Transfer Pricing Is a Financing for Development Issue

JOMO KWAME SUNDARAM
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- Transfer pricing refers to the pricing arrangements for transactions between companies that are members of a corporate multinational enterprise. If the method used to determine the fair tax owed to a country by a multinational doesn't reflect the true profits earned in that country, the country is unfairly deprived of revenue.

- Transfer pricing is regarded as a Financing for Development issue because – without its due tax revenues – a country's ability to mobilize domestic resources for development is hampered.

- Transfer pricing – because of the extreme complexity of its concepts and the resource-intensive nature of their practical application – tests the caliber of international co-operation on tax matters because it is the area of international taxation in which developing countries, especially those with weak or small administrations, are especially disadvantaged by a lack of capacity and resources.

- The United Nations is increasingly seen as the most impartial, responsible, representative and legitimate body in which to advance discussions and agreements on transfer pricing with a long-term view to development that includes both fair returns to countries and a favourable climate to investment.

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1. Introduction

In the last few years, the question of what constitutes equitable taxation has gained a very high profile domestically and internationally. One key aspect is the issue of what level of taxation of investment represents the appropriate balance between recognising an economic footprint or engagement in the taxing country that justifies a contribution to the revenue, on the one hand, and acknowledging that taxing such investments too highly might deter them, meaning they are not made at all, on the other.

Each country makes its own sovereign decisions on such matters, of course. But there is increasing acceptance that governments need to work together more often and more deeply to ensure that such sovereign decisions are respected, thus lending support to the development of a country and its ability to gain fiscal and policy space. How countries cooperate to ensure appropriate taxation behaviours by the multinationals of one country in relation to another country is therefore a test of just how sincere this age of apparently greater international cooperation really is.

The subset of »transfer pricing« cases will be especially important in this context. In referring to transfer pricing, we are talking about the pricing arrangements for transactions between related parties – such as among companies that are members of a corporate or Multinational Enterprise (MNE) group. These arrangements can relate to prices for goods, services, loans or use of property.

Transfer prices are inherently part of the way in which MNEs operate. This is because MNEs need to assess which parts of the group are profitable or not. By itself, the term »transfer pricing« refers strictly to this process of allocating values to transactions, without necessarily implying any tax evasion or avoidance.

There is, however, a risk that the prices declared by the MNE will, either deliberately or not, fail to reflect its real economic engagement in a country. In other words, there is a »transfer mis-pricing«. One result of mis-pricing (whether it constitutes tax avoidance or evasion) is that less income (or more expenses) might be reported in a country where in fact more income (or fewer expenses) should have been reported. If this remains unchallenged, it affects the taxable profits of the group member in that country and therefore the taxes paid to that government, which would otherwise be available for development. Ultimately, it is the people of that country who bear the cost of any shortfall in taxation due to mis-pricing. Provision of food, water, energy, healthcare and education may, therefore, be particularly hard hit by mis-pricing.

The reason why transfer pricing represents such a test of international cooperation on tax matters is because, in many respects, developing countries, especially those with weak or small administrations, are especially disadvantaged by a variety of factors:

- the complexity of transfer pricing concepts and their practical application;
- the »fuzziness« of some of the concepts involved;
- the frequent lack of data needed to evaluate the correctness of the profit allocation (and the cost of access to relevant data);
- the resource-hungry nature and long time-frame of transfer pricing cases, in terms of person-hours and costs; and
- the very large sums often involved.

2. Some General Challenges

A key transfer pricing challenge for both developing and developed countries is how to identify, for tax purposes, a fair price for intra-group transactions. This has to be done bearing in mind the real economic engagement of the multinational in a particular country, and therefore, the extent to which profits are truly being made there or elsewhere. If the transfer pricing does not reflect the true profits earned in that country, the country is unfairly deprived of revenue. This is, to use the language of the Financing for Development (FfD) process,[1] the »*domestic resource mobilisation*« aspect of transfer pricing.

But that is not the only challenge. There is also a need to have internationally accepted »norms« in this area that are fair to countries involved in the transaction generally, and also to taxpayers. There is a risk that if one country adjusts the pricing of a transaction within a group so

1. As addressed in the »Monterrey Consensus« Report of the International Conference on Financing for Development, Monterrey, Mexico, 18–22 March 2002 (United Nations publication, Sales No. E.02.II.A.7). See also the follow-up 2008 Doha Declaration on Financing for Development; General Assembly resolution 63/239.

as to increase profits made and taxable in that country, another country will not decrease its calculation of the profits made (and tax payable) in that country by making an adjustment.

In that case, some part of the profits may be taxed twice, with a possible discouragement or deterrence of investment that can itself hinder development. In FfD terms, this is an aspect of *mobilising foreign direct investment*, as a private flow, in support of development.

There is a further aspect, which in FfD terms, is referred to as a »*systemic issue*« and involves what could be termed »the rules of the game« for transfer pricing. Whether one agrees with them, or disagrees, current approaches to transfer pricing were elaborated by developed countries and premised on an access to technical resources – including skills, knowledge and data – that are beyond the reach of many developing countries. In the future, indeed, in the present, more attention needs to be paid to the role of developing countries as »norm makers«, rather than as just »norm takers«. Transfer pricing is an area where this issue arises with particular cogency.

Another related issue is whether the home countries of MNEs need to make greater efforts in ensuring that the taxation behaviours of their residents, the MNEs, support development in other countries rather than acting as a brake on it. This is indeed a complex issue, but one that deserves greater discussion in an increasingly globalised world.

3. Particular Areas of Controversy

There are particular issues and controversies in the area of transfer pricing that – when examined in light of the FfD-focused approach to international tax cooperation – reveal opportunities for international cooperation on these issues and also illuminate the potential role of the United Nations and other multilateral organisations in that process.

3.1 The arm's length approach versus global formulary apportionment

The tax treaties and domestic rules of countries seeking to address transfer pricing issues almost always reflect the approach that pricing of internal transactions within a multinational should be done on basis of the »arm's length principle«. This means comparing the transaction between the two related parties to one that occurred on market terms between companies that have no special relationship with each other (i. e., that are unrelated and operate at »arm's length«).

The difficulties begin when this is put into practice, especially since many MNE transactions do not have direct market equivalents. This can be because they involve intangibles (such as intellectual property rights) that have a unique, but difficult-to-determine value, or because they involve »set-off«[2] arrangements that would not occur between unrelated companies, or because they involve the sharing of costs that would only ever be shared within a related group.

Critics assert that this is a fatal flaw in the arm's length approach; that hypothesising an arm's length relationship is the antithesis of the synergistic relationship between different parts of an MNE and of the ways in which MNEs use their integrated, non-arm's length nature to unlock value from their transactions. Those who take that view often argue that a different approach is required, based less on hypothesising an arm's length return in a non-arm's length situation, and more about apportioning the overall profits of an MNE between different economic aspects of its operations on an agreed basis.

Critics of the arm's length approach often propose some form of »global formulary apportionment«, which would allocate the profits and losses of an MNE among the different jurisdictions where it operates. A formula would be used, based upon factors showing economic activity such as the proportion of sales (on the demand side) and assets or payrolls / employees (on the supply side) in that jurisdiction. There is room for considerable debate about which of these factors are most relevant, and therefore, about the proportionate weighting such factors should have in determining the areas of real economic activity.

This method is similar to the formulary approach taken by many states of the United States, where a Multistate Tax Compact reflects the value to both states (especially

2. »Set-off« arrangements are where payments may not be made by the purchaser to the seller in the usual direct way. Some other benefit may be given, such as a payment by the purchaser to another entity, who will then give an equivalent benefit to the seller. An example is where amounts are paid to one of the seller's suppliers, to pay for those supplies.

smaller ones) and taxpayers of a single approach, more or less uniformly applied by the Multistate Tax Commission.[3] There are also developments in the European Union, with a proposed (and optional for taxpayers) Common Consolidated Corporate Tax Base[4] that relies on a formulary apportionment method which evenly weights the three factors chosen, and which therefore, ultimately favours the supply side.

It is worth noting that proponents of formulary apportionment not only emphasise the benefits to jurisdictions of a common approach that addresses profit shifting and helps taxpayers in filing tax returns relevant to several jurisdictions, but that also points to the benefits for taxpayers of a consistent approach across several jurisdictions.

Taken in a broader perspective, the debate about the arm's length approach versus formulary apportionment reveals a clash of preferences between a more overarching, or »macro«, approach that proposes a *generalised* fairness, and a more »micro« approach that emphasises the »particularised« examination of transactions offering fairness to individual taxpayers on a case-by-case basis. In view of the resource constraints of many developing countries, there is a particular significance to this debate. It is one that developing countries should be closely engaged in.

The process of applying the arm's length principle in actual practice is very complex. In order to find the arm's length price of a transaction, tax authorities and businesses make use of transfer pricing methods that are esoteric and convoluted. These represent ways of calculating the profit margins of transactions or entire enterprises, or of calculating a transfer price (or indeed, a range of prices) that qualifies as being at arm's length. There are a variety of methods for doing this, each one more appropriate to a particular form of transaction or to cases where relevant data are not available. Access to data and analytical resources is critical to an effective arm's length approach.

For example, traditional transfer pricing methods used to find the arm's length price are applied, in practice, by establishing comparability between the conditions of a controlled transaction (between parts of an MNE) and of an uncontrolled transaction (between independent parties). They therefore rely, to a great extent, on the availability of data from comparable uncontrolled transactions (that is, sufficiently similar transactions between unrelated parties) in a comparable market.

However, in many developing countries, a market for such transactions does not exist or is not properly documented, and a market price can be difficult or even impossible to determine. There are usually not organised databases where one can find such comparables about activities in the local market. Some developing countries use data extracted from developed country databases, such as European and United States sources. This can be problematic, however, since access to such databases is costly, and market conditions may be so different that for the data to be useful, it must be adjusted for the developing country's market conditions. Such adjustment is itself a resource-intensive process (and therefore costly, including in terms of other work foregone that might assist revenue collection). It often also leads to contested results.

The difficulty in finding suitable and available comparables when determining the arm's length price on a case-by-case basis, especially in developing countries, raises the contentious question of whether »fixed margins« should be introduced in transfer pricing regimes. The term »fixed margins« refers to cases where tax laws indicate what level of profits can be treated as »arm's length« in particular transactions, and consequently, what are treated as being, at least *prima facie*, mis-priced.

Those arguing for a fixed margin approach consider that as long as fixed margins are transparent and »scientific« in their formulation and operation, and genuinely seek to determine prevailing market margins, they provide a more flexible, real world response to what constitutes an arm's length price. They take the view that such an approach gives certainty to both taxpayers and authorities, and means that neither is required to use resource-intensive case-by-case analyses and expensive, highly specific or »tailored« outside advice.

Proponents argue that the fixed margin approach is a simplified, but fair regime that may pave the way to a more traditional case-by-case regime. They say that this is especially the case if there is only a rebuttable presumption under the fixed margins regime, so that

3. See http://www.mtc.gov. Canada, Germany and Switzerland also have some formulary apportionment experience at the sub national level.

4. http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm

taxpayers bear the onus of showing that the fixed margins do not reflect arm's length pricing in a particular case. This equates to having a »ready-to-wear« approach to what constitutes correct transfer pricing, rather than requiring a »tailored« approach in each individual case, with the time and costs the latter entails.

Those opposing the fixed margins approach say it is intrinsically inconsistent with the arm's length principle, and would only work (if at all) in large, competitive markets where profits tend to equalise among different competitors. They argue that it is impossible, in practice, to keep margins so up to date as to reflect the reality of the limitless number of types of transactions in a varied set of market conditions. They consider that it would be especially difficult for smaller countries to keep the fixed margins under review and to update them as necessary, and to cover the many different types of industries and cases.

Once again, this debate illustrates a clash of preferences between, on the one hand, a more overarching approach (this time, in the form of fixed margins) that proposes a *generalised* fairness and, on the other, an approach favouring a more *particularised* examination of individual transactions that proposes fairness to taxpayers on a case-by-case basis.

In this context, greater recognition is needed on the part of the most highly developed countries that favour the approach that the complexity and individualised attention to each case found in the traditional arm's length approach often creates its own unfairness, even though in theory it is designed to give a fair result in each individual case.

In fact, the more complex the exercise to hypothesise an arm's length price (in the face of the reality that multinationals are highly integrated in their operations, and even more distant in their internal dealings than in normal market conditions), the more disproportionate will be the impact on those least well equipped to deal with unnecessary complexity. They will be unable to bridge the gap between theory and reality and to fulfil the promise of the arm's length principle – the promise of fairness to all stakeholders in the system.

There is no doubt also that the complexity involved in case-by-case analysis has encouraged an industry of tailored advice. The role of advisers on tax issues is an important one, but critics have warned that this can produce a bias, and leads to even greater complexity and to unnecessarily individualised attention that is burdensome, and not just upon smaller and less well resourced taxpayers, but also on smaller and less well resourced countries.

It follows that developing countries, particularly those with the fewest resources, will disproportionately bear the cost *in practice* of what are, *in theory*, fair solutions tailored to the facts and circumstances of individual cases.

Global formulary apportionment is not the solution, at least at this time. Even though it may be part of it, or may be a framework for other approaches, the global formulary apportionment method is not yet sufficiently worked out in practice at the international level to replace the arm's length approach.

Assistance in applying the arm's length principle can, however, play an important role in equalising the positions of developing countries with those of developed countries and MNEs, however. For this reason, the UN Tax Committee[5] has prioritised – for its substantive involvement in transfer pricing work – the completion of the UN *Practical Manual for Developing Countries* in 2012. The Manual is currently being written to help make the arm's length approach as understandable and workable for developing countries as possible.

This project acknowledges the fact that, at present, most developing countries working on transfer pricing policy seek to apply the arm's length principle, and it is designed to assist them in doing so. The *Manual* also recognises the difficulties in this approach and the value of longer term discussions aimed at shaping transfer pricing norms in the future. The *Manual* will become a powerful tool to help countries form their own judgements of the arm's length approach and its applicability to their respective situations.

The *Manual* will not stand alone; it will be integrated with an enhanced UN capacity building programme on tax matters that addresses the policy and technical issues of the arm's length approach in a practical way, and also better equips countries to know where – in terms of risk management – they can most effectively target their limited resources, and how to build up those capacities.

5. http://www.un.org/esa/ffd/tax/

Efficient capacity building also involves encouraging countries to share experiences, both good and bad, with a view to building enduring networks and limiting the risk of costly policy and administrative dead-ends. This South-South sharing of successful tax practices is something we have been working on closely with the Special Unit for South-South Cooperation of the UN Development Programme and others.[6] At the global level, effective capacity building requires that the United Nations, the Bretton Woods institutions[7], the OECD[8], non-governmental organisations and regional institutions, all working closely and effectively together, seek to avoid unnecessary duplication, but also remain true to their differing mandates, memberships and guiding philosophies. This will sometimes mean that developing countries have alternative views to choose from in the context of their situations and priorities, and that is a good thing.

3.2 Dispute settlement

The need for clarity and predictability to promote investment and to avoid long and resource-intensive disputes raises questions regarding the potential role of dispute avoidance and resolution mechanisms such as 1) Mutual Agreement Procedure (MAP), 2) Arbitration and 3) Advance Pricing Agreements (APAs) in the area of transfer pricing.

The *Mutual Agreement Procedure* (MAP), under bilateral tax treaties, is designed to settle treaty-related questions and to provide a forum where residents of one of the involved states can seek reconsideration of actions they find to be contrary to a tax treaty. It does not compel a result, and MAP proceedings can become bogged down for years with no ultimate resolution.

Arbitration, on the other hand, provides for an alternative dispute settlement outside the courts when the parties have not been able to reach an agreement through the MAP.

6. http://www.s4tp.org

7. Including especially the World Bank Group (http://www.worldbank.org) and the International Monetary Fund (http://www.imf.org/external/index.htm).

8.http://www.oecd.org/department/0,3355,en_2649_34897_1_1_1_1_1,00.html

Finally, *Advance Pricing Agreements* are agreements between a taxpayer and a tax authority (or more than one tax authorities) on an appropriate transfer pricing approach for some future set of transactions.

Despite the potential to provide greater clarity and predictability to taxpayers, and possibly assist smaller or weaker countries in dealing with complex transfer pricing issues, arbitration raises some potential concerns, especially for resource-strapped developing countries.

Arbitration is a potentially costly and complex procedure. For example, the costs of the arbitrator(s), facilities, translators and other support services in arbitration – unlike in a court-based system – must be paid for by the parties. Also, extra-budgetary allocation of amounts for arbitration and the use of foreign currency reserves for payment, for example in US dollars or euros, might be required for arbitration. This could tend to increase pressure on countries to settle outstanding cases merely for practical or budgetary reasons, regardless of the merits of the case. This problem becomes especially acute if multiple arbitrations are launched by different taxpayers on essentially the same facts – a situation similar to the many investment protection arbitrations faced by Argentina following its debt restructuring in response to the 2001 economic crisis. There is no apparent provision for consolidating multiple cases into a single arbitration.

Resource constraints can therefore challenge the practical application of such arbitration procedures in developing countries and may unduly weight the scales against them in the way those procedures work. If the cost were borne by the taxpayer, the concern is that this would encourage (or more accurately, be perceived as encouraging) arbitrators to make decisions unfavourable to the tax administration.

Another possible perception is that arbitrators in this area are likely to be predominantly from developed countries for some time and may lack understanding of developing countries' realities and conditions. Developing countries may have had no experience of arbitration, or may have had a bad experience in an area such as investment treaty arbitrations.

In the long term, arbitration probably has a very important part to play in dealing with transfer pricing disputes, but in the short to medium term it is an approach that needs to be taken with caution, and with a full understanding of all the potential scenarios, including not only the best case scenarios, but also the worst case ones.

Advance Pricing Agreements also have great long term potential, but agreeing upon such issues in advance requires a good understanding of the rules of the game and of potential loopholes that need to be closed off. There is also a concern frequently expressed, that in the early years of a transfer pricing regime, APAs can tie up key resources as an administration deals with taxpayers seeking the APAs (taxpayers likely to be broadly in compliance) rather than allocating those resources to address the greatest transfer pricing risks.

4. The Role of the United Nations?

The complexities in the area of transfer pricing, and the issues they raise from the perspective of developing countries, lead us to consider what special characteristics the United Nations, with its current limited tax cooperation resources, can bring to the table in meeting these challenges.

The first such characteristic is its universal membership and legitimacy. The challenges in this area, the growing recognition of the development aspect of tax systems, and even the emergence of multinationals that are »home grown« to developing countries, all mean that efforts to reduce the complications of transfer pricing, in a way that is fair to all stakeholders, must have broader input and ownership than in the past. An approach of *inclusive* multilateralism is called for – one that draws upon the experience and perspectives of all stakeholders in international taxation issues, including business and non-governmental organisations.

The United Nations is increasingly looked to in this area as an impartial, responsible, representative and legitimate means to advance international tax cooperation with a view to development, including both fair returns to countries and a climate favourable to investment as part of a long term partnership for development.

As a representative of universal values, the United Nations has a unique convening power that brings the many viewpoints on this issue together in a respectful and constructive way. The United Nations work embraces all these viewpoints. It can recognise different approaches in state practice, and give transparency and some explanation of those approaches and their practical consequences. It can help reduce the differences purely of expression and therefore bring clarity to what the real differences are. In addition, the United Nations can give greater voice and extra legitimacy to the best work done by others in this area, by endorsing it where it is useful for developing countries.

The United Nations can, in short, help safeguard that all with an interest in the »rules of game« will have a full seat at the table, to ensure that those rules meet the challenges and needs of development, and not only the needs of developed countries. In fulfilling this role, both procedures and outcomes must be fair to all those affected, and ultimately remain people-focused, because to be properly people-focused is to be development-focused, and vice versa.

References

European Union Taxation and Customs Union

http://ec.europa.eu/taxation_customs/index_en.htm

This site oriented to the strategy of the European Union (EU) contains information on the tax obstacles preventing individuals and companies from operating freely across borders and obtaining the full benefit of the EU Market: it also serves to encourage changes to tax systems so that they support Community objectives such as competitiveness and sustainable.

Multistate Tax Commission

http://www.mtc.gov

The Multistate Tax Commission is an intergovernmental state tax agency working on behalf of states and taxpayers to administer, equitably and efficiently, tax laws that apply to multistate and multinational enterprises.

OECD Centre for Tax Policy and Administration

http://www.oecd.org/department/0,3355,en_2649_34897_1_1_1_1_1,00.html

Site contains information about the Committee on Fiscal Affairs, which brings together senior officials from all OECD Member governments who play an active role in formulating and implementing tax policies.

Tax Justice Network

http://www.taxjustice.net/cms/front_content.php?idcat=139

This link references Tax Justice Network's (TJN) material on transfer pricing. TJN is an independent organisation launched in the British Houses of Parliament in March 2003. It is dedicated to high-level research, analysis and advocacy in the field of tax and regulation.

United Nations Committee of Experts on International Cooperation in Tax Matters

http://www.un.org/esa/ffd/tax

This site compiles documents related to the UN Committee of Experts on International Cooperation in Tax Matters. As such, it provides links to working drafts and completed documents of the committee, including the P*ractical Manual on Transfer Pricing for Developing Countries and the United Nations Model Double Taxation Convention between Developed and Developing Countries*.

About the author

Jomo Kwame Sundaram (Jomo K. S.) has been Assistant Secretary-General for Economic Development in the United Nations' Department of Economic and Social Affairs (DESA) since January 2005, and (Honorary) Research Coordinator for the G24 Intergovernmental Group on International Monetary Affairs and Development since December 2006. In 2007, he was awarded the Wassily Leontief Prize for Advancing the Frontiers of Economic Thought. Jomo has authored over 35 monographs, edited over 50 books and translated 12 volumes besides writing many academic papers and articles for the media. Jomo was Professor in the Applied Economics Department, Faculty of Economics and Administration, University of Malaya until November 2004, Founder Director (1978–2004) of the Institute of Social Analysis (INSAN) and Founder Chair (2001–2004) of IDEAs, International Development Economics Associates (www.ideaswebsite.org) where he now serves on the Advisory Panel. He was also on the Board of the United Nations Research Institute on Social Development (UNRISD), Geneva (2002–2004). He is on the editorial boards of several learned journals. During 2008–2009, he served as a member of the [Stiglitz] Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System.

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Friedrich-Ebert-Stiftung | Global Policy and Development
Hiroshimastr. 28 | 10785 Berlin | Germany

Friedrich-Ebert-Stiftung | New York Office
747 Third Avenue | Suite 22B | New York, NY 10017 | USA

Responsible:
Dr. Werner Puschra, Executive Director, FES New York

Phone: ++1-212-687-0208 | Fax: ++1-212-687-0261
www.fes-globalization.org/new_york/index.htm

To order publications:
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