



Working Paper 44

**Developing Country Revenue  
Mobilisation: A Proposal to Modify the  
‘Transactional Net Margin’ Transfer Pricing  
Method**

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ICTD Working Paper 44  
First published by the Institute of Development Studies in January 2016  
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ISBN: 978-1-78118-287-1

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# Developing Country Revenue Mobilisation: a Proposal to Modify the ‘Transactional Net Margin’ Transfer Pricing Method

Michael C. Durst

## Summary

Developing countries tend to rely more heavily than wealthier countries on corporate tax revenue from multinational companies operating in their jurisdiction. Therefore, the practice that the Organisation for Economic Cooperation and Development (OECD) has labelled ‘base erosion and profit shifting’ (BEPS) – the diversion of taxable income by multinational groups from countries where they conduct business to other, zero- and low-tax countries – poses an especially challenging problem for developing countries.

Some of developing countries’ vulnerability to BEPS stems from the manner in which the Transactional Net Margin Method (TNMM), a particular transfer pricing method (method for dividing the income of a multinational group among the countries where the group operates), which is permitted under OECD guidelines, is currently being applied in practice. This paper argues that developing countries might be made less vulnerable to profit shifting if the OECD modifies TNMM in several respects. In particular, this paper suggests that: (i) the current dependence of TNMM on searches for ‘uncontrolled comparables’ be replaced by benchmarking based on the global profitability of the taxpayer’s multinational group; and (ii) the accounting rules used under TNMM be changed, so that the method is capable of reducing profit shifting through payment of interest on loans from affiliates, as well as from other kinds of related-party transactions.

As a first step in considering these proposals for implementation, the OECD and perhaps other international organisations will need to work with national tax administrations in order to develop reasonable estimates of the likely revenue effects. In addition, as a political matter, adoption of the suggested changes to TNMM will require multinational companies, and the governments that represent their interests, to be willing to exercise a degree of restraint in their tax policymaking in favour of the fiscal interests of developing countries. If that restraint is forthcoming, however, and revenue estimates prove encouraging, then changes to TNMM along the lines suggested below might contribute to worthwhile improvements in the current North/South fiscal balance.

**Keywords:** transfer pricing; developing countries; OECD; transactional net margin method (TNMM); base erosion and profit shifting (BEPS).

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# Contents

	Summary	3
	Acknowledgements	5
	Acronyms	5
	<b>Introduction</b>	<b>6</b>
<b>1</b>	<b>The use of TNMM in tax planning practices</b>	<b>7</b>
	1.1 Historical background of OECD transfer pricing methods	7
	1.2 TNMM's role in international tax planning	9
<b>2</b>	<b>How the proposed changes to TNMM would work</b>	<b>11</b>
<b>3</b>	<b>Limitations and arguable shortcomings of the revised TNMM</b>	<b>12</b>
<b>4</b>	<b>Conclusion</b>	<b>15</b>
	<b>References</b>	<b>16</b>

# Acknowledgements

The author is grateful for comments provided on an earlier version of this paper by participants in workshops sponsored by leading Indian professional firms in December 2015, in conjunction with the annual conference of the Foundation for International Taxation in Mumbai. The author particularly thanks Roy Rohatgi for his role in organising the conference and workshops. The author is also grateful for comments received from numerous colleagues over the course of the preparation of this paper. The author is, of course, fully responsible for any shortcomings.

# Acronyms

BEPS	Base Erosion and Profit Shifting
EBT	Earnings before tax
OECD	Organisation for Economic Co-operation and Development
TNMM	Transactional Net Margin Method

# Introduction

Over the past several years, the OECD, under instructions from the G-20 group of the world's largest economies, has been coordinating efforts among governments to devise remedies for the perceived problem of base erosion and profit shifting (BEPS).<sup>1</sup> BEPS refers to the ability of members of multinational groups, under tax laws currently in effect around the world, to divert taxable income from countries where the groups conduct business to other zero- or low-tax countries where the groups may conduct few, if any, activities. The diversion of business profits under BEPS tax-planning structures appears to have eroded the tax bases of countries at all levels of economic development. Revenue losses from BEPS, however, are often seen as especially serious for developing countries, where the income of local affiliates of multinational groups often accounts for a large proportion of the revenue that is potentially reachable by tax authorities.<sup>2</sup>

The OECD's BEPS study has, in the author's view, produced unprecedentedly clear analyses of the causes and mechanisms of international profit shifting under corporate tax, and has generated legislative and administrative proposals that, if adopted by governments around the world, should reduce the incidence of profit shifting around the world. As would be true of any serious re-evaluation of international tax laws, however, the BEPS project has throughout been affected by political pressures to limit any resulting increase to the effective tax burden faced by cross-border investment and trade.<sup>3</sup> Moreover, the issues that the BEPS process addresses are technically, as well as politically, complex. The BEPS recommendations in their current form, therefore, cannot realistically be seen as the last word in international tax reform. Instead, the BEPS project should be understood as a step in a long-term and continuing process of evolution toward a more satisfactorily functioning global system of international taxation.

As a suggested addition to the currently pending BEPS recommendations, this paper recommends that the OECD, and tax policymakers in national governments, consider modifying the rules for application of the Transactional Net Margin Method (TNMM), which is one of the transfer pricing methods that almost all countries in the world currently use, under guidelines

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<sup>1</sup> The OECD maintains a website containing its ongoing BEPS analyses at <[www.oecd.org](http://www.oecd.org)>. For a summary of the BEPS project at year-end 2015, see Finley (2015).

<sup>2</sup> For discussion of the potential significance of the BEPS project for developing countries, see IMF (2014) and OECD (2014a).

<sup>3</sup> The political forces that have, from the start, confronted the BEPS efforts reflect longstanding economic and political pressure faced by countries to limit attempts to collect taxes on income from companies' cross-border operations – the same pressures of tax competition that gave rise in the first instance to countries' toleration of widespread profit shifting by multinational groups. The pressures of tax competition have discouraged the implementation of effective corporate tax regimes by countries at all levels of wealth and economic development. The wealthier capital-exporting nations, which tend to be home to most of the world's large multinationals, have been willing to forgo the ability to tax their home-based multinationals on income from their international operations, in order to place the home-based multinationals in a competitive tax position relative to multinationals based in other countries. The world's developing countries, which tend to be importers of capital, have been willing to forgo taxation of the income of multinationals doing business in their countries in order to encourage inbound investment. The willingness of developing countries to forgo taxation of inbound investors has long been reflected in a variety of tax incentives, some of which are offered explicitly (as in the case of tax holidays offered to inbound investors), and others implicitly (as in the case of governments' toleration of income-stripping through BEPS). For an important early reflection on this phenomenon, see Avi-Yonah (2000). For a more recent discussion focused on developing countries, see Durst (2015a).

In recent years, China and India – countries that have reason to perceive themselves as having inherent economic advantages in attracting inbound investment – have been exceptions to the general rule of acquiescence in today's international tax regime, and often have advocated moving the international fiscal balance in favour of 'source' countries. See, for example, Dhillon (2015) and Desouza (2015). In addition, Brazil employs a system of fixed margins for transfer pricing purposes, instead of the comparables-based system prescribed by the OECD; this posture may reflect dissatisfaction with the results that are typically obtained under OECD practices (see United Nations (2013 Chapter 10-2)). With the exception of these countries, however, relatively little opposition to current tax planning structures seems to have been voiced by officials of developing country governments.

maintained by the OECD,<sup>4</sup> to seek to enforce appropriate levels of income for locally operating members of multinational groups. The OECD's current transfer pricing guidelines reflect a long history of international rulemaking regarding the division of income among countries for tax purposes; this history began under the auspices of the League of Nations in the 1920s and 1930s, and achieved further development through US regulatory efforts beginning in the 1960s, and various releases of *Transfer Pricing Guidelines* by the OECD, primarily in 1979 and 1995.<sup>5</sup> At the inception of the BEPS study, officials expressed concern that existing transfer pricing methods were affording multinational groups undue latitude for profit shifting, and a primary objective of the BEPS work has been to recommend changes that would strengthen transfer pricing rules. The BEPS reports that were released in late 2015 include an extensive analysis of transfer pricing rules, and significant suggestions for modifications to existing practices.<sup>6</sup> The BEPS recommendations, however, are targeted to particular provisions of the *Transfer Pricing Guidelines*, and do not include recommended revisions to TNMM.<sup>7</sup>

This paper offers for consideration changes to the rules of the *OECD Guidelines* governing implementation of the TNMM.<sup>8</sup> The modifications are intended to remove some elements of TNMM that historically have reduced the method's effectiveness in constraining erosion of the tax bases of developing countries. The remainder of this paper: (i) describes the role that TNMM typically plays in the tax planning structures used by multinational groups today, and (ii) offers a technical explanation of the proposed modifications to TNMM.

In reviewing these proposals, it should be recognised that an important step in considering their implementation will be to subject the proposals to careful revenue estimates, presumably performed by the OECD in cooperation with national tax administrations, and perhaps other international organisations. These kinds of revenue estimates are a prerequisite for disciplined consideration of any significant change to tax rules. It is hoped that the suggestions made below will demonstrate enough potential benefit to developing countries to justify the cost and effort required for the necessary revenue estimates, so that serious consideration of these proposals will be possible.

# 1 The use of TNMM in tax planning practices

## 1.1 Historical background of OECD transfer pricing methods

When it initiated the first steps in the long historical development of today's transfer pricing laws, the League of Nations made what would prove to be a durable choice, on the part of the world

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<sup>4</sup> The OECD maintains its guidelines under the title *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD various years). The *Guidelines* are revised from time to time (as they have been recently, in connection with the OECD's BEPS studies). Rules for the Transactional Net Margin Method are found in paragraphs 2.58-2.107 of the *OECD Guidelines*.

<sup>5</sup> Historical discussions can be found in Avi-Yonah (1995); Avi-Yonah and Clausing (2007); Durst and Culbertson (2003); Langbein (1986); Wells and Lowell (2012).

<sup>6</sup> The OECD has released its recommendations regarding the modification of transfer pricing rules in its report on Actions 8-10 under the BEPS recommendations. See note 1 above.

<sup>7</sup> In the course of the BEPS analysis, the OECD and other international organisations have described practical difficulties that developing countries appear to face in applying TNMM, especially as those difficulties appear to be affecting developing countries, and the OECD and other international organisations are committed to working with developing country governments toward alleviation of these difficulties. See, e.g., OECD (2014b). No changes to the rules governing TNMM, however, have been proposed.

<sup>8</sup> The technical discussion in this paper of a suggested new transfer pricing method relies on early explorations of this topic by the author: Durst (2015b, 2015c, 2015d, 2012).



community, between two possible approaches to dividing the income of a multinational business group among the countries in which the group conducts business.<sup>9</sup> One approach is called unitary taxation or formulary apportionment: it involves the computation of a group's total global income, from all countries, and the division of that income according to a formula that is designed to measure the relative amount of business activity conducted in the different countries.<sup>10</sup> The states of the United States had already been using a formulary approach for the division of income for several decades when the League of Nations committee conducted its review; the approach had proven satisfactory to the US states, and indeed the states continue to use a formulary approach today – as do the Canadian provinces. The League of Nations concluded, however, that it would be infeasible and unnecessary to try to construct a formula that might be used for the apportionment of income on the international scale, and instead recommended use of an alternative system for the division of income, which is based on what has come to be known as the arm's-length principle. The arm's-length principle continues to govern transfer pricing rules under the *OECD Guidelines*, and debate over its continued utility has been one focus of the recent international conversation about BEPS.

Under the arm's-length principle, a multinational group is required to divide its income among countries, for tax purposes, in the same manner in which the group's income would be divided if the members of the group were unrelated business entities transacting with one another at arm's length. For example, if a US member of a multinational group were to mine 100 tons of coal in the US and sell the coal for distribution to an affiliated company located in Mexico, the parties to the sale would be required under the arm's-length principle to price the coal at its fair market value, presumably determined by reference to prices for comparable coal observable in the marketplace.

Of course, even in the 1920s and 1930s many transactions among members of multinational business groups were more complicated than sales of raw coal or other commodities, and as technology has developed over the decades the complexity of transactions among group members has increased dramatically. Arm's-length transfer pricing therefore has never been as simple as determining market prices of raw commodities that might be transferred among group members. In practice, it is impossible to account separately for all of the thousands of transactions that occur among the members of a complex multinational business group members in the course of, say, a year, and identify with any degree of confidence market prices for the large variety of goods and services that are transferred in these transactions. As a result, application of the arm's-length principle has developed largely into a system of stylised benchmarking of the net incomes of certain affiliates within multinational groups, under the rubric of TNMM.

Under the *OECD Guidelines*, taxpayers and tax administrations are to use TNMM to test whether the incomes of certain kinds of business operations – in particular, distribution, manufacturing, and service-providing operations (for example, data processing operations and customer service call-in centres) – that multinational groups typically establish around the world, are earning incomes at levels consistent with the arm's-length standard. TNMM, as contained in the *OECD Guidelines*, is based on 'comparables'. Consider, for example, a distribution

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<sup>9</sup> See note 5 above.

<sup>10</sup> The author has compiled an analysis of the feasibility of global formulary apportionment for tax purposes, including a historical summary of the topic, in Durst (2015e). Although the author believes that a careful and open-minded study of formulary approaches can benefit policymakers of countries at all levels of economic development, the author has cautioned against attempts by countries to seek to implement formulary systems unilaterally (see Durst (2015f)). The current paper can be seen as entailing the incorporation of one characteristic element of a formulary system – reference to a group's consolidated global profitability – into a transfer pricing method that generally would retain the traditional features and structure of an arm's-length method.

subsidiary that a multinational beverages group might establish in Country A. The subsidiary might report on its Country A tax return that it has earned a net operating margin (ratio of operating income to sales) during the taxable year of 3.5 per cent. The subsidiary is supposed to have reviewed these results by reference to the results of comparable distributors of similar products in Country A that are not members of multinational groups. The tax authority is then entitled under TNMM to review the taxpayer's determination by conducting the authority's own analysis of available data from comparables; if the taxpayer's reported income is materially lower than the level indicated by the tax authority's analysis, the tax authority can propose an upward adjustment to the subsidiary's income.

## 1.2 TNMM's role in international tax planning

The use of TNMM by multinationals in global tax planning involves several conceptual steps. First, the group will form companies, to serve as what are typically referred to as hub or principal companies, in zero- or low-tax countries.<sup>11</sup> The group typically will cause these hub companies to enter into contracts with the group's operating entities around the world – the various distribution, manufacturing and service-provider subsidiaries through which the group conducts its business – under which the hub companies claim to indemnify the operating subsidiaries against most of their major business risks. In legal form, the contracts establish the operating subsidiaries essentially as servants of the hub companies, performing their business operations at the behest of and under the financial protection of the hubs.

It is a hallmark of this kind of tax structure that the hub companies physically perform few active business functions of their own: instead, the hubs typically have few employees, with the great bulk of the group's personnel distributed among the group's many operating subsidiaries. The contracts therefore tend to reflect a certain amount of artificiality, in that they provide for many of the risks of a business to be borne in countries where few, if any, of the activities that give rise to those risks are performed. As a legal matter, however, the risk-limiting contracts established under the tax planning structure conform to patterns that might be found in agreements made between unrelated companies acting at arm's-length; under longstanding legal principles, tax administrations around the world generally respect their *bona fides*.<sup>12</sup>

The groups involved in these kinds of contractually based tax planning structures typically perform transfer pricing analyses, under TNMM, based on the theory that the protection against risk afforded to the group's operating subsidiaries entitles the subsidiaries to earn only limited levels of operating income, consistent with the results observed among the simplest kinds of business entities for which comparables data can be found. In general, tax administrations around the world have not challenged the sufficiency of the levels of income reported by local subsidiaries under this approach.<sup>13</sup> As a result, the use of the hub structure, based upon

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<sup>11</sup> Although many countries are willing to host hub companies, the Cayman Islands, Bermuda, and the British Virgin Islands are among the jurisdictions in which multinational groups establish their hubs. The legal arrangements involved in hub-based tax planning are discussed in detail in Kleinbard (2011a, 2011b) and US Congress (2010). A report that is highly critical of the effects of hub tax planning structures on developing countries has been compiled by the non-governmental organisation ActionAid (ActionAid 2012).

<sup>12</sup> The extent to which tax administrations should be required to respect contractual arrangements made between commonly-owned entities has long been controversial. As a matter of legal principle, however, respect for the separate legal personality of the different members of commonly-owned corporate groups seems central to the institution of corporate-level taxation, and it is difficult to envision tax rules under the current arm's-length transfer pricing paradigm that would not afford a high level of deference to intragroup contracts. See, for example, the discussion in Durst and Culbertson (2003: 114-122).

<sup>13</sup> Notable exceptions to this tendency have been India and China, which are often reported as challenging what they perceive to be low levels of subsidiary income determined by taxpayers' applications of TNMM (see note 3 above). The extent to which the apparent reluctance of other countries to challenge TNMM results can be attributed to considerations of tax competition, to technical difficulties encountered by revenue administrations in applying TNMM, or to some combination of these two factors, cannot, of course, be determined.

networks of risk-limiting contracts, has become virtually universal among the world's business groups.

It seems likely to this author that the apparent toleration by most developing country governments of tax planning structures based on TNMM reflects, in large part, a homeostatic equilibrium that has developed in recent decades between countries' desire for tax revenue on one hand, and their countervailing desire to keep corporate tax burdens low to avoid discouraging inbound investment. Numerous conversations in which the author has engaged with tax specialists around the world support this perception of political-economic equilibrium rather strongly. The possibility that global toleration of TNMM-based planning structures represents an economically determined equilibrium, however, does not mean that the perpetuation of the current equilibrium is normatively desirable. In particular, there is no reason to assume that the current equilibrium happens to have settled at a point that is optimal in terms of social well-being. To the contrary, it may well be the case that the current equilibrium leaves developing countries with corporate tax revenue that is insufficient to meet the countries' reasonable economic and social needs. If that is the case, then measures designed to modify the current corporate tax equilibrium to some extent, in favour of developing countries, may provide significant net social benefits.

As a matter of practical politics, given the pervasiveness of the forces of tax competition that have brought about the current North-South corporate tax equilibrium, measures designed to change the equilibrium are not likely to occur of their own accord. Instead, multinational companies, and the governments that represent their interests, will need to be willing to exercise a degree of restraint in their tax policymaking in favour of the fiscal interests of developing countries.<sup>14</sup> Essentially these parties will need to be willing, as a group, to forgo tax advantages they would otherwise, as a matter of political and economic power, be able to retain, in order to assist developing countries in raising revenue to build social and economic infrastructure. This paper assumes that multinational companies and their governments do in fact perceive advantages, at both the humanitarian and economic levels, in improving the relative fiscal positions of developing countries, so that proposals like the one suggested in this paper are not entirely unrealistic as a political matter.

The following section of this paper therefore proposes changes to the rules governing TNMM that are designed – subject, of course, to verification by revenue estimates – to enhance developing countries' ability to raise corporate tax revenue, while at the same time avoiding increasing corporate tax burdens to competitively untenable levels. The proposals address two features of TNMM as currently configured in the *OECD Guidelines*:

- (i) *Problems related to comparables.* TNMM's reliance on searches for uncontrolled comparables have long been perceived as posing serious and unresolved problems in administration. On economic grounds, there are reasons to expect close comparables for the activities performed by members of multinational groups to be difficult to locate, even in wealthy countries with highly developed economies.<sup>15</sup> The difficulty of locating satisfactory comparables appear especially acute in developing countries, where few independent

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<sup>14</sup> See, e.g., Durst (2014).

<sup>15</sup> Essentially, the argument is that multinational groups form in industries where the common ownership of legal entities performing different functions is necessary in order to operate competitively. Therefore, in industries that are organised in international groups – precisely the industries for which transfer pricing regulation is required – few satisfactory comparables for, say, distribution and manufacturing subsidiaries are likely to be found. See, e.g., Durst and Culbertson (2003: 81-87).

companies of any kind are likely to exist that are publicly traded, and therefore do not report financial data in a format that is useful for analysis under TNMM.<sup>16</sup>

- (ii) *Problems related to profit shifting through interest payments.* Large volumes of profit shifting are attributable to payment of interest by corporate subsidiaries, on loans that have been extended to the subsidiaries by zero- or low-tax hub affiliates. TNMM, however, like other transfer pricing methods under the *OECD Guidelines*, generally requires taxpayers to report minimum levels of operating income, which is an accounting measurement of income *before* payment of interest. Historically, international tax law has not sought to limit the volume of interest payments between affiliates by means of transfer pricing rules, but on separate, specialised systems of rules for limiting interest on related-party debt. However, perhaps from pressures of tax competition, countries' limitations on interest deductions have typically been of limited effect, or have been non-existent. The OECD, in its BEPS reports, has recommended some tightening of existing interest-limitation rules, but it is unclear whether these will lead in practice to substantial changes.<sup>17</sup> The suggested changes to TNMM would seek to redress this difficulty to some extent by substituting 'earnings before tax' (EBT), a measure of a company's earnings *after* payment of interest, in place of operating income as the basis for benchmarking under TNMM.

## 2 How the proposed changes to TNMM would work

The suggested revisions would leave the rules for TNMM identical to those now in the *OECD Guidelines*, except that: (i) benchmarking would not be based on searches for comparables, but taxpayers would instead be required to earn profit margins equal to 25 per cent of the global consolidated margin earned by the taxpayer's multinational group; and (ii) the measure of profitability used for purposes of benchmarking under TNMM would be earnings before tax, instead of operating income.

Consider for illustration the situation of a distribution subsidiary, Sellco, that earns \$1 billion in revenue during the taxable year. If the multinational group of which Sellco is a member reports on its annual financial statements a consolidated EBT margin of 15 per cent, then the revised TNMM will require Sellco to earn an EBT margin of  $.25 \times 15$ , or 3.75 per cent. Therefore, under the revised TNMM, Sellco's income for the year should be \$37.5 million. (If, alternatively, the consolidated group had operated at a loss for the year as measured by the group's consolidated EBT, then Sellco would be permitted for tax purposes to report a corresponding loss, based on the 25 per cent rule. The loss would be subject to any carryover rules allowed under the locally applicable income tax laws.)

In the case of a subsidiary that is not a distributor, but is instead a manufacturer, the revised TNMM would not base its benchmarking on the taxpayer's return on sales, but instead – as is commonly the practice today under TNMM – on the taxpayer's return on its total expenses. Consider, for example, a manufacturing subsidiary, Manuco, with total expenses of \$800 million per year. If Manuco's group earns a consolidated EBT return on total expenses of 24 per cent,

<sup>16</sup> The OECD and other international organisations are committed to assisting developing countries in seeking remedies for current difficulties in locating comparables for use in transfer pricing administration (see note 7 above). The author hopes that the observations offered in this paper will be helpful in the design and implementation of this technical assistance effort.

<sup>17</sup> The BEPS recommendations relating to the limitation of interest deductions are found in the OECD's report under BEPS Action 4. For a discussion of this topic, see Durst (2015g).

then Manuco would be required under the revised TNMM to earn an EBT margin of at least 0.25 x 24, or 6 per cent, indicating an arm's-length level of income of \$48 million. Again, if application of the revised TNMM indicates that Manuco should incur a loss, the loss will be allowed for corporate tax purposes. (As is true under the current version of TNMM, subsidiaries that are neither distributors or manufacturers, but instead are engaged in the provision of services, might be benchmarked by reference either to their returns on sales or their returns on cost, depending on the clientele served by the particular subsidiary.)<sup>18</sup>

The suggestion that the revised TNMM be applied using a coefficient of 0.25 – that is, that the taxpayer be required to report an EBT margin that is 25 per cent of the group's consolidated margin – reflects several considerations. First, conceptually, it seems reasonable to assume that any single function of the taxpayer, like distribution, manufacturing, or the provision of services, is likely in itself to account for only a relatively small portion of the total income generated by a multinational group, and 25 per cent seems like a reasonable broad estimate of the appropriate percentage. Second, a coefficient of 25 per cent appears to lead to results that are roughly in line with expectations of practitioners, as recalled by the author, when TNMM was first developed in the early 1990s, but before its application in practice had been affected on a large scale by the proliferation of limited-risk subsidiaries. Ultimately, the choice of a particular coefficient reflects some degree of subjective judgment, but 25 per cent seems sensible (subject to verification by revenue estimates) if the revised method is to result in meaningful, but still relatively moderate, increases in effective tax burdens.

The key to the improved administrability of the revised version of TNMM is its reliance for purposes of benchmarking on information taken from groups' routinely reported financial results, rather than on data derived from attempted searches for comparables. Most large multinational groups publish their consolidated results annually, under the supervision of professional auditors and national securities regulators. Companies are unlikely to try to understate their global profitability, as that would put the companies at a disadvantage in the capital markets; therefore, the information on profitability that is published by multinational groups generally should be reliable for use in tax administration. Not all multinationals are publicly traded, but all but the smallest nevertheless maintain audited financial statements, and even those that do not typically will maintain some form of consolidated financial information. Also, those without audited statements are likely to be the smallest multinationals, for which little revenue is at stake under transfer pricing laws.

### 3 Limitations and arguable shortcomings of the revised TNMM

The suggested revisions to TNMM are not intended as a panacea for all problems of transfer pricing administration, but to provide a reasonable backup to current methods, and, in particular, to reduce the degree of profit shifting that the TNMM now permits in connection with the use of limited-risk subsidiaries. As a consequence of its deliberately limited reach, the revised TNMM

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<sup>18</sup> Subsidiaries that provide services primarily to unrelated customers in the local market (as might be the case, e.g., for a local subsidiary of a global oil drilling services group) typically are treated under TNMM similarly to distributors and benchmarked on the basis of return on sales. Subsidiaries that provide services mainly to related parties (for example, subsidiaries that provide R&D services, or operate customer call centres, for the benefit of other members of their commonly-controlled groups), typically are treated under TNMM similarly to manufacturers and are benchmarked on the basis of their returns on costs.

admittedly retains some of the weaknesses of current transfer pricing methods, including the current version of TNMM.

In particular, the revised TNMM will continue to require the taxpayer and the tax authority to characterise particular subsidiaries or divisions within subsidiaries (tested parties) as distributors, manufacturers or particular kinds of service providers, and sometimes this characterisation is difficult to accomplish. In addition, the revised TNMM will continue, like OECD transfer pricing methods generally, to benchmark taxpayers' book (financial statement) incomes, not their taxable incomes. This means that, even after revision, TNMM will continue to require the taxpayer and the tax authority to determine how results under the applicable transfer pricing method should be translated from book to taxable income – sometimes a difficult accounting task. The suggested revisions to TNMM do not attempt to address this significant methodological weakness, which seems unavoidable under any transfer pricing method that is in use today.

Another limitation is that the revised TNMM would be useful to benchmark financial results only of the kinds of distribution, manufacturing and service operations to which TNMM currently is applied under the rules of the *OECD Guidelines*. Even after revision, TNMM would not be useful in benchmarking the incomes of other kinds of taxpayers, including those with especially complex operations. In particular, the revisions to TNMM would not solve the problem – currently unsolved under existing OECD transfer pricing methods – of evaluating the income of banks, insurance companies and other financial businesses. The revisions would, however, enable governments, including governments in developing countries with relatively limited tax administration resources, to reduce revenue losses in a large number of situations in which taxpayers have established tax planning structures based on the use of risk-limited distribution, manufacturing and service provider subsidiaries.

Although the revised TNMM, by benchmarking based on EBT rather than operating income, will provide developing country governments with greater protection against excessive interest deductions than is available today, the protection provided by the revised TNMM will remain somewhat porous. Because the revised TNMM will not prescribe minimum EBT levels for a group's entire operations within a particular country, but instead only for tested parties that have been identified for purposes of applying TNMM, some taxpayers will have opportunity to seek to apportion some or all of their interest deductions to portions of their operations that are not subject to TNMM. To the extent this occurs, tax administrations will need to rely not on transfer pricing rules, but instead on special rules for the limitation of interest deductions (which, as discussed above, tend to be quite weak in many countries) to prevent excessive revenue leakage.<sup>19</sup> Therefore, although the suggested revisions to TNMM should help to some extent in reducing profit shifting through the use of interest deductions, institution of the suggested new method will not obviate the need for more effective overall limitations on interest deductions.

The revised TNMM might also be criticised for basing its minimally required levels of income not on the success or failure of the specific business operations that the taxpayer conducts in its particular country, but instead on the financial success or failure during the year of the taxpayer's global group as a whole. At least in theory, this feature of the revised TNMM will dilute some of the risk-mitigating effects of the income tax. Normally, when taxpayers invest to perform particular activities within a country, they can theoretically expect that the risks of that investment will be dampened by the fact that their tax burden will increase only in the case of success, and that failure will be cushioned to some extent by deductible losses in that country.

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<sup>19</sup> See note 17 above.

This risk-dampening effect would seem to be diluted if tax obligations in a particular country are determined by the taxpayer's global, rather than local, financial results, from all the activities in which the group is engaged.

This problem, however, seems likely to be less significant in practice than in theory. It would indeed be better from the perspective of mitigating financial risk to base tax results on a taxpayer's local rather than global profitability – but the problems of transfer pricing administration over many decades have shown that measurement of local profitability with any degree of precision is infeasible. Indeed, the inherent technical problems of local income measurement appear to have contributed greatly to the current situation with respect to base erosion and profit shifting. In addition, the revised TNMM's approach to benchmarking in effect allows multinational groups some degree of cross-border offsetting of losses and sub-part profitability – a feature that investors in the group as a whole should find attractive on grounds of risk mitigation.<sup>20</sup>

It also might be objected that, under the revised TNMM, 'start-up' subsidiaries that are contained within profitable multinational groups might be required to report positive levels of income, even before they realistically could be expected to be earning a profit on a local basis. This prospect might be viewed as posing a disincentive to new inbound investment. It is unclear whether the taxation of local subsidiaries during a start-up period is entirely inappropriate as a conceptual matter. Arguably, all subsidiaries of a multinational group should be seen as supporting the operations of the group as a whole, even when some of the subsidiaries are in start-up phases, as all subsidiaries can be seen as mutually supportive parts of the group's overall programme of geographic diversification. Thus, even in a start-up period a subsidiary can be seen as performing a service for the parent company, for which the subsidiary should receive net compensation. This argument, however, is not likely to be persuasive to developing country governments, which historically have perceived some kind of special tax treatment for start-up operations as being necessary to afford appropriate investment incentives. Accordingly, it is suggested that governments that currently accord new businesses tax incentives during a start-up period continue to do so after adopting revisions to TNMM.

Some may criticise the suggested revisions to TNMM on conceptual grounds, as a departure from a longstanding international consensus in favour of transfer pricing methods that adhere closely to reliance on data from comparables, and on refraining from reliance on group-wide financial results. It is true that both of these preferences are now deeply embedded in practice under transfer pricing law, and even minor departures from these tendencies might reasonably raise fears of unintended adverse effects. Conceptual models of taxation, however, are always approximate. International tax law is an amalgam of many different and sometimes idiosyncratic rules, which have been conditioned over time by a wide variety of practical considerations, political as well as economic. Models in tax policy and administration inevitably need to change from time to time, at least to some extent, to meet new economic and political needs; indeed, even the changes to the *OECD Guidelines* in 1995, which introduced the TNMM, responded to changing perceptions of the practical exigencies of transfer pricing administration. Conceptual models have their value in tax policy and administration, but they should not be elevated to the level of a controlling theology. In the current global environment, some departure from historically influential conceptual models should be seen as acceptable, if it can achieve politically viable improvements in the fiscal situation of developing countries.

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<sup>20</sup> An alternative to basing required margins, under TNMM, on consolidated group results would be to adopt a system of fixed margins similar to that employed by Brazil (see note 3 above). Fixed margins, however, would appear to involve more potential for economically anomalous results than the approach suggested here; moreover, fixed margins, unlike consolidated group margins reported in companies' audited financial statements, are vulnerable to political manipulation.

## 4 Conclusion

Revenue estimates will need to be made as a first step in considering the implementation of the proposals made in this paper. In addition, the adoption of changes to TNMM along the lines suggested in this paper will depend heavily on some measure of political support from the world's large multinational companies, and from the governments of countries where the groups are based. On both political and economic grounds, however, proposals along the lines suggested above would appear to offer sufficient potential, from the standpoint of contributing to the fiscal wellbeing of developing countries, to justify careful evaluation, beginning with an assessment of their likely revenue effects.



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