Transfer Pricing Laws

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Tight government budgets and media reports on the international tax avoidance activities of Google, Apple, Amazon and other big multinational enterprises (MNEs) have reinforced public debates about the principles and regulations that govern the international tax system (see, for example, Reuters 2013).

The main challenge of taxing MNEs is to align the geographic distribution of economic and tax income. The long-standing international approach to addressing this problem relies on separate accounting (SA) regulations[2] and provisions which require intra-firm transfer prices (TP) to be set according to the arm's length principle (ALP) and thus to correspond to prices that would have been contracted between unrelated parties.

The Achilles' heel of the approach is that arm's length prices are often difficult to observe in practice, and MNEs thus have some leeway in choosing intra-firm prices such that income is relocated from high-tax to low-tax entities (Janeba 1996, Haufler and Schjelderup 2000). Empirical papers support the notion that MNEs systematically transfer income to low-tax locations by distorting intra-firm prices (Dharmapala 2014, Heckemeyer and Overesch 2013). The seminal work by Clausing (2003) reports that prices for US intra-firm trade decrease by 1.8 to 2.0 percent relative to non-intra-firm transactions if the tax rate in the host country of a delivering subsidiary rises by one percentage point. Her findings have been confirmed in Bernard et al. (2006), Cristea et al. (2013) and Davies et al. (2014).

To limit the outflow of MNEs' profits from their borders, many countries have augmented their tax law by transfer pricing legislations. While the scope and strictness of these legislations differ across countries, most rules (partly) follow the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, which have been provided and updated by the OECD over several decades.

The guidelines allow for five methods to determine whether prices for intra-firm transactions are in line with the ALP. There are three traditional transaction methods, namely the comparable uncontrolled price method (CUPM), the resale price method (RPM) and the cost plus method (CPM), which compare intra-firm transactions with prices or gross margins agreed by independent parties. The guidelines furthermore refer to two transactional profit methods: the transactional net margin method (TNMM) and the transaction-based profit split method (TPSM), which compare the profit of related parties to the profit earned by comparable uncontrolled parties. While the OECD had long given preference to transaction methods over transactional profit methods, this pecking order was removed in the 2010 revision of the TP guidelines. The "heart of the application" (OECD 2010, 33) of the ALP is thus to find comparable transactions between uncontrolled parties. The OECD identifies five factors that determine comparability: the characteristics of the property or service transferred, the functions performed by the parties, the contractual terms, the economic circumstances and the business strategies pursued by the parties.

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Implementing comparability analyses is often difficult in practice though (Durst and Culbertson 2003, Vidal 2009, Luckhaupt et al. 2012). In many modern MNEs it is far from straightforward to trace back core functions to certain locations as value drivers, risk taking and entrepreneurial functions may be spread across entities in different tax jurisdictions. Several core assets, like IP

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[2] SA prescribes taxable income to be determined separately for each group affiliate.

and trademarks, are furthermore firm-specific in nature, and hence difficult to be compensated at arm's length. This creates considerable discretion in the pricing of intra-firm transactions and endows MNEs with opportunities to shift profits to low-tax jurisdictions.

To limit the scope for such mispricing behavior, more and more countries have augmented their TP regulations by provisions that require MNEs to produce contemporaneous transfer price documentation (Zinn et al. 2014). While TP documentation increases transparency in corporate price setting behavior and eases TP audits for tax authorities, it also puts a high compliance and administrative burden on firms. A survey among European MNEs indicates that TP documentation significantly raises tax compliance costs (European Communities 2004).[3] Anecdotal evidence moreover points to strict TP auditing of tax authorities in many countries. A recent survey among German inbound investors e.g. indicates that tax auditors challenged arm's length pricing in 75 percent of all tax audits (Deloitte 2010).[4]

Whether TP regulations are instrumental in limiting income-shifting behavior remains an empirical question. Systematic evidence is still scarce. A recent exception is Beuselick et al. (2009) who, based on data for European subsidiaries, present evidence which suggests that tax-motivated income-shifting is confined to cases where TP regulations are weakly enforced. The effectiveness of TP documentation rules and TP penalties in limiting shifting behavior is confirmed in Lohse and Riedel (2012), Saunders-Scott (2013) and Beer and Loeprick (2014). The latter study, however, also indicates that TP regulations hardly limit price distortions related to trade in intangible property, consistent with the lack of comparables for these transactions.[5]

One main element of the OECD's recent action plan against base erosion and profit shifting (BEPS) is thus to revise the application of the ALP for transfers of intangibles and other mobile assets (OECD 2013). Intertwined with this issue are group structures, where over-capitalized entities in low-tax countries obtain high returns because they have contractually assumed risks or provided capital in situations that would be unlikely to occur between unrelated parties.[6] New regulations may include tests whether group affiliates that contractually assume risk can financially bear and control that risk, the general strengthening of economic substance considerations over pure contractual arrangements[7], the endowment of tax authorities with the right to adjust prices for hard-to-value IP based on actual results, as enacted in Germany's law on the "transfer of functions" (*Funktionsverlagerung*), and the implementation of country-by-country reporting.[8]

The action plan furthermore aims to establish more efficient mutual agreement procedures (MAP) in case of transfer pricing disputes between authorities. Most importantly, double taxation treaties should be complemented by arbitration provisions, as under most of the current treaties tax authorities do not have to agree on a common price, which exposes tax payers to double taxation risk. Notable exceptions are the arbitration provisions in the European Union and the German-US double taxation treaty (Kroppen et al. 2012).[9]

Critics of the OECD's BEPS initiative, however, claim that incremental reforms within the SA system may not help to abolish income shifting to low-tax entities and do not remove the "absurdly" (Avi-Yonah 2010) high and "stupefying" (Taylor 2005) complexity of the arm's length system and the associated compliance costs for MNEs. They argue that the only credible long-term solution is "the defenestration of the arm's length

[3] Survey evidence suggests that tax compliance costs increase sharply when firms establish or increase foreign operations (Blumenthal and Slemrod 1995, Slemrod and Venkatesh 2002). Saunders-Scott (2013) furthermore shows that TP risk is associated with significant compliance costs for multinational groups. In particular, using micro data on MNEs, she finds that TP regulations reduce the reported earnings of the average multinational firm by a significant 1.5 percent.

[4] This exposes firms to significant tax risks and helps to explain why around 40 percent of tax managers in MNEs consider TP to be the most important tax issue for their group (Ernst and Young 2007). Constructing a survey-based indicator on the strictness of TP regimes, which among others accounts for the strictness of TP enforcement, Mescall and Klassen (2014) report rules to be particularly strict in Brazil, Canada, France, Germany, South Africa, the United Kingdom and the US.

[5] In line with these findings, several papers report indirect evidence that shifting opportunities are particularly large if groups have intangible property holdings (Grubert 2003, Dischinger and Riedel 2011).

[6] A common structure to transfer IP income to low-tax affiliates is to set up contractual arrangements where affiliates in low-tax countries finance research and development (R&D) activity undertaken at high-tax locations. The R&D unit in the high-tax country earns a fixed margin on its costs, while all residual income accrues with the financing entity in the low-tax country.

[7] One option might be to define specific cases where capital providers at low-tax locations are reclassified and treated as lenders rather than equity investors.

[8] Proponents of country-by-country reporting hope that requiring MNEs to report taxes payed and accrued, pre-tax profits and indicators for value-creating activity to tax authorities on a country-by-country basis allows for a better 'high-level' risk assessment and an improved allocation of auditing activity of tax authority ressources. While adminstrative ressources are scare in all countries, this holds true especially for developing economies, which have been reported to be particularly prone to income shifting behavior (Fuest et al. 2011).

[9] Given the lack of arbitration provisions, the elimination of the pecking order in TP methods additionally increases double taxation risk as authorities may now follow different TP methods. To reduce compliance costs, academics and practitionners have called for a more extensive application of safe-harbor-provisions and a more efficient implementation of advanced pricing agreements (APAs) (Kroppen et al. 2012). See Becker et al. (2014) for a recent contribution, which rationalizes APAs as an instrument to mitigate a hold-up-problem.

standard and its replacement with formulary apportionment [(FA)] methods" (Sullivan 2010), which consolidate income at the group level and apportion it to group affiliates based on fixed allocation keys designed to proxy for economic activity (commonly a combination of firm assets, payroll and sales). FA systems have been applied to subnational taxation in the US, Canada, Germany and Switzerland. In 2001, the European Commission proposed to implement an FA system within the European Union (European Commission 2001).

The major strength of FA is that income consolidation at the group level abolishes profit shifting incentives and FA thus overcomes the practical problems of finding comparable uncontrolled transactions when applying the ALP. Proponents of FA furthermore stress that it rids the international tax system of the various conceptual shortcomings of the ALP, most importantly of the "fiction" (Wilkie 2012) that different parts of a multinational group can be treated as if they were stand-alone entities. Firms, on the contrary, decide to form a multinational group in order to avoid costs and limitations, implying that rents are generated that are unique to the MNE. The ALP is not a helpful concept in subdividing this additional value (Wilkie 2012). Bauer and Langenmayr (2013), moreover, show that even a correct application of the ALP under SA may imply profit shifting and lower taxes for MNEs. In particular, as MNEs are more productive than stand-alone firms and have a better bargaining position vis-a-vis their suppliers than firms that obtain the input from an external source, they can receive inputs at significantly lower prices. The prices of uncontrolled transactions hence systematically exceed the marginal cost of input production within MNEs, which opens up shifting opportunities, even with a correct application of the ALP.[10]

Addressing income shifting under SA through a switch to FA rather than the implementation of TP laws may also be beneficial as transfer prices also serve a number of internal management functions like incentivizing local managers and acting as an instrument for the strategic delegation of decision-making under asymmetric information (Hirshleifer 1956, Holmstrom and Tirole 1991, Nielsen and Raimondos-Møller 2012). If firms also manipulate transfer prices under SA in order to minimize their tax burden, they face a trade-off in the choice of their optimal transfer pricing, which impairs efficiency (Elitzur and Mintz 1996, Smith 2002, Baldenius et al. 2004, Hyde and Choe 2006).[11] In addition, Devereux and Keuschnigg (2013) stress that profit shifting through manipulated transfer prices might be welfare-enhancing as it may help to reduce the financial frictions of group affiliates. If transfer price regulations effectively constrain transfer price distortions under SA, external funding and investment levels in foreign affiliates are reduced, which may trigger global welfare losses. Harris and Sansing (1998) and Sansing (1999) finally point out that the ALP may distort vertical integration decisions and thus harm production efficiency.

While these criticisms of the SA system and the ALP are certainly well taken, FA comes with its own problems. The OECD opposes the "mechanistic" nature of FA and stresses that it triggers incentives for MNEs to distort the location of the factors included in the formula towards low-tax jurisdictions (See Pethig and Wagener (2007) and Eichner and Runkel (2008) for theoretical contributions stressing factor distortions and Riedel (2010) for empirical evidence).[12] A move towards FA may hence just replace one set of inefficiencies (transfer price distortions and profit shifting) with another (distortions of apportionment factors). As shifting paper profits is, however, plausibly easier than reallocating real production or sales, inefficiencies are likely larger under SA (Runkel 2012, Luckhaupt et al. 2012). Mintz and Smart (2004) provide empirical evidence in line with this notion by showing that under the provincial corporate tax in Canada the profitability of firms subject to SA reacts more sensitively to tax changes than the profitability of firms taxed under FA.[13]

Nevertheless, it appears unlikely that political consensus for a global or regional switch to FA will be achieved in the near future. A pragmatic reform within the existing framework of the arm's length regulations by strengthening the profit split method, which shares similarities with FA rules. Nevertheless, it appears unlikely that

[10] Put differently, the ALP supposes that two identical firms, in practice, may make diverging decisions on whether to form an MNE or not. This is highly unlikely. On the contrary, given the economic reasons for internal coordination, all firms facing the same circumstances will make the same organizational choice.

[11] This tension could be eliminated by using a two-book system with two sets of prices for management and tax purposes. This comes with significant administrative costs though and may signal a "bookkeeping" game, which would neither be acceptable to local managers nor to tax authorities (Luckhaupt et al. 2012). Survey evidence thus suggests a striking prevalence of one-book systems, see Ernst & Young (2003).

[12] The introduction of FA also distorts investment through a tax base effect, i.e. an increase in one country's tax rate raises the average tax rate and gives multinationals the incentive to reduce their overall investment.

[13] The investment effects of profit shifting activities under SA are complex and depend on the shape of the firm's concealment cost function (see e.g. Nielsen et al. (2010) and Nielsen et al. (2014)). The little empirical evidence available on TP legislations and MNEs' investment behavior does not find a stable negative relationship (see Büttner et al. (2014)). Mescall and Klassen (2014), in turn, report that transfer pricing laws affect the premium rates in cross-border mergers and acquisitions.

political consensus for a global or regional switch to FA will be achieved in the near future. Several authors thus argue in favor of opting for a pragmatic reform within the existing framework of the arm's length regulations by strengthening the profit split method, which shares similarities with FA rules.

More specifically, profit splits allocate income from controlled transactions in two stages. In the first stage, each participant is compensated for its routine non-unique activities, whose price is determined on the basis of uncontrolled comparables using CUPM, RPM, CPM or TNMM. In the second stage, the residual profit is split based on how unrelated parties (would have) split the residual profit in the given situation and thus makes it possible to allocate profit, even if sufficiently comparable third party data for the specific transaction is unavailable. The share of residual profits received by each participant corresponds to its contribution to the transaction, which is approximated using one or more transaction-specific allocation factors (OECD 2010).

The conceptual difference between transactional profit splits and FA thus boils down to a case-specific apportionment formula in the former and a pre-determined formula in the latter case. In recent years, several authors suggested to move to a more 'formulary' residual profit split, see e.g. Avi-Yonah et al. (2009) and Luckhaupt et al. (2012).[14] While fixed factor apportionment is, to some extent, arbitrary and may override specifics of the value contributing factors in a given transaction, it comes with the benefit of removing discretionary power in MNEs' TP choices and thus helps to eliminate opportunities to relocate income to low-tax entities.[15] This especially holds true if the apportionment formula assigns a high weight to destination-based sales as firms lack vast discretionary powers over sales locations (Luckhaupt et al. 2012). Liberally interpreted, the ALP as currently defined in the OECD guidelines is also capable of encompassing FA, implying that such a reform could be implemented without major changes to the current system (Avi-Yonah et al. 2009, Avi-Yonah 2010, and Li 2002, 2003, 2012).

[14] The reduced complexity and discretion may also lower tax payer compliance costs (although we are not aware of studies that estimate compliance costs under FA). In response to concerns that FA assigns profit to group locations on an arbitrary basis, it has been pointed out that in the absence of comparables, any profit allocation is, in the end, arbitrary; and that the allocation factors under FA reflect the economic reality of multinational groups (Avi-Yonah 2010).

[15] Underpinning this point, a recent paper by Blouin et al. (2014), in the context of thin-capitalization rules, suggests that anti-shifting provisions are significantly more effective in limiting MNEs' shifting behavior if discretionary components are removed from the legislations.

In conclusion, this article briefly sketched the characteristics and shortcomings of current transfer pricing laws, and of the reform options discussed in the course of the OECD's current BEPS initiative. In general, it should be kept in mind that incentives for income shifting and price distortions relate to international tax rate differentials. The most direct – and from the compliance and enforcement perspective most cost-efficient – path to removing these incentives is thus to renew previous efforts to move towards a more harmonized corporate tax rate setting in the European Union (e.g. by considering the implementation of a minimum corporate tax rate or more comprehensive provisions against harmful tax practices).

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