TITLE: Multinationals and profit shifting: analyzing the efficacy of transfer pricing guidelines

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1. Introduction

1.1 Subject of the Thesis

The process of setting prices of goods or services between subsidiaries or divisions in a company is called transfer pricing. These intra-group transactions and the prices allocated to them affect the costs and revenues of the individual departments participating in the transaction. This has implications for the tax liability of each department: depending on the transaction price, more or less profit is made in a department, over which taxes are paid.

Recent developments in technology, transportation and communication have resulted in a growing number of multinationals. World exports as a share of GDP increased from 20% in 1994 to 32% in 2008 (PWC, 2010). Foreign direct investments (FDI) have also significantly increased over this period of time. This globalisation has increased the importance of transfer pricing from a fiscal point of view. When departments engage in intra-group transactions across borders, there is an incentive for setting the transfer price lower or higher depending on the tax implications in each country. While the reason for charging prices for goods and services from one department of a company to another is to determine the performance of each department, companies can thus distort this profit measurement for tax minimizing purposes. As large multinationals have many millions in revenues and tax rates differ amongst countries, setting the right transfer price (and determining the ensuing profit allocation) can be a valuable business.

This is especially the case when considering that intra-group transactions of multinational companies account for at least 60% of all international transactions (Sikka, 2009). For a simplified intra-group transaction, there are 3 parties involved in the tax implications of this transaction: the multinational and two tax authorities from the different countries involved in the transaction. The drawback for the tax authority that has a higher tax rate is that it misses out on tax revenue that it would have the right to collect in case the transaction was carried out under normal circumstances, i.e. when two unrelated parties would have engaged in the same transaction.

The price that would have been charged in such normal circumstances is called the arm's length price. This is the basis of, amongst others, the OECD's transfer pricing guidelines that it wrote in order to help solve these transfer pricing developments (OECD, 2017). Seeing that the growing number of multinational enterprises and their level of integration brings forth increasingly complex situations, the OECD aims to address these issues in a broad international context. Not only do tax authorities have the problem of claiming too little or too much tax (double taxation arises when two tax authorities claim the right to the same tax base), multinational companies are burdened by having to use resources to make sure they comply with the different transfer pricing laws of the countries it operates in.

This 2010 publication served to address transfer pricing issues in one set of guidelines for the OECD member countries. Since then, for example as recently as July 2017, the guidelines have been revised occasionally to clarify previous publications, add new recommendations and to continue to solve practical difficulties concerning transfer pricing. This is due to the importance that multinational companies comply with transfer pricing regulations and that tax authorities receive their "fair share" of taxes. The arm's length principle has been the constant base of these guidelines throughout the years.

In the OECD Model Tax Convention on Income and on Capital (OECD, 2015a), which the OECD updates periodically (similar to the transfer pricing guidelines revisions mentioned in the previous paragraph), article 7 already mentions the arm's length principle. In this Model, serving to facilitate tax treaties between member countries and to eliminate double taxation, standard rules regarding business profits for (multinational) enterprises with permanent establishments in other countries are given. Permanent establishments are defined as fixed places of business of the enterprise through which the business of that enterprise is wholly or partly carried on (article 5, paragraph 1 of that Model Convention). In the first paragraph, business profits of a permanent establishment in another country may be taxed in the country of the multinational. However, these profits are to be interpreted as "the profits it (the permanent establishment) might be expected to make (...) if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions" (paragraph 2), also known as the separate entity approach.

If associated enterprises engage in transactions where the price is not at arm's length, article 9 of the OECD Model Tax Convention may apply. This article allows national tax authorities to rewrite the accounts of the associated enterprises to make these accounts show the result of an arm's length transaction, resulting in a certain tax liability that is considered "true" to the

transaction. The second paragraph of this article aims to prevent double taxation resulting from such an adjustment.
An important issue the OECD focuses on with a recent project is base erosion and profit shifting (OECD, 2013). Transfer pricing is one of the key issues that lead to profit shifting and subsequent distortion and/or reducing of tax revenues of different tax authorities (base erosion). The OECD addressed base erosion and profit shifting in 2013, mentioning that the tax jurisdiction has not kept pace with the changing business environment.

Subsequently, there still seems to exist some space for multinational companies to exploit gaps in transfer pricing laws. An example is Apple, which in August 2016 was ordered by the European Commission to pay $14.5 billion in taxes to Ireland, despite claiming to have followed the law (European Commission, 2014). As Ireland failed to recover the money, the country was announced in October 2017 to be taken to the European Court of Justice by the European Commission to pay back the $14.5 billion in Irish taxes for allegedly illegal transfer pricing arrangements, including illegal state aid.

It is evident that multinational companies have an incentive to shift profit through transfer pricing. The case of Apple, however, reflects that multinationals face pressure from transfer pricing guidelines and regulations, as compliance with these implies that independent, arms-length prices have to be calculated and applied. A 2010 survey of EY found that multinational enterprises find transfer pricing increasingly more important over the last years: 74% of respondents believe that transfer pricing documentation has increased in importance over the previous two years and an equal percentage believes that it will keep increasing over the next two years. 32% of respondents define transfer pricing as one of the most important tax challenges that the multinational faces.

Given these facts, the OECD's focus on transfer pricing is not surprising. Multinational companies and tax authorities could benefit greatly from effective and clear transfer pricing rules. Regarding the former, large fines such as the one imposed on Apple are not rare and the increasing role of multinationals and transfer pricing in global trade brings focus to the question if a company's transfer pricing methods are in line with the arm's length principle. The latter, national tax authorities, face lost income in case transfer pricing shifts profit abnormally: income that they would have collected if the arm's length principle would hold in intra-group transactions.

To facilitate the jobs of both multinationals (complying with arm's length transfer pricing) and tax authorities (preventing double taxation and claiming the right tax base), the OECD regularly publishes and updates guidance concerning transfer pricing in an effort to equalize consistent and clear transfer pricing laws throughout the world. For example, it published a 2010 paper which discusses five transfer pricing methods consistent with the arm's length principle, which have since been the prescribed methods for multinationals to be compliant. As this document is merely an indication of usable methods, lawmakers have the option to implement them or deviate and choose for alternative methods, perhaps not even ones based on the arm's length principle, such as formulary apportionment. This, however, is advised against by the OECD, as varying transfer pricing laws among countries negates its goals to battle double taxation and tax avoidance.

Among critics, opinions are divided on whether the current, arm's length principle-based methods are still fit for the future given globalisation developments, especially with regards to its conceptual framework and intangible assets. Consequently, many experts in the field of international taxation call for leaving the arm's length principle behind and moving on to formula-based transfer pricing methods. It is questionable whether this should be done, as on the one hand, keeping the current methods, for which there is better international consensus, might prevent incoherence in corporate taxation laws. This might consequently prevent more legal action against multinationals and states and solve pressure on multinational firms. On the other hand, the current regulations put great pressure on multinational firms as new documentation legislation is implemented and they are forced to comply with arm's length standards – even if no comparable transactions can be found. In order to formulate an opinion on what should be done with the future of transfer pricing regulations, it is necessary to know what (unnecessary) pressure the current OECD transfer pricing course puts on multinationals and why. In addition to this, we must assess it for efficacy and practicality.

In conclusion, the OECD has an important and challenging task. If it wants to continue ensuring that income is taxed where it should be and that national governments are able to tax the tax base they have the ideological right to, the future of transfer pricing needs to be consistent with the changing business environment. It should question whether the current TP methods and regulations are fit for the future and feasible enough, or whether alternatives, perhaps departing from the arm's length principle, will better ensure that multinationals are compliant, regulations are effective against tax evasion and the outcome of the taxation is fair.

1.2 Research Question and sub-questions

This thesis aims to research the implications of the OECD's transfer pricing regulations on the business strategy and resources of multinational companies and assess the efficacy and practicality of current transfer pricing guidelines on solving unfair tax distribution over national tax authorities. The following main research question lies at the heart of this research:

"What is the pressure of transfer pricing regulations on companies and how can national governments be sure of their real fair share of profit tax?"

While this research question is made up of two seemingly separate questions, the answer to the first part will clarify the necessity of assessing the current transfer pricing guidelines and rules. This will relate both to the tax-minimizing, accounting aspect of companies, as well as the tax-maximizing fiscal drive of national governments. Consequently, this assessment can be done with regards to efficacy and practicality. To this end, three sub-questions will serve in answering the research question:

1. What (international) tax-related reasons exist for multinationals to adjust transfer pricing?
2. What pressure do companies face from rules concerning transfer pricing?
3. What can be changed in the current OECD transfer pricing regulations to advance efficacy and practicality?

1.3 Method

To answer these questions, insights will be taken from existing literature on transfer pricing such as research articles, books, OECD publications and accounting-related surveys. Only transfer pricing will be considered from profit shifting methods, so other profit shifting methods are irrelevant. The chapters will follow the sequence of sub-questions as presented on the previous page, each introducing the importance of this sub-question in relation to the main research question and summarizing the findings in a conclusion. A summary of the nature of transfer pricing regulations as prepared by the OECD is not given in a particular chapter or sub-question as the focus is more on the implications of these regulations. As the last sub-question both discusses the transfer pricing methods and applies the information from the first two sub-questions in an assessment (based on literature) of efficacy and practicality, it is the larger chapter.

The OECD consists of 35 member countries[1] at the time of writing. For this research, transfer pricing regulations in countries other than these 35 countries are not primarily relevant for the research. As the adoption of OECD guidelines are vastly different and ever-changing, but the general principles are the same, not each member can be considered individually: in the research, in case a member of the OECD is mentioned, this is due to this particular country being different, relevantly, from the other countries regarding taxation law. This is because country-specific and irrelevant information does not add enough insight to the answer to the research (sub-)question(s). In general, the most important aspects of a subject are included, while less important matters are limited. Sources from the OECD are very extensive, but as the focus is on the actual answer to the sub-questions, preference is given to summarize the information in favour of spending more time directly answering the sub-question.

For the last sub-question, the OECD's core transfer pricing regulations are assessed in terms of efficacy and practicality. This means that an assessment will be done as to whether the regulations have the desired effect, are fair and convenient and whether any practical issues may arise. The research will then continue to review ideas for transfer pricing regulations that may have better efficacy and practicality than those of the OECD. This assessment is somewhat similar to the so-called constitutional review, as a law (such as the potential transfer pricing regulations this research focuses on) is evaluated in terms of efficacy, practicality and whether its functioning is at odds with other laws (e.g. state aid).

The structure of this thesis is as follows: the chapters follow the sequence of sub-questions, while the main research question is answered in chapter 5, the conclusion. This chapter only serves as a summary of the information gathered in the answers to the sub-questions in chapters 2 through 4. The end of this thesis contains a reference list of the literature used.

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1 For a list, see http://www.oecd.org/about/membersandpartners/list-oecd-member-countries.htm

2. What (international) tax-related reasons exist for multinationals to adjust transfer pricing?

2.1 Introduction

In recent years, transfer pricing has become a hot subject of debate in media and economic research. Much of the focus on transfer pricing concerns governments being withheld their fair share of the profit taxes that a multinational enterprise must pay. The first sub-question that this thesis will seek an answer to is how and to what extent multinationals can adjust their paid taxes through transfer pricing – and why they do.

Ideally for them, multinational enterprises will use their possibility of being active in different countries to adjust profit upwards in low-tax countries and report lower income or higher costs in high-tax countries. This may be done because of the multinational owning subsidiaries or permanent establishments in several countries, in which different parts of the production process may be carried out. A drawing of David Rooney used in an article of the OECD Observer (Neighbour, 2002) shows that the production of a hypothetical multinational enterprise is virtually fully in country A, while the long arm of this enterprise pays its taxes in low-tax country B. In a simplified situation, this could be achieved by allocating more profits to the enterprise's department in country B through a high profit mark-up as the department in country B sells produce to the department in country A.

This results in a lower total amount of tax payment compared to a situation with independent enterprises. The price that would be charged for a transaction of goods or services in such a situation is commonly referred to as an arm's length price. The arm's length principle – the notion that transfer pricing must be based on comparable transactions between independent entities – is the red line in OECD transfer pricing guidelines and the Model Tax Convention, which will be discussed thoroughly in this thesis. In order to tackle these instances of profit shifting, these frameworks for bilateral treaties between (the tax authorities of) OECD countries, use the arm's length principle to ensure their fair share of profit.

2.2 Profit shifting and tax avoidance

Transfer pricing is one of the major methods used in profit shifting within multinationals (Huizinga & Laeven, 2006). Manipulating the transfer price in order to reduce (accounting) profits in high-tax countries and inflate profits in low-tax countries is a widely documented strategy multinationals use to save on their corporate tax bill. Tax rate differences between countries are, according to Huizinga and Laeven, the main reason for profit shifting. Using

European firm-level data, they find “that there is a semi-elasticity of reported profits with respect to the top statutory tax rate of 1.43”, meaning that profit shifting by European multinationals is significant. Due to its high tax rate, Germany is the major loser of corporate tax revenues. As a result of international profit shifting, European countries have reduced their top tax rates. A second method of profit shifting is through debt structures within the multinational, by issuing debt to affiliates/subsidiaries in high-tax jurisdictions so that the interest payments are deductible. The interest revenues are then ideally generated in a low-tax jurisdiction. This form of profit shifting is not relevant for this thesis, as the focus is on transfer pricing. The same is true for a third method of profit shifting – allocating a multinational’s common expenses (e.g. R&D) to high-tax jurisdictions – however capitalized R&D is an intangible asset, which also is used in profit shifting through transfer pricing, and therefore relevant.

The drawing of David Rooney mentioned earlier, depicting the use of transfer pricing to shift profits favourably between associated multinational departments, shows a type of tax avoidance. While tax avoidance and tax evasion are often used interchangeably, the difference is that tax avoidance is (on the border of) legal and concerns finding “escapes” in the law to flee from having to pay certain taxes. Tax avoidance can include the use of tax deductions to lower the amount of tax paid, effective use of tax-free amounts and other constructions, as long as they are fully permitted by law. Whether these instances of tax avoidance are generally seen as unfair is a different question altogether and depends greatly on the circumstances. Tax evasion, however, is always illegal.

It must be noted that not all profit and cost allocation mechanisms of an enterprise that lower tax expenses are intrinsically aimed towards tax avoidance. Firstly, this is because allocation of overhead costs is highly subjective and there is quite some discretion in the allocation over associated enterprises. Secondly, the same can be said about estimations of the arm’s length transfer price. These discretions form the basis of the way that transfer pricing is used in profit shifting for tax purposes.

2.3 Intangible Assets

A very important overhead cost in transfer pricing is the use of intangible assets. When (the right to use) an intangible asset is involved in the production process, the arm’s length renumeration of this right might be difficult to calculate. For a certain patent, for example, there might be no market, i.e. no market price can be computed that would be charged by or to a third party for exactly the use of this patent. This implies that there is considerable discretion in formulating a transfer price for the product.

A simplified example as to illustrate how multinationals may use the presence of intangible assets in transfer pricing involves a parent company in a country with a high corporate tax rate and a subsidiary in a country with a low tax rate. In case a second high-tax subsidiary uses an intangible asset (such as a patent) held by the low-tax subsidiary for the production of a product that is then traded to the parent, the transfer price could be inflated greatly by allocating a major part of the transfer price to the holder of the intangible asset. This would shift the majority of profits from the internal transaction to the low-tax subsidiary and less to the high-tax subsidiary, while the real value added by the use of the intangible asset may be significantly lower. However, Action 8 of the BEPS Project (OECD, 2015b), reads "members of the MNE group are to be compensated based on the value they create through functions performed, assets used and risks assumed in the development, enhancement, maintenance, protection and exploitation of intangibles." This is necessary to prevent profit shifting as the example above shows a disproportionate compensation for the value created by the low-tax subsidiary's patent.

This Action 8 of the BEPS Project aims to solve the information asymmetry that tax authorities face regarding value creation and renumeration in transfer pricing. If no broad and clear definition of intangibles is given and no clear rules and benchmarks exist to allocate profits in accordance with value creation, MNEs have (too much) discretion in allocating profit. This gives tax authorities unnecessary challenges in determining whether this calculated profit allocation from the transfer price is compliant with the prescribed transfer pricing method in that country. It is also important that a subsidiary does not only have the legal ownership of the intangible asset, but also truly performs the functions related to the development, enhancement, maintenance, protection and exploitation thereof. If this is in fact done by the parent company and the risks regarding this intangible asset are assumed by the parent, not the subsidiary, then the returns from the use of this intangible asset should be allocated to the parent company. This is what is meant with control over the intangible asset.

2.4 Transfer pricing adjustment opportunities

Regardless of whether a certain tax-decreasing construction is classified as tax avoidance or tax evasion, a construction that is viewed unfavourably and unfair by society and media can often lead to political debate and an increase of legislation or control and audits. Transfer pricing therefore is a hotly debated subject both in literature and media.

A 2009 opinion article in The Guardian from University of Essex professor Prem Sikka mentions a more expanded version of a situation such as the previously mentioned drawing of David Rooney (Sikka, 2009). Design, manufacturing, testing, patents and marketing rights of a product may be in five different countries. Through internal trade within the multinational that produces this product, there are many opportunities to shift profits to lower tax jurisdictions. Sikka mentions that "developing countries may be losing over US$160 bn of tax revenues a year, primarily through transfer pricing strategies". The unfairness that attracts the media attention lies in the fact that this tax avoidance ultimately comes at the cost of less social security, healthcare and education, due to budgetary issues. Also, the problem is that there is a sheer lack of resources that tax authorities face in their attempts to audit multinational enterprises. Professor Sikka therefore proposes full transparency of enterprises in their transfer pricing data.

Before discussing the role of transfer pricing in tax avoidance more in-depth, it is worth mentioning how much media attention recent cases such as the one of Apple and Starbucks attracted (European Commission, 2014). In the case of Apple, the Irish IRS (Internal Revenue Services) allowed the tech giant to abuse intra-company trading by setting transfer prices resulting in a minute reported profit in Ireland (Mullen, 2016). This was done by an Advance Pricing Agreement ("APA") granted by the IRS to Apple allowing the multinational enterprise to pay less than one percent of their profits in taxes. The fact that this is considered illegal state aid and the consequent sanctions by the EC are more in the scope of the following sub-question, but this does show that there are incentives for firms to engage in possibly unethical transfer pricing tactics, especially if tax authorities cooperate.

It might also be difficult for the European Commission to penalize multinational enterprises that engage in risky transfer pricing schemes. Undoubtedly, these tax avoidance schemes were set up by large accountancy firms which offer their clients insight in which transfer pricing leads to the lowest tax liability (just) on the compliant side of the legal system. This implies that from the point of view of professionals, a certain transfer pricing strategy is worth implementing given the legal framework that the enterprise takes part in. Clearly, there is an incentive to consult professionals in transfer pricing for multinationals, as this appears to be a rewarding business. This thought is especially true as 60% of world trade is between affiliated companies, as Sikka mentioned. Setting a transfer price that minimizes tax payment while keeping the risk of sanctions low, could be assumed to be one of the top tax-related strategies of multinational enterprises.

This assumption is proved in the 2016 EY Transfer Pricing Survey (EY, 2016), where 75% of 623 transfer pricing executives (up from 50% in 2010) indicate that tax risk management is their top transfer pricing priority. This likely has to do with increasing pressure from transfer pricing regulations. This also is a reason for multinationals to adjust their transfer pricing methods, either in order to comply more with regulations or public expectations, or in order to hide their practices better from the tax authorities. Another interesting number from the EY survey is that only 21% of respondents claim to be fully compliant in all countries they operate in. This shows that multinationals are willing to take risks in transfer pricing strategies for tax lowering purposes.

Further explanation of this observation can be found in another article of Sikka (Sikka & Willmott, 2010). With directors of large companies aiming for an optimal return on investment for the shareholders (i.e. profit), they might turn to "financial engineers who regard [tax] as an avoidable cost, rather than a return to society". Taxes are seen as costs of business, which company managers will aim to lower as much as possible. Given that "smart" transfer pricing has everything to do with lowering tax costs, managers will use the malleability of (overhead) costs to assign profits in subsidiaries, departments or permanent establishments as tax-efficiently as possible. While the arm's length principle has been around for years and efforts are done to harmonize transfer pricing interpretations (e.g. OECD), the difficulty of finding an arm's length transfer price lies in the fact that active comparable markets may be absent. This is especially the case when allocating (costs of) intangible assets to the various parts of the production process. This paves the way for discretion for companies in their transfer pricing strategy. National tax authorities might have the authority to change the income, deductions, credits and other allowances of an enterprise's entities for tax purposes (such as in OECD Model Tax Convention article 9 (OECD, 2017)) in case this is necessary for preventing tax evasion, however, this is limited to the administrative and auditing capacity of the tax authority.

Sikka and Willmott also mention that this is one of the reasons why developing countries are vulnerable to tax avoidance through transfer pricing. The growing globalisation of trade has as a side effect that some enterprises manipulate transfer prices to move profits to low tax jurisdictions, which causes problems for national tax authorities. More interesting is the statement that some microstates such as the British and US Virgin Islands, Barbados and the Caymans compete to attract investment to advance their economies. By effectively using this competition for taking advantage of beneficial taxation laws in those countries, large multinationals have all power at hand, which might explain why these microstates have low tax rates. This provides space for multinationals to use non-arm's length transfer pricing structures to locate profits on these low tax jurisdictions. As a result, the British Virgin Islands have 3389 companies per 100 inhabitants, the Caymans have 182 companies per 100 inhabitants and one building on the Caymans houses 18,857 corporations. We can thus establish that another reason for multinationals to shift profits using transfer pricing is the lax or even cooperative stance of governments.

A now bankrupt US multinational called WorldCom constructed a transfer pricing program that included creating an intangible asset called "management foresight" in a low tax jurisdiction (United States Bankruptcy Court Southern District of New York, 2004). This asset was licenced to WorldCom's subsidiaries in exchange for a royalty fee that exceeded the company's net income in the years 1998-2001. With the royalty payments being tax deductible costs in higher tax jurisdictions and the revenues collected from the intangible asset being taxed marginally, this arrangement saved WorldCom between US$100 million and US$350 million in taxes.

Apparently, this transfer pricing arrangement was worth making, at least prospectively. A paper by Davies, Martin, Parenti and Toubal (2018) observed that the majority of transfer pricing-related tax avoidance comes from a handful of large multinationals such as WorldCom. Due to the lack of data, such as transparency about transfer prices used between a multinational's entities (which Sikka in 2009 called for) and calculations of the arm's length price that should be used, compelling research cannot be done about the true monetary value of transfer pricing practices and the number of firms involved. Transfer pricing information and especially its role in tax avoidance, therefore depends mostly on separate observations of professionals, tax authorities and multinational firm managers. The finding of this paper that the majority of transfer pricing-related tax avoidance is from a small number of firms, however, yields some interesting information for the answer to sub-question 4. For tax authorities to efficiently counteract tax avoidance, they could disincentivize it by targeting the largest x% of multinationals with, for example, intensive audits.

A working paper (Bartelsman & Beetsma, 2000) also gives policy advice for tax authorities. This paper also gives evidence that multinationals do indeed shift profits as a result of tax rate increases, which lowers the corporate tax revenues of that country. This is reflected in the finding that the ratio of taxes paid in Germany vs. worldwide of BMW decreased sharply as a result of the high corporate tax rate there. This introduces the concept of tax competition, meaning that governments reduce their tax rates in order to attract investment (Houlder, 2017). This is what, for example, the aforementioned microstates do, effectively helping multinationals to shift profits through transfer pricing. However, using transfer pricing regulations for tax competition may result in double taxation and lower world trade if governments do not cooperate (Mansori & Weichenrieder, 1999). The economic model used in this research, which involves the comparison of two non-cooperative governments and two cooperative governments, finds that cooperation with respect to a common transfer price (determination/definition) therefore is beneficial for the tax revenues of both countries. Tax competition through tax rate reductions leads to profit shifting between countries (which is inherently beneficial for multinationals, otherwise no profits would be shifted). Both the Bartelsman & Beetsma and Mansori & Weichenrieder papers therefore advise harmonization and cooperation between countries, which the OECD aims to achieve. Before all (OECD) countries have adopted and enforced the guidelines and their regular updates, multinationals may still use transfer pricing and tax havens to lower their tax expenses.

2.5 Conclusion

In conclusion, multinationals can shift profits through transfer pricing as they are active in multiple countries. If there are differences in tax rates between those countries, profit shifting is likely to occur, as this can save them large amounts of tax expense. While many countries have adopted the arm's length principle in their transfer pricing laws, there are still possibilities of profit shifting through transfer pricing for large multinationals, such as the use of intangible assets on tax havens. Information asymmetry between multinationals and tax authorities fuels (the possibility of) profit shifting, as does a lax stance of governments. To disincentivize this, coordination of governments regarding transfer pricing rules and targeting large multinationals are vital strategies to consider.

While the subjectivity of the arm's length transfer price (certainly in the past) could be exploited by multinationals and their financial professionals, this opportunity may as well be a threat to them if there is a lack of consistency in countries' transfer pricing rules (Secular, 2012). Differences in the degree and complexness of the adoption of OECD transfer pricing guidelines into national tax laws may pose a challenge for multinationals in terms of compliance. Tax authorities may not accept all methods and the requirements of one tax jurisdiction may vary from another jurisdiction. Additionally, the OECD guidelines are often updated. The penalties for non-compliance are, according to Secular, increasing and changing in shape, while the length and costs of agreeing an APA deter multinationals from benefiting from achieving more certainty this way. For some goods and services, finding comparable transactions is difficult or impossible. All these challenges put multinationals under pressure when trying to find the best middle ground between tax compliance and favourable tax strategies. The next chapter will analyse the extent to which this pressure exists and how it affects a multinational's accounting for internal transactions.

3. What pressure do companies face from rules concerning transfer pricing?

3.1 Introduction

Transfer pricing, as the previous chapter discussed, is an important way for multinationals to avoid taxes, both of the parent company and subsidiaries. Using their business presence in multiple countries, multinational enterprises can lower their tax expenses by reporting lower profits in high-tax countries. This can be facilitated by the subjective nature of intangible assets and the compensation for internal services related to them, discrepancies in taxation laws and a lack of resources in tax authorities.

While this prospect of higher net profits through profit shifting by using transfer pricing may be exciting for managers and shareholders of multinational enterprises, transfer pricing guidelines have become increasingly stricter to ensure national tax authorities their fair share of tax revenues. Only a handful of transfer pricing methods are allowed, focusing on where value is actually created within the production process. The previously mentioned lack of transparency is addressed as well in the BEPS Project. When illegal transfer pricing practices are detected, such as with Coca-Cola Co. (Esterl & Dulaney, 2015), billion-dollar disputes may arise, plus interest, legal assistance costs and bad publicity. Even when both the local government and the MNE claim that the transfer pricing practice is legal, the European Commission may view the arrangement as state aid, leading to similar disputes (European Commission, 2014). OECD guidelines are frequently updated to better close tax-related loopholes and are adopted accordingly in national legislation. If an MNE is active in transfer pricing tactics that may (still) be legal or undetectable, changing rules may force the company and its subsidiaries to adjust the transfer prices and profit mark-ups. Lastly, the risk of double taxation can arise when transfer pricing leads to two tax authorities claiming tax competence over a certain profit.

All of these risks nuance the incentives of transfer pricing and are important to understand when establishing the necessity and result of actions against aggressive transfer pricing tactics. The aim of this chapter is to summarize the pressure that OECD transfer pricing guidelines and national transfer pricing laws have on multinational companies. To this end, this chapter focuses on (compliance with) transfer pricing rules, the subsequent considerations for MNEs and the risks and consequences associated with non-compliance.

3.2 Arm's length prices

The height of the price of an intra-group transaction determines the profit that the selling party gains as well as the cost of goods or services for the buying party. Both affect the pre-tax income of both parties, i.e. the tax base for each of the subsidiaries (or parent company plus subsidiary). It is important to notice that these generally two subsidiaries, permanent establishments or parent and subsidiary, are two stand-alone companies, with own assets and liabilities, (taxable) profits from operations and employees, with the only thing in common being the ownership of these companies. This is why transfer prices are ideally at arm's length, as they most factually represent the value creation that would have happened in transactions between unrelated parties. For tax authorities, this is desirable as they are able to tax the right amount of profit that arises from this transaction in the tax jurisdiction. For the related companies themselves, receiving a generally used price will lead to profits that are authentic to their operations making them comparable and reliable for business purposes. It is only when tax avoidance opportunities arise that there are incentives to deviate from the arm's length price, as the previous chapter discussed.

The draft version of the first OECD Model Tax Convention was compiled in 1963, with the model being published in 1977 (Owens & Bennett, 2008). The aim of this model was to prevent double taxation and tax evasion by drafting a model (bilateral) tax treaty that two countries could use to conclude their treaty. In light of the rapid global economic integration in the 1950s, this Model aimed to help tax authorities claim their rightful tax revenues and prevent multinationals from uncertainty about tax liabilities in multiple countries. The point of reference for transfer prices has been the arm's length price ever since. A 1979 report of the OECD specifically addresses transfer pricing problems, such as difficulties in determining the appropriate transfer price. There are five main methods that can be used to calculate an OECD Tax Model-compliant transfer price (and subsequently, through tax treaties, taxation law compliant), which will be thoroughly discussed in the next chapter. The problem with most of these methods, however, is that comparable prices do not always exist due to the absence of an open market or complexities in real life business situations. Besides, problems may arise with finding evidence of the comparability of these transactions. Flexibility in transfer pricing arising from these problems could lead to arbitrage and potential tax avoidance.

If the computed transfer price is rejected by the tax authority in one of the countries where the MNE is present, double taxation may occur without being "saved" by the provisions in Article 9 of the OECD Model Convention (Carter, Maloney & Van Vranken, 1998). A change in the transfer pricing system may cause similar problems, as this also can mean income shifts from one country to another, leaving one worse off. Without valid motivation for such a recalculation of the transfer price, this tax authority may reject the new system, which imposes the risk of double taxation upon the MNE.

Therefore, the possibility exists for a transfer price to be agreed upon in advance by the tax authority or authorities with the MNE. In this case, the relevant associated enterprises agree Advance Pricing Agreements (APAs) with the tax authorities, so that they are provided certainty about the correct transfer price to be used, preventing compliance risk. This is a win-win situation, as the tax authority is sure of the fair share of profit tax without having to engage in rigorous audits. The benefit for the MNE is that the risk of transfer pricing disputes subsides as compliance is guaranteed through the agreement, subject to some monitoring by the tax authority. This may have great benefits for MNEs when faced with complications in calculating the arm's length price, while trying to be compliant with the tax jurisdiction it operates in.

The possibility of agreeing an APA with the tax authorities greatly vary per country (Cools & Emmanuel, 2007). The OECD, however, has extensive guidance on the APA process, including the pre-agreement process, discussion and conclusion of the agreement and the monitoring. This is because "greater uniformity in APA practices could be beneficial to both tax administrations and taxpayers" (OECD, 2017, Annex II to Chapter IV). This uniformity would also be valuable as this would reduce the administrative effort of bilateral (between the taxpayer and two tax authorities) and multilateral APAs (involving more than two tax authorities). The OECD encourages taxpayers to try to conclude as many bilateral or multilateral agreements as possible to reduce the risk of double taxation, as two unilateral APAs may have different outcomes. The notion that APAs are agreements about the transfer price for multiple years after the agreement (so prospectively), instead of audits about transfer prices of multiple previous years, implies that an informational advantage for the tax authority arises. The reason of compiling special APA guidance for the OECD was that member countries complained about the difficulty and cost, both monetary and in terms of time, of traditional audits of transfer pricing. However, when APAs are concluded, the taxpayer and tax authority/authorities cooperate to agree a transfer price that complies with the tax legislation. This solves the problem of information asymmetry between the MNE and the tax authority, freeing (scarce) resources.

While this may differ per taxpayer, disclosure of information related to the company's transfer pricing calculation may be more extensive than under the normal transfer pricing documentation requirement (Cools & Emmanuel, 2007). This may require a lot of resources, especially if bilateral APAs have different requirements, and this process may take several years before the benefits are reaped. From a business point of view, it would then be more profitable for non-compliant MNEs to refrain from APAs if the compliance risk is low.

3.3 The OECD Base Erosion and Profit Shifting Project (BEPS)

As the previous paragraph stated, there are numerous problems in the calculation of arm's length transfer prices, both for MNEs and tax authorities. Without proper guidance, problems may arise as a result of differences in TP calculation methods, documentation, APA possibilities and requirements. These problems will inevitably require serious coordination and cooperation between OECD member states to solve. An important project that the OECD has developed to help governments address these tax challenges, is the BEPS project, consisting of 15 "actions" to address base erosion and profit shifting. The project was launched in 2013 and is in the implementation phase. Transfer pricing is the subject of actions 8-10 and documentation thereof is in action 13. The BEPS Action Plan (OECD, 2013) can be seen as a background for the Final Reports on transfer pricing (OECD, 2015b) and the subsequent OECD Transfer Pricing Guidelines (OECD, 2017), as the actions involve adjustments to these guidelines. The focus of this chapter is on the pressure of these rules on MNEs. First, the content of these actions will be discussed, then, the implications that the BEPS Project actions have for MNEs.

Action 8 of the BEPS Project was already described in the previous chapter and focuses on intangibles, the transfer price of which is to be based on value creation. Action 9 aims to prevent entities from accruing large returns solely for holding risks and/or capital, which would on the first glance be in line with value creation, but in fact could be a tax evasion method. Tax evasion through high-risk and uncommon transactions between associated enterprises, which would not occur between third parties, is the subject of Action 10. Examples include management fees and head office expenses. For this purpose, the OECD proposes a so-called benefits test to test whether such intragroup services are actually provided or not.

Action 13 focuses on the documentation of information used to calculate transfer prices, to enhance transparency of relevant information such as income allocation, economic activity and taxes paid, which previously was challenging for tax authorities to collect. This information asymmetry was to the disadvantage of tax authorities, which could be used by MNEs to shift profits to tax havens. To solve this, the OECD followed up on Action 13 by means of the "three-tiered approach to transfer pricing documentation" in the TP Guidelines (OECD, 2017). This implies that governments include in the tax legislation that (certain) MNEs are required to provide certain three reports containing information to complement the transfer pricing requirements that already exist. The first of these three reports is the Master File, which includes an overview of transfer pricing policies, global allocation of income and economic activities, serving as a summary for the tax administration to assess the risk of noncompliant transfer pricing. The Master File therefore is a high-level overview of important information of the MNE group structure as a whole, intangible assets and tax positions. The second report focuses more on information necessary to establish whether the intercompany transactions are priced at arm's length and is known as the Local File. This information has to include financial information, comparability analyses and the motivation for why the company uses a specific transfer pricing method. The final report is the Country-by-Country Report, including information such as the income in different tax jurisdictions, financial information about intragroup transactions and third-party transactions and taxes paid. This information serves as an indication for the transfer pricing risk and other BEPS related risks.

The information required in these reports brings a new dimension to the battle of the OECD against profit shifting and base erosion and compliance (risk). With these requirements, the OECD aims to help tax administrations in being provided information to better assess TP risk and harmonize the transfer pricing regulations that countries implement. The Netherlands, for example, has already implemented these three reports in chapter VIIa of their corporate tax law (Wet op de vennootschapsbelasting, 1969) in 2016. The information that MNEs are to provide when these reports are implemented, is extensive, which puts great pressure on them to remain compliant.

Following these actions and a survey of 623 transfer pricing executives, EY provides insight for MNEs in their second report of the Global Transfer Pricing Survey series (EY, 2016). This guidance elaborates on how to deal with the pressure that BEPS puts on the already strict transfer pricing operations that MNEs face. In trying to comply with the implementations of the new rules on transfer pricing in multiple countries, multinationals may face substantial difficulties. This is proved by a result from the survey, namely that only 21% of companies are fully compliant with the new TP documentation requirements from Action 13. Insights like these from advisory companies are valuable as they are based on observations and experience in the transfer pricing field, especially when the subject is what pressures companies face in trying to comply with the new transfer pricing (documentation) requirements. This pressure, for example, includes the requirement to document everything needed in the Local File, Master File and Country-by-Country report.

Another observation is that only 17% of executives say that their transfer pricing documentation is aligned with the BEPS principles, as the rest are not at all aligned (16%) or only in key transactions or key territories (67%). The introduction of BEPS and implementation of its actions has severely tightened rules and the stance of tax authorities on what transfer pricing (documentation) is acceptable. 84% of MNEs surveyed, however, indicate that steps are being taken to implement a BEPS-aligned documentation process within the next year. Implementation of Country-by-Country reporting, however, is lacking, as only a third of executives claim to be on schedule with key transition actions. This may put companies in a tight position in terms of time necessary to be fully compliant, which, according to EY, may frustrate their chances of making adjustments to operations if necessary.

Two fields that are the most impacted by BEPS, are permanent establishments and intangible assets. While permanent establishments refer more to the prevention of artificial permanent establishment status-avoidance in Action 7 of the BEPS Action Plan, intangible assets refer to actual transfer pricing to be aligned with real value creation (Action 8). Still, only one in five respondents have taken action regarding the new intangible assets requirements. A similar percentage has no awareness whatsoever of the implications. The aim of the OECD with regard to intangible assets is that these are no longer used in tax avoidance through a diluted form of ownership (and disproportional considerations received by this ownership). The new documentation rules and benefits test are meant to give tax authorities a transparent view about whether an entity actually exercises ownership, decision-making and control over the asset, which can be used to assess whether an intra-group price for the use of intangible assets is allocated in accordance with value creation (Churton, Lambert & Dennis, 2016). The pressure for MNEs regarding the BEPS intangible assets requirements is that the transfer prices must be adjusted to BEPS-compliant prices, aligning value creation and ownership with the profit allocation. Additionally, the definition of an intangible asset may trigger debates, as this definition is not a clear-cut description based on legal or accounting rules: a non-physical or financial asset, usable in commercial activities, whose use or transfer would be compensated in a comparable third-party transaction (Daluzeau, 2016). As MNEs will have to review which obligations arise from which transfer pricing facts, given the new definitions and requirements of intangible assets, “low-value adding intragroup services”, ownership and documentation, any uncertainty arising from these already pressuring requirements will cost a lot of resources.

In the TP guidelines (OECD, 2017), the OECD does admit that taxpayers should not incur disproportionately high costs for producing documentation, such as finding comparable data for their transactions, asking tax authorities to not require this at all costs. Also, materiality thresholds are proposed to not burden all (or smaller) MNEs with disproportionate documentation requirements. In the Netherlands, for example, this recommendation was translated into article 29c of the Corporate Tax Law (Wet op de vennootschapsbelasting, 1969), which says that the Country-by-Country report is only mandatory for MNEs with over €750.000.000 of consolidated revenues. These recommendations for implementation of the OECD guidelines help relieve pressure from MNEs in their objective to be compliant.

3.4 Management Accounting Risk

A final type of risk as a result of TP regulations is management accounting risk. An article by Cools and Emmanuel (2007) concludes that the stricter a tax jurisdiction is with respect to transfer pricing, the more inclined a multinational enterprise will be to use an arm’s length acceptable transfer price for internal management purposes. The thought behind this is that the detailedness of strict tax regulation brings forth a lot of non-compliance risk, meaning that it is best to be compliant in full detail already, as otherwise large penalties or difficulties may arise in the audit/APA process, the so-called highest-common-denominator effect. Besides, the increasing documentation requirements leave little space for sub-unit managers to set or change the transfer price to improve their unit results.

Similar evidence is found in a paper using data from the aforementioned EY (2016) survey (Jost, Pfaffermayr & Winner). The authors estimate that the procedural risk of tax compliance, so for example penalties and difficulties agreeing APAs, is more crucially perceived than statutory corporate tax rates, as previous tax audit experiences affect MNEs’ perception of what the largest risk is. This would mean that regulation and frequent auditing is a good deterrent to non-compliance. In effect, this is an incentive for companies to use unified transfer prices for both tax compliance purposes and management accounting.

From a financial accounting perspective, however, the mandatory adoption of IFRS may cause 11.5% more tax-motivated profit shifting, despite an increase of the number of benchmark firms (De Simone, 2016). Following adoption, namely, the availability of benchmark firms for substantiating transfer prices increases, but this may enable MNEs to abuse the wider range of acceptable transfer prices to pick one that minimizes tax liabilities. In that sense, IFRS adoption may lead to lower compliance risk, while on the contrary, tax authorities prefer a tighter set of tax standards. This may instead bring forth a higher tax compliance risk.

Another problem found by the former OECD Transfer Pricing Unit Head (Hickman, 2018) concerns low value-adding intragroup services, which face a significant compliance risk compared to its importance or value. Besides, the benefits test in Chapter VII of the OECD TP Guidelines is said to be redundant. Hickman also advocates guidance on distinguishing and valuing intragroup high value services.

3.5 Conclusion

Transfer pricing laws and customs are different for every country; however, the OECD attempts to harmonize the cornerstones of these regulations. If MNEs are not compliant, penalties of up to billion dollars may arise. Therefore, it is important that they understand the core concept of arm's length prices and value creation, both vital concepts to base a transfer price on to be compliant. APAs give incentives to be compliant and transparent, relieving TP compliance risk. If these core concepts are not adopted well by TP executives, as well as well documented, problems may arise quickly, as the stringent BEPS regulations put companies at the highest ever pressure to be compliant – something, according to a survey from EY, is not an easy task. All in all, the result of transfer pricing regulations, and in particular the OECD BEPS implementations, has the desired effect of disincentivising non-compliance (through profit shifting) and rewarding compliance. Whether the OECD transfer pricing regulations are effective enough in preventing non-compliant transfer pricing and whether these will be able to keep up with the changing business climate, will be assessed in the next chapter. This chapter will start with an outline of the five OECD-prescribed transfer pricing methods to better understand the criticism further in the chapter.

4. What can be changed in the current OECD transfer pricing regulations to advance efficacy and practicality?

4.1 The role of MNEs in ensuring tax authorities a fair tax base: the five TP methods

4.1.1 Introduction

A vital part of answering the main question, specifically how national governments can be sure of their real fair share of profit tax, is knowing how MNEs should act to ensure this fair share. Besides, defining what a fair share is for those in charge of international transfer pricing laws is important, as it is the very base of this legislation. Therefore, in this sub-chapter 4.1, the methods and principles that lie at the very heart of the latest transfer pricing (documentation) rules will be discussed.

When unrelated parties engage in international transactions, the price is mostly dependent on market forces. The effect of such a transaction on the revenues, costs and profits of the companies directly influences the level of profit tax to be paid in the different countries that these companies operate in. Ignoring possible double taxation, this distribution of tax ensuing from this transaction, affected by "natural" market factors, can be seen as the fair distribution of taxes. In a transaction between associated enterprises, however, the price may not be fully based on real market factors, but rather on strategy. To prevent such transfer pricing from artificially shifting profits where taxes are the lowest, the main principle of the OECD is that the transfer price should reflect the market as much as possible, essentially being the same as at a similar transaction between unrelated parties (OECD, 2017). This arm's length principle is therefore seen as the transfer pricing benchmark that leads to the fairest distribution of profit tax.

If this price or any renumeration condition deviates from an arm's length price, Article 9 of the OECD Model Tax Convention (OECD, 2015a) enables tax authorities to adjust the profits for tax purposes to ensure their fair share. Besides, penalties exist for breaking transfer pricing laws, which focus on enforcing the use of arm's length transfer prices. The OECD tries to harmonize these laws with guidance and actions fully based on the arm's length principle. Therefore, the focus of this sub-chapter is on how this principle is applied in practice: ensuring that multinationals use transfer pricing methods that lead to a fair distribution of profit tax.

4.1.2 The separate entity approach

The arm's length principle is applied in the OECD Model Convention (and subsequently the Guidelines) using the separate entity approach, which treats members of an MNE group as independent, separate entities, as would be the case in a comparable uncontrolled transaction of goods or services. This prevents unfair tax advantages of associated enterprises over separate third-party transactions. In the case of permanent establishments in another country, the separate entity approach is explicitly mentioned in Article 7 of the OECD Model, "in particular in its dealings with other parts of the enterprise". This parity of tax treatment for associated enterprises and independent enterprises is the most important reason why OECD member countries have adopted the arm's length principle. There are cases in which the calculating the arm's length price is challenging even using the prescribed five transfer pricing methods that will be discussed in this chapter. Also, the arm's length principle being the base of current transfer pricing legislation is met with criticism, which will be discussed later in this chapter as part of assessing the efficacy and practicality of the next methods.

As equal treatment for MNE group members and independent agents is the standard for how a compliant transfer price should be calculated, the most OECD-favoured methods (traditional transaction methods) focus on directly establishing the arm's length price. These are three methods that have a high degree of comparing comparable transactions and circumstances to calculate the appropriate transfer price. In general, these methods are preferred over the two transactional profit methods because they neutralize the difference between uncontrolled and controlled prices by eliminating the effect of the commercial and financial relations between controlled companies. Transactional profit methods (based on the division on profits from independent comparable transactions rather than prices) less directly establish a price based on independent comparable transactions but may be more appropriate to use in situations where the information about comparable prices is too limited to find an arm's length price. This may also be the case when transactions are unique or highly integrated. The bottom line of an acceptable transfer price (in terms of complying with transfer pricing laws) is that the price is based on arm's length factors at all times.

When setting a transfer price for an internal transaction, members of an MNE are only free to choose a method to some degree. The selection of using one of the five methods depends on available information, the nature of the transaction and comparability of the transaction, keeping in mind the order of preference of the OECD when methods are found to be equally suitable. This selection should be motivated as such and therefore cannot be driven by tax saving reasons. In more extreme cases, other methods than the OECD TP Guidelines-prescribed methods are allowed as long as they satisfy the arm's length principle and are well documented.

4.1.3 Traditional transaction methods

Out of the three traditional transaction methods for transfer pricing, the comparable uncontrolled price method (CUP) most directly fits the definition of an arm's length price, which often is the method referred to in national TP legislation. The information in the previous section is most true for the CUP method as it involves using the price for a similar but uncontrolled good or service as the transfer price between associated enterprises. If there is readily available information on comparable uncontrolled transactions (i.e. no or eliminable material differences exist), this method is the recommended OECD method for MNEs. This not only concerns product comparability but should include broad business functions as well. Examples include at which level of the market the product or service is transferred, where, when and with which contractual terms, taking intangible property use into account and potential foreign currency risks. For regularly traded commodities, this method is a simple and reliable method to calculate the transfer price at arm's length. When no product or service can be found that has a high enough comparability to the internally traded product, for example in case of monopolies, the CUP method is not as useful, even with adjustments.

The second traditional transaction method is the resale price method, which is most appropriate for resellers. It applies the arm's length principle in the sense that the difference between the resale price and the arm's length transfer price is a gross margin that comparable businesses would use to cover expenses, risks and profits (Hughes & Nicholls, 2010). The comparison in this case is also with comparable uncontrolled transactions but focuses on a resale margin that unassociated enterprises would use. Therefore, the same comparability measures apply.

The same is true for the third method, which works the other way around: an arm's length mark-up is calculated and added to the costs incurred by the MNE group member which sells the product or service, reaching an arm's length transfer price. This so-called cost-plus method is applied to the production costs, direct and indirect, not the full costs. The easiest version of this method is using the mark-up that the supplier would use in case it would sell the same product or service to a third party (internal comparable). If no such transactions exist, for example because the supplier only sells internally, then a comparison may be made using an external comparable: the mark-up that a comparable independent enterprise would earn in comparable circumstances. Differences in function, risks, assets (especially intangibles) and market conditions decrease the usability of this method, however, which is why the method is less useful in more complex controlled transactions.

4.1.4 Transactional profit methods

The drawback that all of the above three traditional transaction methods have, is that information from highly comparable arm's length transactions is used to form a compliant, arm's length transfer price. This information may be readily available in competitive, transparent commodity markets, but may also be absent or non-comparable due to the use of intangible assets. Difficulties in comparability may already arise from marketing costs or brand reputation being different. If this results in a situation where the traditional transaction methods are unable to be used to find an arm's length transfer price, the circumstances may call for using transactional profit methods. Enumerating all situations where this may be the case is not the aim of this thesis, but rather the way these methods make transfer prices be at arm's length. The OECD TP Guidelines in that case discuss two methods: the transactional net margin method (TNMM) and the profit split method. As the name suggests, transactional profit methods focus on setting a transfer price based on the profit allocation that would have happened in an uncontrolled transaction.

Especially in the case of the profit split method, the question where value is created is relevant. This method sets an arm's length transfer price through dividing profits based on the relative contribution of each MNE group member, thereby being how the total profit would have been allocated between independent parties. Out of the five TP methods discussed in the OECD TP Guidelines, the profit split method is the only non-one-sided method, meaning that it does not only focus on one party in the transaction. While this concept of value creation is often used as a transfer pricing policy in practice, the OECD favours the traditional transaction methods because of their arm's length basis and extensive guidance on this method is lacking.

The transactional net margin method (TNMM) is based on examining the net profit margin earned by the same party in a transaction with a third party (internal comparable, similar to the cost-plus method) or if unavailable, the net profit margin earned in a comparable uncontrolled transaction of two other parties (external comparable). The simplicity of this method relative to the other methods, especially in case of internal comparability, makes this the most widely used method. In practice, the margin is applied by determining a net profit indicator directly related to the controlled transaction such as sales, costs or assets. Another advantage is that this method is less sensitive to small differences in products and services. However, if both parties make unique and valuable contributions, such as intangible assets not found in other independent parties, this method is less usable.

4.1.5 Conclusion

To prevent unfair tax advantages of MNE group members over independent third-party enterprises and to promote a fair distribution of profit taxes, the OECD member countries use the arm's length principle as the core of transfer pricing legislation. As preventing unwanted transfer pricing practices is better than correcting them, five methods are discussed in the OECD Transfer Pricing Guidelines that MNEs should use to set an arm's length transfer price. The traditional transaction methods focus directly on the definition of an arm's length price by looking at what would be the price of a transaction between independent parties. Transactional profit methods, however, are more often used for non-commodity products and services due to less information on comparable transaction being needed to find an arm's length transfer price. The correct use of one of these methods, chosen on the right grounds, ensures a correct transfer price and subsequently, a just and fair profit distribution among member states of the OECD.

While the arm's length principle is agreed on by the OECD member countries as the base of fair transfer pricing, it has shortcomings with regard to economies of scale and integrated businesses. This means that the principle in itself may not lead to a real fair distribution of profit tax between tax jurisdictions, and that alternatives are fairer for that matter. In the next sub-chapter, these alternatives and amendments advocated by critics of the current OECD course are discussed. While transfer pricing guidelines are regularly updated and OECD Working Parties work continuously to fine-tune guidance, the OECD says on page 38 of its Transfer Pricing Guidelines that "a move away from the arm's length principle would abandon the sound theoretical basis described above and threaten the international consensus, thereby substantially increasing the risk of double taxation" (OECD, 2017).

4.2 Assessing the arm's length principle's fit for the future – and the OECD's application

4.2.1 Introduction

As the goal of this research is to assess how national governments can ensure their real fair share of profit tax through effective transfer pricing regulation, a question that may require substantial attention is whether the current regulations and considerations are in fact fair, effective and practical. From the point of view of the OECD, the simple answer to this question is enforcing transfer pricing based on arm's length prices in combination with transparency of the methods that a multinational enterprise uses. Despite there being a large consensus about this theory, the current methods prescribed by the OECD are said to have shortcomings, especially with regard to the use of intangible assets in transfer pricing. Critics further claim that the current OECD projects, such as the BEPS project (regarding transfer pricing) and the Transfer Pricing Guidelines, are not fit for the future, but rather focus on closing tax loopholes (Devereux & Vella, 2014). In that sense, the arm's length standard as an anti-avoidance measure is conceptually flawed. Criticism often is based on the notion that the arm's length standard does not reflect economic reality as it treats MNE group members separately instead of as integrated entities, while also not taking economies of scale into account and ignoring synergy effects (e.g. less costs made for the agreement itself). Moreover, the methods prescribed by the OECD do not work (Schoueri, 2015). As a result, MNEs may face considerable pressure to document information to comply with newly introduced TP laws (as described in chapter 2).

The current course of the OECD regarding transfer pricing legislation, which has been thoroughly discussed in the previous chapters, may have the support of its member countries' tax administrations, but given the increasingly integrated nature of MNE groups, the question is whether this course is robust enough. If this is not the case due to minor details, more effort could be put into updating the guidelines periodically. However, criticism on the arm's length principle as the standard of fairness in taxation would imply that there are additions, amendments and complete alternatives possible. As part of the main question of this thesis and the goal of this research is to assess how governments can best ensure their fair share of the tax base of multinational enterprises, researching the pros and cons, shortcomings and alternatives of the current OECD transfer pricing course is necessary to provide a complete answer.

4.2.2 Why the arm's length standard?

Taxation laws differ between countries, which might lead to the risk of double taxation or income shifting by MNEs in case of transfer pricing. The OECD aims to prevent both issues. Problems may arise when transfer prices are not based on market factors: one country may receive less tax than it would have the right to in uncontrolled situations. Consequently, this country may, as a result of its national taxation laws, claim part of the tax base that initially was claimed by another jurisdiction. (source 21) MNEs may artificially shift income to tax havens through transfer pricing at sub-market conditions. Different taxation laws also bring forth unnecessary compliance pressure in multiple jurisdictions.

These problems call for uniformity in taxation laws, which is what the numerous OECD projects are meant to achieve. The cornerstone of these project has been the arm's length principle from the first OECD Model Conventions and beyond. This principle was already in use in different countries as a transfer pricing standard and was adopted because of the wish to tax income where it is generated. Market conditions reflect where value is created and where income is generated (and consequently taxed), so this principle, which treats uncontrolled and controlled transactions equally, was seen as a fair principle to allocate taxation rights and ensure neutrality between MNE group members and independent entities. As the basic model of tax treaties between OECD members, the OECD Model Convention (specifically Article 9) has the central reference to the arm's length standard and comparable uncontrolled prices (OECD, 2015a; OECD, 2017). The aforementioned parity and fairness in tax treatment as a result of this standard without affecting international trade and investment is the OECD's argument in favour of the arm's length standard. Furthermore, its simplicity in use with regard to commodities, where comparable transactions are plenty, advanced its adoption. Finally, with international consensus on the arm's length principle and its application in Article 9 of the OECD Model, the number of double taxation situations diminishes.

Schoueri (2015) mentions that the rationale of the arm's length standard is based on fairness in tax distribution among countries and equality between associated and independent firms. Besides, the standard reflects the ability-to-pay principle which is inherent in taxation. Taxes are ultimately spent on the needs of the country's community, such as health care, infrastructure and the economy. The arm's length standard ideologically fits well with the very idea of taxation in the sense that those with equal ability to pay, pay equal taxes: MNE group members and independent firms. With profits being the proxy for an enterprise's ability to pay, and profits being assessed on an individual, national basis but affected by transfer pricing, application of the arm's length standard is a fair method to ensure equality in contributing to the tax revenues of countries. Schoueri, rightly so, therefore declares that the arm's length standard is an adequate principle to fairly distribute the tax burden among enterprises.

To be compliant with arm's length standards calls for setting a transfer price in a certain range of arm's length prices, which is where comparability comes into play (Cooper, Fox, Loeprick and Mohindra, 2017). If this comparability analysis is simple, the arm's length standard functions well in its role of ensuring tax neutrality and fairness, as do the traditional transaction methods. However, when there is a lack of available information from databases, statutory accounts of entities and financial data, the arm's length standard loses its effectiveness. Pankiv (2017) notes that a misapplication of the arm's length standard arises particularly in three areas: "intangibles, contribution to their development and deployment, and entitlement to a return; (ii) contractual allocation of risks and capital and what it means to bear risk; and (iii) non-recognition of transactions". Especially intangible assets are a major problem for the OECD in terms of ensuring efficacy of transfer pricing regulations. This makes comparability analyses difficult and calls for a different approach, possibly deviating from the arm's length principle and focusing more on profit splits and value creation. Specific commentary on intangibles and how the transfer pricing regulations should be regarding those, is later in this chapter. Pankiv also mentions that the arm's length standard is not an anti-avoidance measure and should not be viewed as such. Instead, domestic law should tackle profit shifting and abusive practices.

While the arm's length principle in itself indeed is not fit nor designed to address the transfer pricing challenges of tax authorities, correct application of the arm's length standard in TP regulations does deter profit shifting (Marques & Pinho, 2016). Similar results are found in an aforementioned survey, as 84% of MNEs indicate that they are implementing BEPS-aligned documentation processes within the next year (EY, 2016).

The results from this survey might indicate that the arm's length principle and tightened regulations based on that principle might be effective in aligning transfer prices with comparable uncontrolled prices (which should lead to a fair distribution of tax base), but there are still difficulties arising from these tightened regulations for MNEs. These difficulties and pressure – also mentioned in chapter 3 - might make one wonder whether there are viable alternatives that have better efficacy and practicality.

4.2.3 The conceptual flaw of the arm's length principle

Criticism on the arm's length principle can be roughly classified into two areas, of which the first is an objection of the arm's length principle as a standard of fair transfer pricing for tax purposes (Schoueri, 2015). The second group of criticism is focused on the feasibility and practicality of the OECD's application of the arm's length principle, i.e. the transfer pricing aspects of the BEPS Project, Model Convention and TP Guidelines. Within that group, intangible assets are given particular attention.

While of course the arm's length standard is ideologically sound in the sense that it embodies equal treatment for equal entities, the question arises whether this is still fair in 2018. MNE group members may not be comparable to independent enterprises anymore, as in reality they are treated as integrated firms over which the parent company has control (Schoueri, 2015). Using these controlled entities, economies of scale and synergy rents are achieved, contract costs can be lowered, and cost pooling becomes possible. This is not exclusive to recent years, but rather a growing process. These differences between controlled and uncontrolled firms call for the question whether the arm's length standard can still be integrally applied, as there is no consensus on how economies of scale should be integrated into transfer pricing regulations (OECD, 2017). The consequent questions that arise are which adjustments should be made, and whether the arm's length principle in transfer pricing is fit and robust for the future. Still, the OECD largely downplays alternatives, such as formulary apportionment, as incapable of replacing it, due to a lack of international consensus. Formulary apportionment is, as crudely defined in the OECD Transfer Pricing Guidelines, an approach that allocates an MNE's global consolidated profits to its associated enterprises using a pre-defined formula based on "some combination of costs, assets, payroll, and sales". This would involve apportioning the total profit of an MNE group, i.e. worldwide revenues minus worldwide costs, over the various affiliates, subsidiaries and permanent establishments of an MNE group.

Further objections to formulary apportionment, as the OECD mentions in its TP Guidelines, state that such an international consensus on the use and formulae of global formulary apportionment would necessitate perfectly coordinated implementation. This is not likely to be a feasible option, moreover, countries would have incentives to deviate from this formula to maximize their own tax revenues. Tax avoidance would be possible by engaging into unnecessary transactions, holding excess inventory and artificially shifting production factors to low-tax countries.

The OECD does, however, realize that the arm's length principle has limitations with regard to the comparability of transactions and finding these transactions (Robillard, 2015). The aforementioned profit split and TNMM methods already drift away from comparability analysis and Robillard argues that the OECD is more and more drawn to formulaic approaches for transfer pricing in case comparable transactions are unavailable. As a consequence, such two- and multi-sided TP methods may be able to step in where one-sided, comparison-based methods have shortcomings. However, we must be wary of the problems that formula-based transfer pricing alternatives may cause: if (or more likely, when) tax authorities implement laws and guidance on these methods unilaterally, major tax disputes and double taxation issues will arise. This hypothesis is based on the observation that formula-based transfer pricing alternatives are proposed disconnectedly and infeasibly into OECD public discussion drafts. In conclusion, according to Robillard, the arm's length standard is not ready to be replaced by formulary apportionment.

The weakness of the arm's length principle seems clear, however: firstly, its inability to deal with the (logical and therefore not unfair) economies of scale that constitutes a difference between uncontrolled and controlled entities. Of course, the notion that the use of unique intangible assets is to be priced at arm's length brings forth difficulties as well. But, there are problems with tax evasion even when the arm's length principle is satisfied (Devereux & Vella, 2014). Through Cost Contribution Arrangements (CCAs), agreements between subsidiaries to share the costs and risks of (intangible) assets, there still are possibilities to shift profit to low-tax jurisdictions. The requirements of such a CCA to be consistent with the arm's length standard is to be reasonably what an independent enterprise would have agreed to contribute, given the probable benefits of this agreement. However, in combination with debt of equity funding, a parent company and a subsidiary (or two subsidiaries) can shift profits even when the CCA is at arm's length according to its definition. The OECD might be aware of this problem and actively trying to solve it, but the problem itself arises from a failure of the arm's length principle.

Even though the OECD opposes the introduction of formulary apportionment in transfer pricing legislation, some critics argue in favour of such a development. Brauner (2014) states that the arm's length standard is broken and that formula-based elements are desirable in a narrow transfer pricing rules reform. As the arm's length principle ignores differences between multinationals and independent entities such as risks and costs, while forcing market prices onto non-market transactions, even the OECD more and more chooses to deviate from it. Another problem that formulary apportionment can solve, according to Brauner, is the complexness and costliness of arm's length implications. The current arm's length documentation obligations, for example, are guaranteed to be time- and resource costly and this burden is solely caused by the need of comparability analyses, which would not be the case in formula-based transfer pricing. The author also argues that the United States government in particular could benefit from the increased fairness that (even unilateral) formulary apportionment would bring, as it has a budgetary deficit while U.S. multinationals abused transfer pricing for years to generate false income in Ireland. In that sense, it certainly would be fairer for the distribution of tax bases if countries chose for leaving the arm's length standard behind for practical purposes, but only if this is done fairly and multilaterally. In addition, the argument that formulary apportionment discourages investment in high-tax countries (which might lead to tax wars) could be solved by using a formula based on the location of sales rather than production (Clausing & Avi-Yonah, 2007; Devereux, 2014).

The arguments in favour of abandoning the arm's length principle may be compelling to some, but unless the OECD is denounced or makes a 180-degree turn, formulary apportionment is highly unlikely to be implemented as a fundamental reform of the current transfer pricing system. Without international consensus on a smooth implementation process and a waterproof anti-tax avoidance system, it will likely be a too large investment of time and resources. Still, the OECD has to update its guidelines and projects to better respond to the challenges of the changing business climate, especially regarding synergy advantages of MNEs.

4.2.4 The Achilles heel of arm's length pricing – intangibles?

As mentioned, the second area of criticism on current transfer pricing regulations focuses on the feasibility and accuracy of modern day transfer pricing regulations. While commodities that are transferred between MNE group members often have comparable transactions ready to prove arm's length pricing, this is not the case for intangible assets. As seen in chapter 2, the OECD aims to solve this problem with Action 8 of the BEPS Project (OECD, 2015b), which focuses on aligning transfer pricing with value creation. It is quite clear that the arm's length principle is not suited to deal with the increased use of intangibles in transfer pricing (Kane, 2014). The same is true with the benefits from integration, i.e. doing business as a multinational enterprise rather than a sole entity (synergy benefits or economies of scale). Kane argues that a formulary mechanism that includes the use of a so-called "synergy intangible" is not desirable as it would not advance the prevention of double taxation. Instead, he states that a three-part taxonomy of integration (or: synergy) intangibles used in transfer pricing would make matters simpler and more effective. As a synergy benefit is an intangible asset that basically explains why controlled and uncontrolled enterprises are not fully comparable (which is one of the objections of the arm's length standard), it is quite relevant in transfer pricing. This value of common control cannot be priced under arm's length standards as it isn't earned in uncontrolled situations. Therefore, value from common control in transfer pricing could best be left to taxpayer discretion, while the comparable parts of an intra-group transaction are priced at arm's length. However, the OECD and other economists disagree and argue that synergies are not intangibles, and that intangible assets should be valued where value is created (Wright, Keates, Lewis and Auten, 2016) so that the arm's length principle is satisfied.

Profit shifting through transfer pricing so that royalty payments to intellectual property (a type of intangible asset) are taxed predominantly in low-tax jurisdictions, in combination with a better valuation of intangible assets in transfer pricing, is one of the key areas that the BEPS project focuses on. According to Treidler (2015), these challenges are the very future of transfer pricing, not overhauling the system in favour of formulary apportionment. This is because there is little empirical evidence that profit shifting occurs on a large scale, as most companies just want to be compliant with transfer pricing rules, which was also stated by Wright, Keates, Lewis and Auten (2016). Therefore also, adoption of a Common Consolidated Corporate Tax Base (CCCTB) would be a major overhaul of the corporate tax system, while not being any more suited than the arm's length principle at accounting for value addition of intangibles. Rather, and I agree with this proposal, intensive cooperation with experts in various fields of business studies can focus on intangibles regarding value chain analysis, accurate valuation and digital/knowledge issues. This would benefit the efficacy of TP legislation, remove uncertainty and align the arm's length principle better with economic reality, rendering formulary apportionment methods such as CCCTB unnecessary. In the future, transfer pricing audits will focus beyond margins and comparable transactions, possibly leaving the traditional transaction methods behind, but with a larger role for value creation, APAs and CCA regulations (Vaidya, 2017).

4.3 Conclusion

These two areas of criticism about the arm's length principle pinpoint the areas of interest for the OECD to keep up with the challenges that transfer pricing brings. With all of the criticism, support, alternatives and recommendations, the sub-question can be answered. As a conclusion to the second sub-chapter, we can state that in the mission to ensure effective, fair and practical transfer pricing regulations, the focus needs to be with taking uncertainty and discrepancies regarding legislation away, focusing on value creation and on intangibles. The current methods, based on the arm's length principle, cannot simply be replaced by formula-based methods to advance efficacy and practicality.

These current methods were discussed in the first sub-chapter to this sub-question. The OECD aims to develop regulations and guidance to make transfer prices better reflect where value is created, so that tax authorities get their fair share of profit tax. The mandated use of comparable transactions in these methods, which is supposed to reflect market conditions and correct unfair advantages, reflects that aim. The traditional profit methods focus directly on comparable transactions from independent parties, while transactional profit methods, such as profit splits, are more common for non-commodity good transfer pricing.

A recent Dutch Transfer Pricing Decree[2] confirmed the arm's length standard as the past, present and future of transfer pricing. It also provides interpretations and guidance on (hard-to-value) intangibles, risk and CCAs. In some situations, the actual value will be compared to the projected value of intra-group transactions to minimize arbitrage. This decree shows that the current transfer pricing regulations are capable of answering to recent developments and will continue being developed to keep doing so.

[2] See https://zoek.officielebekendmakingen.nl/stcrt-2018-26874.html

5. Conclusion

The goal of this thesis was to research what the pressure of the OECD's (proposed) transfer pricing regulations is on multinational companies and to what extent these can be improved in terms of efficacy and practicality. Using three sub-questions, I answered the main question in detail. Various literature sources served to provide enough information to achieve this.

Transfer pricing has recently drawn considerable media attention as it was used in notable tax evasion schemes, such as the Apple case. Multinational enterprises may use their presence in multiple countries to make use of differences in tax rates and laws to lower their total tax liability. This can be done through transfer pricing at a non-arm's length price, to report higher profits in low-tax countries or tax havens. Formulating an arm's length renumeration for the use of intangible assets might be difficult and if this leads to discretion in pricing, governments may be withheld their fair share of profit tax. The BEPS Project aims to solve such issues. This does cause the need for additional regulations, which makes companies need to exert more effort to be compliant.

This pressure includes an enlarged pressure to prove that transfer prices are at arm's length through comparability analyses, or through APAs. Besides, a three-tiered transfer pricing documentation requirement was introduced with the BEPS programme, which require companies to document their transfer pricing strategy and the thought behind it. This aims to achieve greater transparency and battle tax evasion. The same can be said of the five transfer pricing methods prescribed by the OECD. While the three traditional transaction methods are directly based on comparability, which is why they are favoured, the two transactional profit methods are more apt for non-commodity goods and services.

These methods and regulations are aimed at making MNEs contribute their fair share of profit tax in the right tax jurisdictions where value is created. There is criticism, however, on the arm's length principle as the cornerstone of fair transfer pricing methods. Two types of criticism are distinguished. Firstly, the principle is said to be conceptually flawed as it cannot account for the real differences between controlled and independent entities. These synergies might be better dealt with by using alternatives, such as formulary apportionment. The OECD, however, argues that a lack of international consensus makes such an alternative undesirable. Secondly, the use of intangible assets in transfer pricing is a difficult and quickly developing area to tackle for the OECD. Value chain analysis, international cooperation and updating intangible asset valuations, while staying true to the principle of arm's length, will make the future of transfer pricing robust enough to keep ensuring tax authorities their real fair share of profit tax.

As a matter of practical recommendation, summarizing from all chapters and using arguments from the previous chapter in particular, it is clear that there is room for improvement. Based on the information about formulary apportionment, I see two large drawbacks that essentially make it not more than a utopian idea. A global corporate tax reform into a formula-based transfer pricing system replacing and abandoning the arm’s length principle would be time-consuming, and the question is whether there will ever be any consensus reached at all about the implementation, formulae, etc. Secondly, it would not be less costly than arm’s length-based methods. Indeed, comparability analyses are time-consuming and sometimes impossible, but formula-based methods would necessitate the use of many factors for even more separate entities and jurisdictions. Extremely good international cooperation would be necessary for this to work well, while other areas of interest would be tax competition and tax avoidance. Formulary apportionment might have its advantages, but it is highly unlikely that a global reform departing from the arm’s length principle will take place, and instead focusing on a more accurate valuation of added value from intangibles might suffice to be more practical, efficient and economic reality-reflecting.

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