percentages in 1965 (just over 16 percent and 22 percent, respectively) experienced some of the biggest falls in the relative reliance on corporate tax (by 2010, Japan was raising just under 10 percent and the United States just under 7 percent) despite having for the last two decades the highest nominal rates on corporate income taxes. If these revenues are expressed as a percentage of gross domestic product, they have increased from just over 2 percent in 1965 to just under 3 percent in 2010, reaching a high of 3.8 percent in 2007.

Care is required in interpreting these data since the percentages are influenced by the increasing proportion of GDP going into profits over the last two decades, changes in tax legislation and enforcement, the trend in some countries to move from the corporate to the non-corporate form of doing business, and the development of global supply chains, which has resulted in a significant part of traditional manufacturing activity moving out of the OECD area.

Care is also required in extrapolating these trends into the future. The fall in revenues associated with future reductions in corporate tax rates is unlikely to be offset by base broadening measures since in many, but not all, countries (particularly the United States), the scope for further base broadening is limited. But whatever the limitations of these types of comparisons, they are at least trying to compare corporate taxes paid to some measure of the profits made and avoid the type of political rhetoric that we have seen recently which tries to link corporate taxes paid to the sales revenue earned in a jurisdiction: a conceptually flawed approach.

[1] See ''Corporate Tax Rankings'' (2012).

[2] See ''Revenue Statistics'', *OECD*, (2012).

The current consensus amongst governments is that the arm's-length standard is superior to a global formulary apportionment approach in that it offers a more principled and practical way of dealing with some of the issues that are currently preoccupying governments.

The political discussion on taxes paid by MNEs also needs to take into account that as part of the international tax competition for geographical mobile activities, many governments have put in place special regimes for specific activities and sector (see, for example, the spread of patent boxes or special headquarters regimes). Governments cannot complain if MNEs use these regimes to lower their taxes.

Much of the political debate has focused on the issue of intangibles. In a knowledge-based economy, intangibles are the main generators of wealth for large MNEs. It is not the things that companies make that generate profits, it's their ideas. Patents, know-how, and other forms of intangibles are what generate the tax base. Unfortunately, it's far easier to move these intangibles into low-tax jurisdictions than it is to move a factory from Manchester to Zug (about 20 percent of U.S. intangibles are held in low-tax countries like Ireland, Luxembourg, Singapore, and Switzerland) and it is also more difficult, both from the perspective of the tax authority and the MNE, to arrive at a correct arm's-length valuation for these intangibles. This is why so much of the current debate in the United Kingdom, United States, and international organizations such as the OECD have focused on how to apply transfer pricing rules to intracompany transfer of intangibles. All too often, the strict application of the current international rules leads to single-digit effective tax rates, which raise questions at the political level, especially at a time when social benefits are being cut and taxes on wages and consumption increased.

How Should Governments Address Concerns?

Governments could conclude that the fundamental principles that underlie the current approach to transfer pricing are so flawed that they need to be replaced or they could continue the gradual adaption of the arm's-length principle to achieve results which are more acceptable to all stakeholders. Both approaches will require unprecedented cooperation between tax authorities and between tax authorities and multinational enterprises—cooperation that must be structured in an open, transparent, and inclusive fashion.

It is also essential to recognize the realities of the present global economy. Many developing countries are now important stakeholders in the global economy but often express the views that their concerns are not fully covered by the present debate on taxation matters[3]. A significant number of economies in transition have themselves become exporters of capital or technology, and sometimes both, but continue to express a tax policy stance of being an importer of both, mainly inherited from the past. There is an urgent need to expand the current process of dialogue to address these issues, and reach agreement on practical ways to apply the arm's-length method in a way that meets these concerns.

Global Formulary Apportionment

The main alternative that has been proposed to divide up the tax base of multinational enterprises is global formulary apportionment, an approach that is operated in a number of countries internally, (e.g., the United States, Australia, and Canada), but which despite more than 75 years of discussion, has not been tried at an international level. The proponents of global formulary apportionment (GFA) argue that it would be easier for countries to apply and harder for multinationals to manipulate, but they overstate its simplicity and underestimate its disadvantage both for developing and developed countries. A GFA approach would allocate the global profits of a multinational on the basis of a predetermined, mechanistic formula. This formula typically would be based on the geographical distribution within an MNE of factors such as sales, employees' wages (sometimes supplemented by the number of employees), and assets.

For a GFA approach to work effectively requires a global consensus on what constitutes a globally integrated business, on what income should be apportioned, and how to compute the profit base of a multinational enterprise, on the formulae for the apportionment of the profits amongst jurisdictions and how each element of the formula is to be applied in practice and weighted. The likelihood of achieving a global consensus on any of these parameters is currently remote. Even within regional groupings this is proving difficult to achieve, although the technical discussions of the Common Consolidated Corporate Tax Base (CCCTB) may provide some guidance. The experience of countries with federal systems and sub-national tax administrations that have applied a formulary approach, (e.g., the United States), also shows that a GFA would be difficult to implement in practice on a worldwide scale, since tax administrations have wide variations in capacity, competence, and integrity levels.

The administrative challenge of auditing the application of the GFA, which requires detailed information about parts of an MNE's global operations having nothing to do with the taxing country, would be formidable, particularly from the perspective of developing countries, since in the absence of a global consensus, broad cooperation from other governments may be absent.

Even if such a global consensus could be achieved, it is difficult to see how global formulary apportionment factors, which would need to be the subject of an international negotiation and consensus, would, as is often claimed by NGOs, be to the advantage of low-income countries. The allocation of factors based on wages, assets, and sales is, for example, unlikely to benefit countries that have cheap labor, limited capital investment,

[3] See, e.g., comments by the government of India at http://www.un.org/esa/ffd/tax/2012ICTM/LetterIndia.pdf

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and less purchasing power (or more reliance on exports). The impact on developing countries of such an approach would require detailed analysis before it should be advocated as a realistic option.

Any formulary apportionment approach would not resolve the key issue of how to deal with intangibles (the CCCTB proposals specifically exclude) and would also not curtail tax planning opportunities but would merely reformulate them, as any tax practitioner in the United States, Canada, or Australia will confirm.

The current consensus amongst governments, in both developed and developing countries, is that the arm's-length standard is superior to a global formulary apportionment approach in that it offers a more principled and practical way of dealing with some of the issues that are currently preoccupying governments. The G-20 should not waste its political capital to explore an option which is conceptually flawed and which stands little chance of success, and NGOs should use their newfound political influence to focus on improving, rather than replacing, the arm's-length principle.

Adapting Arm's-Length Principle To Changing Business Environment

The arm's-length principle is neither rigid nor immovable. Since OECD published the 1979 Transfer Pricing Guidelines, these have been continuously adapted to reflect new business models and the emergence of new players. The major change since 1979 is the recognition that profit-based methods (the profit split and transactional net margin method) may be more appropriate to deal with complex intracompany transactions in highly integrated businesses (e.g., global trading in the financial sector).

This process of adaptation continues. OECD, through the Global Forum on Transfer Pricing that was created in 2012, is examining the applications of the guidelines to intangibles. OECD is also looking at how the guidelines can be applied more effectively by tax administrations and has set out proposals in terms of what should be the nature of the dialogue between multinational enterprises and tax authorities (the so-called enhanced relationship) and on the governance procedures that should be followed by governments in transfer pricing audits.

As a result of earlier G-20 initiatives, tax authorities have unprecedented access to information that they can use to complete transfer pricing audits. This information from their treaty partners complements what they obtain from transfer pricing documentation requirements which, in turn, enable them to carry out more sophisticated risk assessments of MNEs, segmenting them into low- and high-risk groups.

This is the context within which the G-20 should review the operation of the arm's-length principle so that it achieves an allocation of tax base that is commensurate with where the economic activities are carried out. A first step would be to strip out routine transactions by putting in place agreed rules on the use of safe harbors, thereby freeing resources to focus on more complex cases. Secondly, there needs to be a timely agreement on how the arm's-length principle can be applied to intangibles, building on the recommendations in the OECD report that should be finalized before September. Thirdly, there may be a case for saying that the digital economy requires a special set of provisions and this should be endorsed by all G-20 countries. Fourthly, we should be prepared to ''stretch'' the profit-based methods so that tailored profit based formulae can be used to allocate profits in certain circumstances. Fifthly, countries should put in place a rigorous peer review mechanism similar to that found in the Global Forum on Tax Transparency to ensure that countries apply consistently any agreements reached at the G-20 level. Sixthly, if a country—OECD or non-OECD—disagrees with particular provisions in the 1995 guidelines it should be able to set out its views since this, with the peer review mechanisms, would over time narrow differences in the implementation of the arm's-length principle. Lastly, governments need to provide tax authorities with the resources they need to undertake effective transfer pricing audits.

The real debate on transfer pricing should not be seen as a black and white debate between the arm's-length principle versus global formulary apportionment. It is more a debate about where governments want to be on a spectrum that spans at one extreme from a pure transaction-based approach to the other extreme of a pure global formulary apportionment method. Government decisions on where they want to be on this spectrum should be guided by what approach is likely to deliver the minimum amount of friction and compliance costs and a sharing of the tax base that accurately reflects the economic activities carried out in each jurisdiction.

Transfer Pricing in the Broader Context

Base erosion and profit shifting go beyond the transfer pricing area. To deal with these broader issues, governments will need to look at some of the basic concepts in tax treaties to see whether they meet the needs of the virtual economy. A greater effort needs to be made in getting a real international consensus on the permanent establishment concept and how it may need adaption as the world has moved from a bricks and mortar economy to a service economy. There may be a need to reassess the traditional OECD position of encouraging countries to reduce their withholding rates under treaties, at least in areas that are open to abuse in developing countries where tax authorities may not have the capacity to enforce sophisticated anti-abuse rules.

It is also time to review the operation of targeted anti-abuse provisions such as controlled foreign corporation (CFC) legislation, thin capitalization rules, and limitations on the deductibility of interest. Despite the widespread use of such provisions, many are now asking if they are they ''fit for purpose,'' in part because there is little effort to coordinate their application across countries. Here a good start would be to consider inserting a ''non-double taxation'' provision into the OECD and U.N. models that would deny exemption if the income is not taxed in the other state.

There may also be a case for the G-20 to endorse the concept of a general anti-avoidance rule (GAAR), building on the recent discussions in the United Kingdom and India and the recent proposal by the European Commission for an EU-wide GAAR. A well-designed and targeted GAAR would encourage firms and their advisers to ensure that their tax planning strategies have economic substance behind them.

Another measure that could counter base erosion would be a greater exchange of information between tax authorities on aggressive tax schemes. Some countries now have disclosure regimes that yield information that would be of interest to their treaty partners, including in developing countries. The Multilateral Convention on Administrative Assistance provides for such spontaneous exchanges. Also, regional groupings could establish Joint International Tax Shelter Information Centre (JITSIC)-type organizations to have real-time discussions on how to improve tax compliance. Countries also need to embrace the idea of joint audits including between OECD and non-OECD countries. Again the Multilateral Convention provides the legal framework.

More generally there needs to be an end to a weakening of existing anti-abuse provisions due to competitive pressures. Working together, governments are more effective in countering these pressures than working by themselves. Finally, governments could agree to share their risk assessments of MNEs and these could be published. The Forum on Tax Administration is ideally placed to take forward this proposal.

Conclusions

There is no ‘‘silver bullet’’ to resolve the issue of base erosion and profit shifting. Lasting solutions will take time to find and will require that the G-20 moves beyond ‘‘talking the talk’’ to ‘‘walking the walk.’’ The G-8 Summit, which will take place three months before the G-20, provides an opportunity for these eight countries to lead by example. It will also require a real engagement with countries outside of the G-20 and OECD since the interests of developing countries are not always aligned with that of BRICS [Brazil, Russia, India, China and South Africa].

Governments also have to recognize that base erosion and profit shifting are not just the outcomes of aggressive behavior on the part of taxpayers, but also on the part of governments to attract the tax base. Any code of conduct for MNEs should be accompanied by a code of conduct for governments, which would distinguish between acceptable and unacceptable forms of tax competition, extending the work of the EU and OECD to cover tax regimes that can be used or misused to erode the tax base of other countries. The G-20 summit could lead by example if it endorses such a code.

The Saint Petersburg Summit should be seen not as the end of this work, but as the beginning of a process which would lead to a new international order balancing the need to protect the tax base against the need to provide a tax environment that facilitates cross-border business. By speaking with one voice and leading by example, the G-20 achieved a breakthrough on exchange of information. With similar political will it can make the same breakthrough in the taxation of MNEs.

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