



TRANSFER PRICING, AND THE TAXING RIGHTS OF DEVELOPING COUNTRIES

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There is now widespread recognition of the importance of domestic resource mobilisation in developing countries, and one key area within that relates to the tax revenues raised from multinational companies. Central to debate in this is the challenge posed by transfer pricing, the mechanism by which profit is allocated between related subsidiaries of companies. This paper explores a range of aspects of the transfer pricing mechanism, with a particular focus on the challenges posed to tax administrations in developing countries.

The central, and unsurprising, finding is that the complexity of the system, coupled with a lack of capacity and expertise in developing countries, leaves the latter open to abuse. As transfer pricing mechanisms currently operate, they cannot but be responsible for a significant shift in taxing rights away from those countries where they are most important for poverty eradication.

A range of responses is proposed: on the one hand are measures which it is argued would serve to reduce the difficulties in implementing current transfer pricing mechanisms, and on the other are proposals for alternative systems for the global allocation of taxing rights which require further research, but may ultimately yield an alternative, effective solution. Among the first group, key proposals to reduce problems posed by transfer pricing mechanisms aim to address tax administration capacity in developing countries through coordinated action; and to address the information asymmetries faced by developing countries via changes in international regulation, to enable a step change in transparency. The proposed alternatives to transfer pricing mechanisms include unitary taxation, with potential to be applied globally, either unilaterally or through coordination at the level of regional economic groupings. However, significant political obstacles remain.

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Introduction

The importance of mobilising domestic financial resources is now widely recognised in intergovernmental and civil society debates on development finance.¹ The Monterrey Consensus of 2002 highlighted that ‘an enabling domestic environment is vital for mobilising domestic resources, increasing productivity, reducing capital flight, encouraging the private sector, and attracting and making use of international investment and assistance.’² Such an enabling environment must recognise the need to effectively raise revenue for investment in public services, in a way which encourages rather than inhibits foreign direct investment (FDI).

A key part of revenue mobilisation involves taxation of the private sector. The complexity of multinational corporations (MNCs) presents a challenge to revenue authorities in developing countries, given their frequent lack of capacity, expertise and bargaining power, and issues of management and corruption.

Yet MNCs play an increasingly important role in global trade, accounting for 10 per cent of world gross domestic product (GDP) in 2007.³ It is estimated that more than 60 per cent of international trade is intra-group trade – that is, it occurs within the same organisation or group of companies.⁴

The compliance burden faced by MNCs operating in numerous tax jurisdictions can be onerous. This is perhaps most significant in the area of international transfer pricing, the means by which companies allocate profits, and therefore taxing rights, between jurisdictions. Transfer pricing is widely recognised as the most complex issue in international taxation and is also one of the most important tax issues faced by MNCs.⁵ It was highlighted in 2006 by the then commissioner of the US Inland Revenue Service (IRS) as ‘one of the most significant challenges for us in corporate tax administration’.⁶

It is this complexity which can lead to intractable disputes over taxing rights and also enables unscrupulous businesses to shift profits from countries where the capacity to monitor and challenge such behaviour is limited. Of course, many MNCs seek to play a positive role through job creation, investment in infrastructure, the innovation of new technologies and their corporate social responsibility actions. However, tax is also becoming an important part of corporate social responsibility⁷ as MNC tax behaviour faces previously unknown levels of external scrutiny.

In addition to the problem of corporate behaviour that undermines revenue collection in the least developed jurisdictions, the systemic impact of power imbalances between states is also likely to be substantial. An imbalance of power is created when the tax administration in one country has more or better information, more dedicated resources and more political power than the other. As such, the disparity in transfer pricing expertise and capacity between the revenue authorities of developing countries and those of developed countries and emerging economies can result in companies apportioning greater profits to developed countries to avoid the risk of transfer pricing disputes with an aggressive and politically powerful revenue authority.⁸

In this context, and with civil society groups increasingly seizing on these issues, the demand for a system that allows a fair determination of the allocation of profits between jurisdictions is likely to increase.

This paper proceeds as follows. The first section describes transfer pricing and the ‘arm’s length principle’ on which the dominant approach rests. In the second section we explore the various motives for companies’ approaches to transfer pricing, including taxation issues. The third section sets out the existing general critique of transfer pricing, including particular challenges which have arisen due to the financial crisis. The challenges faced by tax administrators in developing countries are described in the fourth

section, where we set out legislative, capacity and information asymmetry issues. The fifth section sets out proposals for improvements to the current system, and also describes some potential alternatives and solutions that may go further in addressing the underlying inequity in the international allocation of taxing rights to developing countries.

1. Transfer pricing and the ‘arm’s length principle’

Transfer pricing is the pricing of transactions between related parties, for example sister companies within the same commonly controlled group of companies. The transactions could include the purchase and sale of goods or tangible and intangible assets, the provision of services, the provision of financing, and also cost allocation or cost sharing arrangements.

It is therefore a commercial issue. MNCs run their business on an international basis, and a sale of goods or service to a customer in one country will often involve group entities in several other countries in the supply chain. The problem is how to allocate the cost of producing and selling the product/service and the profit earned on the sale. For book and tax purposes, this needs to be split between the various countries and legal entities which have played a role.

Intra-group transactions are not exposed to the same market forces as transactions between independent enterprises. As such, they are referred to as ‘controlled transactions’. Where these transactions occur across borders, they may be artificially lowered or raised, resulting in the over- or under-declaration of costs and profits in a jurisdiction.⁹ This has implications for the tax base of both tax jurisdictions and for the taxpayer because taxes tend to be levied on a country-by-country basis.

This is a political issue. Tax authorities are likely to want to minimise costs and maximise the profits booked in their country as this will increase their tax take. On the other hand, taxpayers (companies) are likely to want to minimise their tax payments on a global basis.

To address this problem, the determination of an appropriate price is governed by the ‘arm’s length principle’ (ALP),¹⁰ that is, the price at which a transaction would take place if the buying and selling entity were not related. The aim of this principle is the proper allocation of MNCs’ tax bases among the countries in which they operate while avoiding double taxation (a situation in which the same profits are taxed in more than one jurisdiction).

The ALP has become an international norm for governing related transactions and is applied by all OECD countries and a number of non-OECD countries.¹¹ Further, many double-tax treaties contain provisions for the resolution of transfer pricing disputes on the basis of the ALP.

The arm’s length principle

‘[When] conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.’

Chapter 1, paragraph 1 of Article 9 of the OECD Model Tax Convention.

Application of the arm's length principle

Most countries which have adopted transfer pricing rules base them on the OECD Transfer Pricing Guidelines for Multinational Enterprises. These guidelines outline a range of methodologies for calculating an arm's length price.¹² These are noted in Appendix One. However, before considering the challenges of identifying an arm's length price, it is important to distinguish between different kinds of trade involved in transfer pricing.

Intra-group trade with MNCs includes physical goods and 'intangibles' such as intellectual property or software. Services such as management and insurance, and financing and cost sharing arrangements are also included. PricewaterhouseCoopers classifies these into four categories: tangibles; intangibles, services, and financing/cost sharing.¹³

Tangibles

Tangible property refers to all the physical assets of a business or organisation. This includes inventory that is made up of raw materials, semi-manufactured and finished products as well as all the machinery and equipment that a company uses in its line of work. These assets can be transferred across boundaries to support subsidiary firms at their start up stages or during an expansion drive. These happen especially in the mining, construction or manufacturing sectors. Establishing an arm's length price for such transactions is relatively simple, given that these are often discrete products. However, where a company has a monopoly for such a product in a country, this becomes more difficult.

Intangibles

Intangibles include brands, trademarks, intellectual property, licences, and publishing rights.¹⁴ These can represent barriers to entry because they can establish a company's monopoly control in a particular field.

Manufacturing intangibles consist of technological expertise and patents. Depending on the effectiveness of a patent as a barrier to entry, this may create a monopoly for the patent owner. In this case, when there is a transfer to an affiliate company, it is vital that the determination of the ALP takes into account the monopoly power conferred by the patent. Thus the transfer price for such an intangible would be higher than that for an ineffective barrier to entry type of patent. Likewise, a transfer price for technical expertise depends on the extent to which this expertise contributes to the production of a unique product.

Marketing intangibles are created in marketing, distribution and after sales services and include trademarks and trade names. The value of a trademark in a particular market depends on the level of acceptance of the product in that market. The calculation of an ALP price will need to take into account the maturity of the product in the market. Clear differentiation of the value of a product in each jurisdiction is difficult as the development of a single product may have involved both countries. In such cases, hybrid intangibles are created.

The identification of a comparable arm's length price for an intangible is problematic, given that intellectual property, by definition, preserves a monopoly for the company which owns it. However, even when this can be established, there remain questions regarding the extent to which a particular product has been successful as a result of technology or as a result of marketing strategy.

When such a valuation has been established, there are questions with regard to where such value lies. If the manufacturing intangible has been created by a global team of experts, how is this value distributed between jurisdictions? How can one find a comparable for the value of a marketing brand in a particular country?

Recently the OECD has produced guidelines on transfer pricing in business restructurings, given the risk that valuable intangibles can be transferred to low tax jurisdictions at a stage in the business cycle when these intangibles are not valuable, but present significant potential for profit.

Services

Services that are transferred between related parties can involve accounting, legal or tax assistance or relatively more complex services. Pricing services that are seen as routine accounting can be calculated using the 'cost plus' formula where the ALP is calculated on the cost of the service plus a small profit. The rendering of more complex technical services to one affiliate by another must also be calculated with the ALP, except in the case where a licence mandates technical assistance. The transfer of managerial and professional skills when an executive is sent from a parent company to provide start-up knowledge in a new market may also be classified as a transfer pricing issue.

Financing/cost sharing

Within a corporate structure, capital management plays a significant role. As such, an MNC must be able to deploy funds and meet its obligations in every country in which it operates. Internal finance can be provided within a MNC group to serve the businesses needs of a particular subsidiary. This may involve short term capital needs, market penetration payments and financing long term capital needs.

When considering the arm's length nature of intra-company financing, the following factors are relevant: the rate of interest on the loan; the capital amount of the loan; the currency and the credit worthiness of the borrower. When a subsidiary is first established, the parent company may need to finance the working capital of the subsidiary in the short term until it starts making a profit. These financing needs may be given as equity, which increases the credit base of the company or as loan, which shows in the debit column of the company's accounts and will have to be repaid with interest.

Depending on the ratio of equity to debt, a company may be said to be thinly capitalised. Short term thin capitalisation results in profits from the new subsidiary being repatriated to repay debt at an interest rate which is higher than the arm's length price. As a result, the host country loses out on corporation tax revenue, because the company may not be posting profits until the bulk of its loans are repaid.

Thin capitalisation

This is when a company has a high level of borrowing relative to its equity base. This term is usually used when the high levels of debt are derived from related companies.

PWC International Transfer Pricing 2008

Market penetration payments involve a parent company injecting capital to introduce itself into the new market and compete for market share or market maintenance mechanisms where, because of competition, the firm may need to implement strategies that will enable it maintain its share in an existing market.

Financing long term capital needs can include mortgages, lease financing, capital stock, long term inter-company loans, equity to share holders, bonds or other financial market instruments.

2. Motivations for the manipulation of transfer pricing

Trade among MNC affiliates is so significant in the global economy, because of the vertical integration of their production processes. Motivation for the manipulation transfer pricing can be classified into four categories:

- managerial
- market
- government policy
- taxation.

A multinational company structure can be arranged to take advantage of the business environment in a jurisdiction. The decision to invest in a particular location is likely to be influenced by factors other than taxation, such as security, infrastructure, logistics, property protection, international schools for employees' children, quality of life and so on. Jurisdictions may put in place specific incentives to attract investment and indeed to encourage MNCs to repatriate profits to their country.

Cash flow issues within an MNC may motivate non-arm's length transfer pricing.¹⁵ For example, an MNC may supply goods and services to a newly established subsidiary at below normal cost. Transfer pricing also has implications for the distribution of ownership shares within joint ventures.¹⁶

Non-arm's length pricing may also be motivated by factors external to the MNC. For example, enterprises are subject to conflicting governmental pressures relating to customs valuations, anti-dumping duties, exchange or price controls, exchange rate risks, asset capitalisation policies, anti-monopoly charges and concerns about political and policy stability.

In addition to the business rationale for transfer pricing, there may be internal conflicts of interest which impact on internal pricing – for example, if a manager acts in his or her personal interest rather than in those of the shareholder, or if there is asymmetric information within the company. Such a situation has the potential to occur in any situation involving cooperative effort and may exist in all organisations, at every level of management.

Prices can be set in three ways: the headquarters sets the price, affiliates negotiate with the parent company or related entity and set the price, or the market price is taken as the price of the goods and services supplied within the group. Table 1 outlines some of the potential functions of subsidiaries within an MNC structure.

Table 1: Typical functions of related MNC subsidiaries¹⁷

Function	MNC subsidiary in low-tax jurisdiction	MNC subsidiary in high-tax jurisdiction
Loan	Loan provider	Interest payer since it is deductible from profit
Intellectual property rights	IPR holder	Royalty payer
Technical expertise	Technical expertise	Technical fee payer
Management services	Management services provider	Management fee payer
Brand	Brand holder	Licence fee payer
Repatriation of dividend		Retained earnings and refinancing

Cash	Holding high cash balance	Holding low cash balance
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Tax-motivated non-arm’s length transfer pricing

If an MNC makes use of a secrecy jurisdiction this may be motivated by tax rates and regulation.¹⁸ Reducing tax rates is attractive to corporations because it can boost shareholder value, post tax earnings and returns to shareholders. As company dividends and executive rewards are linked to reported earnings, individuals within a company may also have a personal motivation to limit effective tax rates.

Differentials in corporate tax rates can motivate MNCs to use transfer pricing to shift income from a high tax to a low tax jurisdiction. For example, jurisdictions can give tax credit for foreign tax paid by foreign subsidiaries when assessing global income. Some jurisdictions exempt MNCs from paying tax on foreign source income until the profits are remitted to the host country. Jurisdictions may put in place specific incentives to attract investment and to encourage MNCs to repatriate profits to their country. For example, in the 1990s the UK’s Advance Corporation Tax system meant that many MNCs had an effective tax rate of 11 per cent. MNCs therefore looked to bring profits through changing royalties for the use of a trademark located in the UK or charging subsidiaries for management services provided by the Head Office. The Inland Revenue at the time argued that MNCs should do this.

Table 2 provides some examples of non-arm’s length pricing which may be conducted when an MNC sells to an affiliate abroad.

Table 2: Motivation for transfer price manipulations when a parent company sells to an affiliate abroad.¹⁹

Motivation	Action by MNC
Corporate profits tax	Underpricing
Customs duties Imports Exports	Underpricing Underpricing
Repatriation of profits or capital	Overpricing
Exchange risks Claims in strong currency	Overpricing
Capitalising machinery	Overpricing
Support claims for price increase when government fixes prices	Overpricing
Responding to anti-monopoly charges	Underpricing
Responding to dumping charges	Overpricing
Mitigating claims for wage increases	Overpricing, to lower reported profits
Joint ventures	Overpricing
Supporting an infant foreign affiliate	Underpricing
Enlarging market share through penetration pricing	Underpricing, provided lower costs to foreign affiliates are reflected in lower prices to the consumer

Transfer pricing manipulation requires a strong level of coordination among subsidiaries, central decision-making, and a high level of expertise in pricing. It may, for example lead

to a low level of profitability in subsidiaries within high tax jurisdictions – which may lead to resentment of local staff.

As identified above, MNCs can use a range of instruments for tax minimisation. These instruments include costs incurred financial costs, technology transfer, costs of shared services, R&D costs, administrative costs, costs charged for the use of brands, and royalties for the use of intellectual property rights. Interest and dividend payments can also be structured to avoid paying taxes in any jurisdiction.

MNCs can reduce their tax obligations by using debt rather than equity finance (thin capitalisation), investing in assets that can be rapidly depreciated for tax purposes or for which tax credits are available, and avoiding dividends payments which incur tax when distributing wealth to investors.

3. A critique of the transfer pricing model

Proponents of the arm's length price argue that it is the most appropriate and efficient way of allocating profits between jurisdictions. However, as we have noted above, the practical implementation of this system present significant challenges.

Durst²⁰ and Avi-Yonah²¹ identify a range of theoretical and practical problems with its implementation. On a conceptual level, Durst argues that the entire system is based on the assumption that the tax results of multinational groups can be evaluated as if they were aggregations of unrelated independent companies transacting with each other at arm's length. This is problematic because commonly controlled multinational groups frequently exist precisely because there are some transactions that do not occur on an economically efficient basis between unrelated parties.

For example, the exploitation of intellectual property in the pharmaceutical industry is too complex to be accomplished by unaffiliated groups of companies transacting with one another independently. As a result, establishing an appropriate arm's length price is difficult.²² Secondly, in treating related entities as if they were unrelated, the arm's length principle respects the results of contracts between related entities that have no real economic effects.²³

Many MNCs go to considerable lengths to provide evidence to support their pricing. Often the results show a range rather than a single result and MNCs will want to place their pricing in the middle of that range. However, given the ambiguities present in the system, the MNC can restructure their business in a way that allocates risk and value to minimise tax liability. For example, valuable intellectual property can be transferred to low tax jurisdictions or subsidiaries in low tax jurisdictions can be designated 'entrepreneurs', meaning that these subsidiaries bear a disproportionate level of risk, thereby gaining the right to a disproportionate share of the income.²⁴

The issue of determining an appropriate arm's length price is hugely problematic when it comes to intangibles. It is a commercial reality, in that what drives the selling price in any market is likely to be the intangible aspects of the supply chain – innovation, brand recognition – rather than the tangible aspects such as where the product is manufactured or the raw materials sourced. The challenge with transfer pricing lies in questions such as how can intangibles such as brand recognition be valued within a particular market? And how can one identify a comparable product against which to value it? And if intangibles are transferred between jurisdictions, how should potential future value and risk be reflected?

On a practical level, Durst argues that a whole industry of accountants, lawyers and economists has built up around gathering evidence to ensure that different parts of a MNC which are, by definition, commonly controlled, act as if they are unrelated. Similarly,

tax authorities engage their own accountants, economists and lawyers to ensure that companies have complied with these regulations.

An exploration of the complexity of transfer pricing demonstrates the challenges which are faced by well-resourced revenue authorities in developed countries. In developing countries, the ability to engage in auditing of transfer pricing and to engage in transfer pricing disputes is severely limited or non-existent.

4. The challenges which transfer pricing poses to developing countries

In interviews for this paper, a transfer pricing expert from PricewaterhouseCoopers suggested that countries bringing in transfer pricing often follow a path: first putting the rules in place and then bringing in additional compliance requirements, such as documentation, and penalties for non compliance. Later they may move to include approaches such as advance pricing agreements.

Yet, while most low income countries are beginning or have not yet begun this process, they do face particular challenges.

These were identified in 2008 by the UN Committee of Experts on International Cooperation in Tax Matters, arguably the only truly multilateral forum in which developing countries can engage in international tax cooperation. The committee recognised the tension for developing countries, between 'enforcing their legitimate taxing rights while ensuring an open, transparent, investment-friendly and fair environment for investors. The skills and informational gaps in many developing countries exacerbate...these difficulties.'²⁵

The challenges can be defined broadly as the lack of effective transfer pricing legislation and the lack of capacity to implement legislation and monitor transfer pricing issues.

For one former revenue official and former employee of one of the Big Four accountancy firms in Mozambique, the challenges were clear:

'There is no adequate legislation governing transfer pricing in Mozambique – what exists is extremely short and weak. When there is a request for transfer pricing placed with the tax authorities, no body knows how to deal with the request,' he explained. 'It is, therefore, easy for multinationals to take advantage to exploit the weak capacity of tax authorities, and the lack of regulation governing transfer pricing.'²⁶

At the heart of the challenge facing tax administrators in developing countries is the lack of capacity to follow, implement and monitor transfer pricing mechanisms occurring within MNCs that operate in their jurisdictions.

Tax administrators in many developing countries lack the resources needed to monitor trade between related enterprises in a way that will let them know when things are going wrong. On the other hand, MNCs have the resources to carry out complicated global transactions and procedures which tax administrators in developing countries may find difficult to trace.

'There is no capacity – government audits just check invoices – there is no capacity for deep analysis of transfer pricing arrangements. It is almost impossible for them to find examples of transfer pricing abuse.'

Former revenue official and former employee of a Big Four accountancy firm in Mozambique

This point is corroborated by a senior revenue official from Sierra Leone. When asked about transfer pricing issues he said: 'No, we don't deal with that.'

This official spoke with pride of Sierra Leone's audit capacity which had increased from one auditor in 2003 to 18 in 2010.²⁷ This lies in stark contrast to the US IRS which reportedly recruited 1,200 additional staff in 2009 and planned to recruit a further 800 in 2010 to scrutinise transfer prices.²⁸

In addition, capable staff members are hard to keep. Frequently, when they are trained, they move to the lucrative private sector, to work for one of the Big Four accountancy firms for example.

In implementing transfer pricing rules, even when they are in place, the UN Committee of Experts on International Cooperation in Tax Matters recently highlighted the identification of comparables as a significant problem for developing countries: 'Lack of comparable data for calculating costs or resale prices of goods and services is a serious problem in many developing countries. Some developing countries used data extracted from developed country databases, such as from European and United States sources, but others took the view that that could be problematic, because the market conditions, including geographical or locational factors (such as "locational savings") would be so different. Customs data were generally obtained at a lower cost, but needed sophisticated analysis to assist in auditing taxpayers, and still remained only one part of a solution.'²⁹

The UN committee agreed to develop a manual for the practical implementation and monitoring of transfer pricing in developing countries. It was agreed that this manual would include the conceptual issues involved in transfer pricing, drafting effective legislation, setting up a transfer pricing unit, as well as advice on links with exchange of information with other revenue authorities, and the links between transfer pricing and customs valuation and thin capitalisation. It was agreed that the committee would also consider the use of safe harbours to use limited audit capacities more effectively.³⁰

One particular challenge when auditing companies relates to the relative profitability of an MNC and its particular functions in each location where it is incorporated. At present, listed companies report company accounts on a global consolidated basis as is required by International Financial Reporting Standards (IFRS).

Of course, well-resourced and politically powerful revenue authorities have the ability to obtain this information from MNCs. However, the fact that less well-resourced revenue authorities (likely to be in developing countries) do not have access to this information creates an asymmetry of power with both the taxpayer and revenue authorities in developed countries. Given the trend towards more aggressive transfer pricing in developed countries, this may impinge on the taxing rights of developing countries.

5. Solutions to the transfer pricing problem

Silberztein suggests that the arm's length principle can help developing countries achieve the goal of protecting their tax base while not hampering FDI.³¹ The rationale for following these internationally accepted principles is as follows:

- They provide countries with the tools they need to fight artificial profit shifting by MNCs.
- They provide MNCs with some certainty of treatment in the country concerned thus encouraging international trade and investment.
- They reduce the risk of economic double taxation, removing disincentives to trade and investment.
- They provide a level playing field between countries.
- They provide a level playing field between MNCs and independent enterprises doing businesses within a country.³²

Given the complexity and administrative burdens of transfer pricing, she suggests that the key to this implementation is to start modestly and build transfer pricing legislation and practices over several years. She suggests that developing countries should focus on the most common transactions and sectors in the first instance and keep compliance burdens to a minimum. Safe harbours can be used to simplify compliance for small taxpayers.

However, critics of transfer pricing would argue that the complexity of the system creates ample opportunities for arbitrage resulting in profit shifting between jurisdictions with differing tax rates and that this complexity, rather than providing a level playing field, advantages developed countries over developing countries, and MNCs over independent enterprises.

The OECD and the UN Committee of Experts on International Tax Matters have sought to address some of the problems posed by transfer pricing through developing new guidelines and manuals for revenue authorities seeking to design and implement tax policies for MNCs.

In particular, through the exploration of mutual agreement procedures between MNCs and revenue authorities, and advance pricing agreements (APA)³³ which allow taxpayers to agree an arm's length price for future transactions within a given period.³⁴

Clearly, addressing capacity problems in developing countries is a long term project. However, five recommendations seem pertinent.

Firstly, developing countries need auditors with expertise in transfer pricing to identify where the allocation of taxing rights is inappropriate.

Secondly, where disputes arise, developing countries need assistance in pursuing these disputes through the courts. Here transfer pricing legislation is essential. Such legislation needs to include information powers setting out what information and documentation is required from the MNC. However, legal assistance from transfer pricing lawyers would go some way in reducing the power asymmetry in taxing rights between developing countries, and taxpayers and developed countries. Some have suggested establishing a group of international tax lawyers who would be on hand to assist developing countries when required.

Thirdly, increased disclosure through country-by-country reporting of MNCs' activities would provide revenue authorities with some information with which to target their auditing resources to where the inappropriate allocation of profits is most likely.

Fourthly, regional cooperation between revenue authorities in identifying appropriate comparables would assist revenue authorities in making appropriate assessments of transfer prices.

Finally, effective tax information exchange between jurisdictions which includes developing countries is crucial in providing a tax authority with access to information regarding a company's operations in other jurisdictions.

However, while we believe these recommendations would strengthen the taxing rights of developing countries in relation to MNCs, questions remain as to whether the current transfer pricing system is appropriate for developing countries at each stage of their development. This leads us to consider potential alternatives and amendments to the current system.

The global formulary apportionment method (GFAM) allocates the global profits of a MNE group on a consolidated basis among the associated enterprises in different countries using a predetermined formula. The formula weights relative activity measures in each tax jurisdiction as follows: the proportion of a multiregional firm's income earned in a given state is expressed as a weighted average of the proportion of the firm's total sales, property and payroll in that state.³⁵

The OECD Transfer Pricing Guidelines for Multinational Enterprises identify numerous practical problems associated with the idea of using an inflexible predetermined formula as the basis of setting transfer prices. Proponents of the GFAM³⁶ argue that the challenges outlined by the OECD are similar to those that have plagued the use of the ALP.

It is true that, if countries chose to adopt different formulas, it could result in significant double taxation which would, in turn, inhibit investment. However, countries could develop hybrid formulas which could resolve disputes relatively quickly.³⁷

The most significant reason for this rejection, however, is a political one: that implementing such a global system will 'require substantial international coordination and consensus on the predetermined formula'.³⁸ Anything that touches national sovereignty and taxing rights and could result in a shift of tax base between countries is fiercely political and resisted.

Those not convinced of GFAM's merits argue that experience of it to date (including the EU's proposed Common Consolidated Corporate Tax Base) is not positive. First of all, a taxable profit still has to be calculated and there are many questions around how to do this, what rules are used, where it is done and whether all the countries concerned will accept the outcome. In terms of the formula for apportionment, there are also many difficulties – how should intangible assets be valued, what weighting should be given to the various aspects of the formula and so on.

Given the political intractability of such a solution, Avi-Yonah presents a proposal for reconciliation which involves the use of formulary apportionment in a way which is compatible with the arm's length principle.³⁹ He proposes that, using the OECD's Profit Split Method, comparables are used to allocate the return on routine functions. This usually leaves a residual which accounts for the value added as a result of a transaction taking place between related companies – often intellectual property. He suggests that in this context, a formula should be used to allocate profit between jurisdictions on the basis of payroll, tangible assets and sales.

Other amendments to the transfer pricing system which may be applicable to developing countries include the use of safe harbours for some activities, for example, a fixed profit margin for some activities carried out in a country. This approach has been successfully applied in Brazil.

Advance pricing agreements (APA) are an area of growing interest, allowing a tax authority to review a company's transfer pricing in advance and give a ruling. This would provide some certainty to both sides and avoid the necessity for a potentially costly audit. Developed country tax authorities could help their colleagues in the developing world to negotiate these, or even an APA agreed by an MNC with a developed tax authority could also be relied on by a developing tax authority, provided the transfer pricing is consistent.

Finally, a change in behaviour, both among companies and tax authorities is crucial. MNCs and tax authorities should acknowledge that international taxation is an uneven playing field and should consider their behaviour in light of this. Internationally recognised guidelines and principles on dealing with developing country tax administrations may be helpful in this regard.

6. Conclusion

Trade liberalisation, globalisation and the growth of MNCs in global trade has contributed to the erosion of taxing rights in developing countries. This is perhaps most stark in the area of transfer pricing. The complexity of transfer pricing audits, particularly in relation to finance, cost sharing and intangibles poses a significant problem for developing countries. Questions are raised regarding the practical application of the transfer pricing model.

In particular, two challenges are identified for developing countries – the absence of transfer pricing legislation, and the limited capacity of revenue administrations to conduct transfer pricing audits.

As a result we propose two sets of reforms:

Firstly, to ameliorate the information and power asymmetries, we suggest the creation of increased technical capacity and expertise through specialist transfer pricing units. An international disclosure standard for listed companies on country by country reporting would address some of the information asymmetries.

However, given the problems with applying transfer pricing on a conceptual and practical level, questions are raised with regard to the application of the transfer pricing system in developing countries. In the long term, we suggest that developing countries should be provided with resources, technical assistance and policy space to design systems which are appropriate to their stage of development.

Appendix One: Methodologies for calculating an arm's length price

The Comparable Uncontrolled Price (CUP) Method is a preferred method of applying the ALP. This compares the price of property or service transferred in a controlled transaction to the prices of property or services transferred in a comparable uncontrolled transaction in comparable circumstances.⁴⁰ Any difference in the prices may indicate that the transaction was not carried out at arm's length and the price of the uncontrolled transaction will be substituted for the former. The relative reliability of this method relies of the degree of accuracy that adjustments are made for similar but not same transactions.

The Resale Price Method begins with the price at which a product or service has been purchased from an associated enterprise is re-sold to an independent enterprise. This price (the resale price) is then reduced by an appropriate gross margin (the resale price margin) representing the amount out of which the reseller would seek to cover its selling and other operating expenses and in the light of the functions performed (taking into account assets used and risks assumed), make an appropriate profit.

This resale price may be determined either by determining the resale price margin that the same reseller earns on comparable items purchased and sold under uncontrolled conditions or by calculating the retail price margin earned by an independent entity in an uncontrolled transaction. The price or a resale could be higher depending on how much of the transaction and how much risk the reseller takes and whether there is the maintenance of an intangible property associated with the sale. This needs to be supported by documentary evidence.

The Cost Plus Method begins with the costs incurred by the supplier of property or services in a controlled transaction for property transferred or services provided to a related purchaser. An appropriate cost plus mark up is then added to make an appropriate benefit in light of the functions performed and the market conditions. What is

arrived at may be regarded as an arm's length price of the original controlled transaction. This method is mostly used to calculate the prices of semi-finished goods sold between related companies, for joint facility agreements, for long term buy and supply agreements, or for the provision of services.⁴¹

Because enterprises may cover their costs over a period of time, which may or may not be recoverable, the determination of costs is problematic. Thus it is not always easy to find a discernable link between the level of costs incurred and a market price, for example, when an owner incurred only a small research cost in making a valuable discovery.⁴²

In exceptional circumstances when the taxpayer is not cooperative or when there is insufficient evidence to verify a transfer price, the OECD has developed guidelines for additional methodologies for calculating an ALP.

The Transactional Profit Method examines the profits that arise from particular controlled transactions. These are either the profit split or the transactional net margin method.

The Profit Split Method is used when the trade between interrelated entities cannot be evaluated on an individual basis. Individual enterprises might decide to form partnerships and agree to split their profits. Thus the profit split method seeks to eliminate the effect of profits on special considerations made or imposed on a controlled transaction.

The strength of this method is that the allocation of profits is based on division of functions between the associated entities and not on comparing with independent similar transactions. Secondly, this method can be used to achieve a division of profits that is based on joint efficiencies in a way that satisfies both the taxpayer and the tax administrator.

The Transactional Net Margin Method (also called the Comparable Profits Method), examines the net profit margin relative to an appropriate base (for example, cost, sales, assets), that a taxpayer realises from a controlled transaction. This method is therefore similar to the cost plus and resale price methods and should be applied consistent with the manner in which these methods would be applied. To make this possible, the net margin of the taxpayer from the controlled transaction should be established by reference to the net margin of the same tax payer in an uncontrolled transaction.

The advantage of using this method is that net margins are less affected by transactional differences than is the case with prices as in the CUP. Also, it is not necessary to obtain all the transactional information of both entities. However the greatest weakness of this method is that many factors have an effect on the net margin of a taxpayer and these may make it difficult to determine the ALP.

¹ D Lesage, D McNair, and M Vermeiren, 'From Monterrey to Doha: Taxation and Financing for Development', *Development Policy Review*, 28 (2), pp155-172, 2010.

² Monterrey Consensus on Financing for Development, United Nations, 2003.

³ UNCTAD, World Investment Report: Transnational Corporations, Extractive Industries and Development, 2007.

⁴ J Neighbour, 'Transfer pricing: Keeping it at arm's length', *OECD Observer*, 2002, www.oecdobserver.org/news/fullstory.php/aid/670/Transfer_p An interview with a transfer pricing expert from one of the Big Four accounting firms suggested the figure to be 70 per cent and growing.

⁵ UNCTAD, *Transfer Pricing*, UNCTAD series on issues in international investment agreements, 1999, www.unctad.org/en/docs/psiteitd11v1.en.pdf

⁶ C Mortished, 'GSK settles largest tax dispute in history for \$3.1bn' *The Times*, 12 September 2006, www.timesonline.co.uk/tol/life_and_style/health/article635994.ece

⁷ PricewaterhouseCoopers suggests that 'paying tax has already started to develop as a corporate responsibility issue' and recommends that companies think about how tax fits into their CSR strategy. T Scheiwiller and S Symons, 'Corporate responsibility and paying tax', *OECD Observer*,

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- 2010,
www.oecdobserver.org/news/fullstory.php/aid/3132/Corporate_responsibility_and_paying_tax.html
- ⁸ This information was gleaned from informal interviews with senior tax officials from large MNCs and transfer pricing specialists from the Big Four accountancy firms. The USA, Canada, Australia, Japan, UK, France and some of the Latin American countries are recognised as among the most aggressive in this area.
- ⁹ C Silbertztein, 'Transfer pricing – A challenge for developing countries', *OECD Observer*, 2010, www.oecdobserver.org/news/fullstory.php/aid/3131/Transfer_pricing:_A_challenge_for_developing_countries.html
- It should be noted that non-arm's length transfer pricing may be motivated by factors other than tax, but there is likely to be a tax consequence, whatever the motivation.
- ¹⁰ The ALP was first established by the League of Nations' 1933 Draft Convention on the Allocation of Business Profits between States. The Fiscal Committee of the OEEC (predecessor to the OECD) drafted articles 5,7 and 9 of the 1963 Draft convention. The wording of article 9 (1) which sets out the ALP is still the same.
- ¹¹ The OECD provides guidelines on transfer pricing, which form the basis for legal treaties – and therefore become law in many countries. In 1995 only a handful of countries had adopted the ALP; by 2005 this grew to over 40 and this has grown since to include OECD and non-OECD countries – notably Argentina, China, India, Russia, Singapore and South Africa.
- ¹² OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2001.
- ¹³ PricewaterhouseCoopers, *International Transfer Pricing*, 2008.
- ¹⁴ Intangible property includes goodwill, patents, brands, trademarks, intellectual properties, licences, publishing rights, and the rights to provide services.
- ¹⁵ OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2009.
- ¹⁶ Y Al-Saadon and S Das, 'Host country policy, transfer pricing and ownership distribution in international joint ventures: A theoretical analysis', *International Journal of Industrial Organization* 14, pp345-364, 1996.
- ¹⁷ G Bhat, *Transfer pricing, tax havens and global governance*, Discussion Paper, Bonn: Deutsches Institut für Entwicklungspolitik, 2009.
- ¹⁸ There is evidence for tax motivated transfer pricing in pricing of commodities (Clausing 2003, Demircuc and Huizunga 1998). Bernard, Jensen and Schott (2006) found that prices for intra-firm transactions of US MNCs are significantly lower than prices for the same goods sent to an arm's length customer or non-affiliate. Using point of export customs documents between 1993 and 2000, Bernard et al examined and compared intra-company sales to arms length sales using the same products, exported to the same country in the same month using the same mode for transport. They found that transactions with arm's length customers were on average 43 per cent higher than intra-company trades. The difference between arm's length and intra-company trades were found to be negatively associated with destination country corporate tax rates and positively associated with destination country import tariffs – to the extent that for a percentage point reduction in the corporate tax rate, a 0.56-0.66 price difference was observed.
- ¹⁹ S Plasschaert, *Transfer Pricing and Taxation*, United Nations Library on Transnational Corporations, Vol 14, New York: Routledge, 1994.
- ²⁰ M Durst, 'It's not just academic: the OECD should reevaluate transfer pricing laws', *Tax Notes International*, 18 January, 2010, pp 247-256.
- ²¹ RS Avi-Yonah, *Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation*, University of Michigan Law School, The John M Olin Center for Law and Economics Working Paper Series, 2009.
- ²² See note 20.
- ²³ Ibid. Whether such contracts are respected depends on whether they are comparable to contracts that would be agreed between unrelated parties. Because the activities of unrelated parties are systemically different, it is difficult to enforce such a standard.
- ²⁴ Ibid.
- ²⁵ Committee of Experts on International Cooperation in Tax Matters, Fifth session, Geneva, 19-23 October 2009, Discussion of substantive issues related to international cooperation in tax matters: transfer pricing, including a manual and checklist for developing countries. E/C.18/2009/5
- ²⁶ Interview with former revenue official and employee of KPMG in Mozambique.
- ²⁷ Christian Aid interview with a senior tax official from the Sierra Leonean Revenue Authority.
- ²⁸ A Stuart, 'Transfer pricing: a world of pain', *CFO*, 1 September 2009, www.cfo.com/article.cfm/14292573
- ²⁹ Committee of Experts on International Cooperation in Tax Matters, Fifth session, Geneva, 19-23 October 2009, 'Discussion of substantive issues related to international cooperation in tax matters: transfer pricing, including a manual and checklist for developing countries', www.un.org/esa/ffd/tax/fifthsession/index.htm
- ³⁰ 'A safe harbour may be defined as an objective standard or measure, such as a range, percentage, or absolute amount, which can be relied on by a taxpayer as an alternative to a rule based on more subjective or judgmental factors or uncertain facts and circumstances. A safe harbour cannot

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- normally be used to the disadvantage of a taxpayer', *IBFD International Tax Glossary*.
- ³¹ See note 9.
- ³² OECD, 'Annex 6: Transfer Pricing and Developing Countries', in *Domestic Resource Mobilisation for Development: the Taxation Challenge*, OECD Global Forum on Development issues paper, www.oecd.org/dataoecd/23/62/44465017.pdf
- ³³ An advance pricing agreement is signed between the taxpayer and the competent tax authority. It constitutes an agreement that a future transaction will be conducted at the agreed-upon price, which is recognised as the arm's length price for the period designated. Although retroactive APAs can be used to reduce tax exposure in past years, APAs are primarily used to avoid the risk of future income assessment adjustments, thus reducing risk for both the tax administration and the tax authority.
- ³⁴ APAs permit corporations and domestic and foreign tax authorities to agree transfer pricing methods in advance of filing a tax return and thus avoiding considerable uncertainties and possible lawsuits. However, available evidence from 2001 suggests that relatively few agreements were entered. Evidence from interviews with transfer pricing specialists suggests that these are viewed with suspicion from MNCs who do not want to disclose sensitive information to tax administrations.
- ³⁵ See note 17.
- ³⁶ See note 20.
- ³⁷ S Neilsen, P Raimondos-Møller and G Schjelderup, *Tax spillovers under separate accounting and formula apportionment*, London: Centre for Economic Policy and Research, discussion paper, 2001 www.cepr.org/pubs/dps/DP2831.asp
- ³⁸ See note 15.
- ³⁹ Avi-Yonah argues that formulary apportionment is compatible under article of the OECD model treaty, assuming that in most cases subsidiaries are dependent agent permanent establishments. RS Avi-Yonah and KA Clausen, 'Business Profits', in M Lang et al, editors, *Source Versus Residence: Problems Arising from the Allocation of Taxing Rights in Tax Treaty Law and Possible Alternatives*, Wolters Kluwer, 2008.
- ⁴⁰ For example, the sale of Columbian coffee of similar type, quality and quantity sold between two associated enterprises compared to same transaction at the same stage in the production/distribution chain at under the same circumstances.
- ⁴¹ The US Cost Plus Method is arguably the most manipulable of the transfer pricing methodologies. Avi-Yonah reports that an informed economist working for a major accounting firm told him that he could achieve any result the client wanted using CPM.
- ⁴² Using these above methodologies, one of two conditions should be met. (i) None of the differences, if any, between the transactions being compared or between the enterprises undertaking those transactions could materially affect the price (when using CUP), resale price (when using resale price) or cost price mark-up (when using CPM) in the open market. (ii) Reasonably accurate adjustments can be made to eliminate the material effects of such differences.

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