



Problems of Transfer Pricing and Possibilities for its Simplification

Summary of Working Paper 86 by Sol Picciotto

The international system for taxation of the profits of multinational enterprises (MNEs) is deeply dysfunctional. The recent attempts at reform have only patched up the system, and alternative approaches should be considered (Picciotto 2017). In the meantime, developing countries sorely need practical guidance, especially on the methods for allocation of profits. These are known as transfer pricing rules.

Although MNEs operate in an integrated manner as single firms, nowadays they consist of often hundreds of legally separate companies and other entities, but all under common ownership and central control. Each tax authority naturally deals with the entities resident or doing business in that country, and it seems normal to determine the profits earned in the country by starting from the accounts of those local entities.

A chequered history

National tax authorities have long had powers to adjust the accounts of such entities, to ensure a fair and reasonable allocation of profit within the MNE as a whole. This is because companies under common control are not independent of each other, and so the relations between them are not like market transactions. Nevertheless, the standard which became internationally agreed in the 1930s for the adjustment of accounts was to compare them with those of similar independent firms. From the 1920s to the 1970s two main approaches were used: one based on comparable profits (applying a benchmark profit margin, for example, to turnover), and the other fractional apportionment of the MNE's global profit.

It is only more recently that the rules became focused on the pricing of transfers between related entities, and on evaluating them by reference to comparable transactions between unrelated parties. The methods devised originally by the USA were initially rejected by other

members of the Organisation for Economic Cooperation and Development (OECD). The US soon found that in practice true comparables could not be found, but revisions to the US rules in the 1980s led to conflicts with other OECD members. The OECD Transfer Pricing Guidelines (TPGs) finally issued in 1995 approved five methods, while emphasising the need for an individual functional analysis of the entities within each MNE and focusing on the transactions between them.

The TPGs have had wide influence, and in some cases have been incorporated into national laws. This is due mainly to the devotion to them of legions of specialists with intellectual investments in these techniques, forming a cognitive community dominated by well-paid business advisers, as well as because of the opportunities for minimising tax that they provide. Even some non-OECD members have adopted regulations based on the TPGs, although few have the resources to apply them rigorously.

Fundamental flaws

The approach of the current TPGs is both mistaken and impractical.

MNEs benefit from distinctive technology, economies of scale, and the synergies resulting from integration. Hence, their internal relations are not comparable to transactions between unrelated parties. It is particularly inappropriate to apply the transactional approach to intragroup financing, intangibles and risk, since these are core functions which are highly centralised within MNEs, and hence shared factors involving overhead costs. These functions are also easy to locate anywhere and this has created the most intractable problems in transfer pricing (Andrus and Collier 2017).

The independent entity principle has encouraged MNEs to create complex structures and transactions to minimise tax.

The requirement of the TPGs for a facts and circumstances analysis in every case requires tax authorities to conduct

a detailed audit of each entity, needing specialised knowledge of the firm's business as well as of the transfer pricing methods. This requires skilled staff, who are a scarce resource especially in poor countries. Tax authorities are always outmatched by MNEs, which know their business better and spend substantial sums on specialist advisors. The subjective nature of the rules means that large MNEs can plan how much tax to pay and where, though with substantial risks of disagreement and conflicts.

Safe harbours

The administrative burdens of applying the TPGs have led some countries to adopt various kinds of 'safe harbour' rules which can be applied automatically. Although these run counter to the emphasis on individual audit, the OECD amended the TPGs in 2013 to permit them, but only provided they are voluntary for taxpayers, and where necessary agreed with other relevant countries. Hence, under the TPGs they have limited scope, mainly consisting of exemption from documentation obligations and for small firms. These do not seem relevant for developing countries, where MNEs are generally large taxpayers.

Some leading developing countries have sought more effective simplification. Brazil has gone furthest, with detailed regulations dating back to 1996. These are based on three of the approved OECD methods, but apply fixed profit margins to all taxpayers within each specified category, dispensing with the need for individual audit. This has the merit of being easy to apply and providing certainty, but is a broad-brush approach, taking no account of differences between firms especially of profitability. Although compatible with tax treaties, it disregards the TPGs' requirements for individualised evaluation.

India enacted rules based on the TPGs in 2001 and experienced an enormous growth in disputes. Consequently, regulations in 2013 specified 'safe harbour' transfer pricing methods for approved firms in specified sectors (mainly out-sourced software and component manufacture). In compliance with the TPGs, these were voluntary, but this

resulted in low take-up, and revisions made in 2017 seem unlikely to improve this.

Other countries have also designed sectoral schemes, e.g. Mexico for sub-contract manufacturing for export ('maquilas'), and the Dominican Republic for the package hotel sector. These seem more successful since they apply automatically to designated taxpayers; opting out is possible but involves a burden of proof.

Safe harbours may therefore be helpful for sectors with many similarly-situated firms, and on an opt-out rather than opt-in basis. If targeted at firms attributing profit inappropriately to affiliates in non-treaty jurisdictions they do not need to be agreed bilaterally.

Alternative simplified methods

More radical methods have been proposed which could help protect the tax base of poor countries while being simple to apply. Some countries have a minimum tax, calculated for example on sales revenue, or using several methods (which allows for different company characteristics). Such a tax is payable if the normal profits tax liability is lower, or is treated as a non-refundable credit against profits tax.

Michael Durst also has proposed a 'shared net margin method', which would require the local affiliate to earn a benchmark profit margin in proportion to that of the corporate group as a whole (Durst 2016).

An extension of this would be to establish a benchmark on a formulary basis, by allocating a proportion of the TNC's global income to the local entity, based on factors reflecting its presence in the jurisdiction, such as employees, assets and sales. This would revert back to the fractional method which was historically in widespread use, and which continues to be permitted for attribution of profits to permanent establishments in most existing tax treaties. This runs counter to the transactional approach in the TPGs, which explicitly reject formulary apportionment. However, it could be applied in a way which is compatible with the TPGs, using the framework of an Advance Pricing Arrangement, preferably on a sectoral basis to achieve the aim of simplicity.

Further reading

- Andrus, J. and Collier, R. (2017) *Transfer Pricing and the Arm's Length Principle After BEPS*, Oxford: Oxford University Press
- Durst, M.C. (2016) 'Developing Country Revenue Mobilisation: A Proposal to Modify the 'Transactional Net Margin' Transfer Pricing Method', ICTD Working Paper 44, Brighton, UK: Institute of Development Studies
- Piccio, S. (2018) 'Problems of transfer pricing and possibilities for simplification', ICTD Working Paper 86, Brighton, IDS, October.
- Piccio, S. (2017) *Taxing Multinational Enterprises as Unitary Firms*. Brighton, UK: Institute of Development Studies

Credits

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