BEPS MONITORING GROUP

Transfer Pricing Comparability Data and Developing Countries

This paper has been prepared by the BEPS Monitoring Group (BMG), in response to the OECD report on this subject. The BMG is a group of experts on various aspects of international tax, set up by a number of civil society organizations which research and campaign for tax justice including the Global Alliance for Tax Justice, Tax Justice Network, Christian Aid, Action Aid, Oxfam, Tax Research UK. This paper has not been approved in advance by these organisations, which do not necessarily accept every detail or specific point made here, but they support the work of the BMG and endorse its general perspectives.

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We welcome the opportunity to comment on the report on *Transfer Pricing Comparability Data and Developing Countries* published by the OECD on 11th March 2014, prepared at the request of the G20.

SUMMARY

In our view, the Report is disappointing. It is inadequate and unhelpful for developing countries. The Report:

- assumes that developing countries should use transfer pricing methodologies which have been found deficient even by OECD countries, and are currently being revised, especially through the project on Base Erosion and Profit Shifting (BEPS);
- prioritizes the use of comparables, although these methods have been shown to be deficient in both theory and practice, especially for developing countries;
- obscures the real problem, which is not the absence of data but lack of appropriate comparables, due to the integrated nature of multinational firms;
- fails to provide any information about what databases are available, or an evaluation of whether or how the data that they provide is supposed to be helpful for the purposes of auditing transfer pricing;
- encourages developing countries to use methods which are likely to require case-by-case negotiation to ameliorate the fundamental deficiency of data without acknowledging the asymmetries of knowledge and power between developing country tax administrations and both tax advisers and developed country tax administrations; and
- provides only a superficial consideration of alternatives to the use of comparables.

In our view methods based on either comparable prices or comparable profits are unsuitable for developing countries, and likely to lead to either over- or under-taxation, because:

- the lack of appropriate comparables means that appropriate assessments require detailed examinations, specialist knowledge, and subjective judgment;
- such assessments are time-consuming, and require skilled specialists, who developing countries find it hard to recruit and retain;
- the subjective judgments involved leave officials open to undue pressures and temptations to corruption;

relying on data-bases can result in the use of inappropriate comparables, which may become generalized as firms also rely on them to avoid disputes;

conversely, the adoption of aggressive adjustments by officials, which may also result from performance incentives, resulting in counter-claims by firms, can lead to an adversarial culture, and sometimes excessive litigation;

the subjective and often arbitrary nature of adjustments based on comparables makes it hard to resolve conflicts if they arise between states other than by equally discretionary bargaining.

Our recommendations are that developing countries should:

learn from the mistakes of the OECD countries, and build on their own experience, for example the `sixth method', or the Brazilian approach;

anticipate rather than await reforms likely to result from initiatives to combat BEPS, such as country-by-country reporting;

establish methods which are clear, transparent and easy to administer without the need for significant ad hoc investigation or subjective judgment;

coordinate transfer price scrutiny with other anti-avoidance measures such as denial of deductions for inappropriate payments to related entities.

We will begin with some general comments, and then address the possible actions identified in the report (para. 12).

1. General Comments

1.1 Transfer Pricing Methods

Detailed transfer pricing regulations were first adopted by the US in 1968, and their approach was adopted in the first OECD Report on the subject in 1979, and followed by other OECD countries. In the past 5-10 years they have spread to many developing countries. Countries are free to adopt whatever approaches they consider most suitable, subject only to any tax treaties which might be applicable.[1] Countries generally declare their adherence to the OECD Transfer Pricing Guidelines and/or the UN Manual on Transfer Pricing; but these are written discursively rather than prescriptively. They currently provide for five accepted methods, but significant revisions and additions are expected in the next two years resulting from the OECD's BEPS project and other possible reforms of international tax rules.

The US 1968 Regulations prioritized the `comparable uncontrolled price' (CUP) method, which requires the prices of transactions between related entities within a corporate group to be adjusted to those charged for the same or similar items between independent parties. However, it was quickly discovered that true comparables could not be found. The reason for this was not lack of data, but essentially because the competitive advantage of multinational firms lies in their technological advantages, or economies of scale or scope. Intra-firm transactions do not involve either fungible commodities or standard services which could be

[1] Tax treaties provide that where conditions between related entities `differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly'. This leaves a wide scope for deciding on what method of adjustment may be used, although interpretation may take account of the official treaty commentaries, and in some countries the OECD Transfer Pricing Guidelines are referred to in legislation, or by courts. However, many developing countries have few tax treaties, and they would apply only to transactions with a related entity resident in a treaty partner.

bought from third parties on open markets. Corporate groups do not source internally items such as plastic buckets or office supplies, or services such as transportation or banking – these are bought from independent suppliers through the market. Both economic theory and practical experience confirm that internal transfers within a firm are of products or services which are unique or distinctive, or can be produced more advantageously internally than by third parties. Companies continuously examine rigorously which activities can more efficiently be outsourced, so that the firm can focus on its core competences.

Historically, tax authorities also used `comparable profit' methods as a basis for adjustments of the declared profits of a local foreign-owned affiliate. The OECD Guidelines specify the `cost plus' method, essentially for entities engaged in production, and `retail minus' for distributors. However, due to the increasingly complex value-chains created by multinational corporate groups, and again following a US initiative in the 1980s, a more refined comparable profit method was adopted in the 1995 OECD Guidelines, the `transactional net margin method' (TNMM). This entails using microeconomic methodologies to define the function of the affiliate concerned, and attributing to it a net profit relative to an appropriate indicator (e.g. return on assets, or operating income to sales).

However, comparable profit methods have also been criticized as inappropriate, and are now described as `one-sided' methods.[2] By assuming that the profitability of an affiliate derives only from its specific function they ignore the additional or `residual' profit resulting from the synergy of the group. For example, it would be inappropriate to attribute to the shops of global mass retailers such as Ikea or Walmart the same profit margin as smaller national or local shops. Other OECD states objected to the US CPM proposal in 1991-2, because it implicitly assumed that the `residual' profit should be attributed to the parent company. More recently, all OECD states have realized that using arm's length transfer pricing, in conjunction with other techniques, multinationals can ensure that such residual profits may be `stateless income', untaxed anywhere.

In response a fifth method, `profit split', was also included in the 1995 OECD Transfer Pricing Guidelines. This entails aggregating the profits of related entities and apportioning them according to appropriate `allocation keys'. It was fiercely resisted by multinational business, on the grounds that it entailed a unitary taxation approach, treating related entities in a multinational group as a combined business and apportioning their aggregate profits according to factors reflecting their contribution. So although profit split was included as an acceptable method within the arm's length principle, the Guidelines described it and the TNMM as `transactional profit' methods. Also, they included statements rejecting `formulary apportionment', defined as apportionment of total profits `by a formula fixed in advance'. Nevertheless, the profit-split method clearly involved apportioning the combined profit resulting from related activities, and hence a step towards unitary taxation. However, it has been treated as a fall back method, in our view regrettably. It is usually applied only to the aggregate profit from a limited segment of activity, and has not yet been systematized or regularized, so it tends to result in arbitrary bargaining.

1.2 Comparables are Unsuitable

In recent decades firms have become ever more adept in exploiting the economies of integration and synergy, and at outsourcing activities which can more efficiently be performed by third parties. Improvements in information and communication technologies

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[2] In particular in the OECD's *Revised Discussion Draft on Transfer Pricing Aspects of Intangibles* (2013), e.g. para. 159.

may enable the reduction of transaction costs between independent entities, as well as facilitating internal coordination by integrated firms. Hence, firms are able to decide whether to internalize or outsource each activity purely on economic grounds. At the same time, the emergence of the knowledge economy and digital technologies, and the increasing importance of services, have facilitated the restructuring of value-chains in all economic sectors, including manufacturing. Minimization of tax is often a major factor driving these restructurings.[3] These trends have made the use of comparables as a basis for transfer pricing even less appropriate.

Hence, we suggest that what is needed is a proper evaluation of whether the use of comparables is cost-effective, especially in view of the arguments laid out briefly above that it is conceptually and practically unsound. The report rather weakly concedes that `[b]oth developing countries and developed countries may encounter the situation that no appropriate internal comparables or publicly available external comparables are identifiable' (para.24). In fact, the experience is that true comparables do not exist for intra-firm transfers. **A firm generally will only perform an activity internally if doing so will add more value than using a third party to do so.** This is why true comparables do not exist.

There are two corollaries of this:

> (i) it is inappropriate to use an apparently comparable price as the standard, since that price will not reflect the added value deriving from the synergy due to coordination;
>
> (ii) it is not possible to attribute that additional value to either of the related parties in such a transaction, since it results from that synergy.

We may take a well-known example, that of Amazon. The rapid growth of Amazon into a universal retailer is largely due to its ability to integrate and coordinate ordering on its website with control of supply-chains and logistics. Those aspects which can economically be outsourced have indeed been given to third parties, such as physical delivery. But it operates its own fulfilment centres, because their organization and integration with both supply and customer sales are central to its business model of rapid and low-cost order execution and customer satisfaction. It is no doubt possible to identify independent firms which offer warehousing and logistical services which might appear to be comparable. But whenever such services can be performed as or more efficiently by a third party, they are outsourced, otherwise the firm would lose its competitive edge. Hence, to attempt to disaggregate Amazon's overall profits and identify the amounts attributable to specific functions and affiliates, is a fruitless exercise. Indeed, it is counter-productive.

2. Expanding Access to Data Sources

Before taking any decision to introduce reliance on data-bases in transfer pricing, it is essential to evaluate the available databases and consider carefully evidence from those with experience of using them. Expanding access would require considerable resources, essentially from public sources, which needs to be justified in terms of demonstrable benefits. Regrettably, we find little of this in the report.

The report does not discuss any specific database, but refers generally to `commercial databases [which] assemble financial information filed with country security regulators and central registries for statutory accounts'. It seems to be referring to databases such as Orbis, or Amadeus, provided by Bureau van Dijk. These compile financial information relating to

[3] See for example the recent study for the US Senate Permanent Subcommittee on Investigations, *Caterpillar's Offshore Tax Strategy* (2014).

individual firms or corporate groups. The data they provide do not include details of the pricing of sales to third parties. Hence, these data are useless for the purpose of the CUP method, which requires `a comparison of the conditions in a controlled transaction with the conditions in transactions between independent enterprises' (OECD Transfer Pricing Guidelines, para. 1.15). All they can provide is a comparison with transactions between related parties in different corporate groups.

The only relevant use of such data would be as a guide to comparable profit margins. Yet for this purpose also they have many deficiencies. To begin with, as the report concedes, their coverage does not extend to most developing countries. The report is correct in stating that at present such databases generally include little data from developing countries, largely due to the non-availability of company accounts, because corporate registries do not exist, or are ineffective. There are certainly good reasons for attempting to improve this situation. However, it does not seem to us that ensuring the availability of comparables for transfer pricing purposes is among them.

The report mentions some of the difficulties entailed in using filters to identify data relating to the relevant business sector, and the problems of casting the net too wide or too narrowly. Many if not most economic sectors are dominated by multinational firms, and excluding them may be difficult or impossible. Even if this can be done, the more fundamental problem is that, as pointed out in the previous section, the cost structures and profitability of smaller national firms cannot be truly comparable to those of a multinational firm. Hence, even if data can be found for profit margins of independent national firms, it would be inaccurate and misleading to rely on them. Thus in practice, as the experience of tax authorities around the world has shown, such data cannot be used without making appropriate adjustments.

The report does not mention the attempts of developing countries such as Kenya, which have paid for access to such databases, and have received assistance to train officials to use them. This represents a significant administrative effort. Yet their experience has been that the lack of appropriate comparables in the databases means that their utility is very limited. They can provide at best only a guide, requiring considerable further investigations to make appropriate adjustments, even to take account of local conditions.

In developed countries such databases are increasingly relied upon by firms or their advisers, but essentially because reference to them may provide support for pricing policies which revenue authorities could accept. It perhaps could be argued in favour of this that if all tax authorities treat such data as providing acceptable comparables, conflicts and disputes would be reduced. This hardly seems a rational approach. The danger is that well-resourced tax authorities could challenge the comparability of such data when they entail erosion of their tax base, while developing country tax authorities would lack capacity to do so.

3. More Effective Use of Data Sources for Comparables

Even if databases are considered to provide at least some evidence for approximate comparables, their effective use would require considerable resources of skilled personnel. The skills involved entail not only learning how to make appropriate searches, as the report mentions, but much more importantly evaluating the terms and conditions of transactions to verify whether they are indeed comparables. Comparability of prices depends to a great extent on the terms and conditions, including delivery dates, quality specifications, and financial terms. Without such an analysis reliance on price data could be seriously misleading. Yet such analysis requires high levels of specialized knowledge of markets for a variety of products and services.

Experience in both developed and developing countries countries shows that reference to comparables often produces only a range of prices or profit margins. The taxpayer will naturally choose a value at the end of the range which is favourable to its tax position. Since the range is validated by comparability data the taxpayer's choice may be hard to challenge. This often occurs for example in pricing intellectual property licences. An example is the case of Starbucks in the UK, publicized by a parliamentary inquiry, which showed a global payment for intellectual property rights to a Dutch affiliate of 6%, subsequently reduced to 4.7%, and a 20% markup to its Swiss affiliate for its coffee purchasing operations.[4] Due to these and other techniques, Starbucks showed little or no taxable profits in its UK operations for some 20 years, and a low overall effective tax rate on all its non-US operations. Yet sophisticated revenue authorities such as the UK's HMRC, presumably having appropriate access to comparables data, seem to have been unable to challenge what seems to have been an egregious example of generation of `stateless income'.[5]

It seems hard to justify developing countries devoting scarce skilled staff for this work. It could perhaps be cost-effective in relation to sectors which are significant to a particular country's economy. An example could be the tourism sector. For instance, following enactment of its transfer pricing legislation in 2006, the Dominican Republic conducted an investigation of the package-tour business sector, resulting in the negotiation of benchmark rates with the National Association of Hotels and Restaurants, used as the basis for advance price agreements with individual hotels.[6] Such an approach might be implemented cost-effectively by setting up teams from several countries, perhaps on a regional basis, to focus on specific industries and major firms, using information exchange provisions. This could be organized by regional groups, such as the East African Community (EAC), or the Council of Finance Ministries of Central America (COSEFIN).

It should be borne in mind that the subjectivity of the decisions involved make staff vulnerable to pressure and corruption. This is not mentioned in the report at all, but it is a significant factor which has led to the preference of some developing countries for alternative methods, based on fixed profit margins or public price benchmarks.

Our view is that there is no justification for wasting scarce resources on training staff in developing countries to use comparables data, since the use of such data is not an effective method. If such staff were trained, many of them would leave for the private sector, and begin to use the techniques in ways that would benefit private clients. The result could be to entrench a system which is dysfunctional. An example is the situation in India, where the enactment of transfer pricing rules deploying a range of methods including comparables has resulted in an enormous growth of lawyers and litigation in this field, with some 3,000 cases pending in the Appeals Tribunals alone. This has done nothing to provide predictability or certainty for taxpayers, nor administrability for the revenue authority.

4. Approaches to Reducing Reliance on Direct Comparables

In our view this should be the main strategy for developing countries. Indeed, it is the one adopted by some of the leading developing countries, with some success. The framework

[4] UK Parliament, Committee on Public Accounts, *HM Revenue & Customs: Annual Report and Accounts 2011–12*, 19th Report of Session 2012-13, HC 716, p.8.

[5] E. D. Kleinbard (2013), `Through a Latte, Darkly: Starbucks' Window into Stateless Income Tax Planning' USC CLEO Research Paper No. C13-9 , Available at SSRN: http://ssrn.com/abstract=2264384 .

[6] See *Legislación y Práctica de Precios de Transferencia en República Dominicana* (Transfer Pricing Law and Practice in the Dominican Republic) (June 2012), Dirección General de Impuestos Internos, available from http://www.dgii.gov.do/publicaciones/estudios/Documents/LegislacionPracticaPreciosTransferencia.pdf .

established in Brazil, for example, has become quite well known, and is effective in Brazil's context. This entails applying profit margins determined centrally and fixed by law. The APAs negotiated by the Dominican Republic with the tourism sector, mentioned above, operate in a similar manner. This ensures ease of administration and ensures predictability for business. It is also important to note that Brazil combines these fixed margin methods with limitations on deductions for royalties, fees for services, and interest on loans, to related parties.

Another approach is the `sixth method', discussed briefly in the report. This has some advantages which it does not fully bring out, especially reduction of the element of subjective judgment and ease of administration. The comments in the report on the `sixth method' (para. 27) in our view miss the point. It is certainly true that even for commodities such as minerals, for which exchange-traded posted prices exist, these cannot simply be assumed to provide true comparables. It is necessary to take an average over a period to deal with price fluctuations, as well as making adjustments for quality, location, and contractual terms. However, such adjustments are also needed if the starting point is comparables derived from a database. Approaches such as the Brazilian system and the sixth method aim to establish clear, simple and easily administered procedures. They do not seek to pursue the illusory search for comparables which do not exist. Hence, they can be considered as palliatives, aiming to provide effective practical measures to deal with a fundamentally flawed international system.

Our view, as we have already made clear in other submissions, is that much more work is needed, especially within the BEPS project, to systematise and regularise the profit split method. At present, the Guidelines only refer vaguely to the need for the accounts of the related parties to be 'put on a common basis as to accounting practice and currency, and then combined'. They suggest that `financial accounting may provide the starting point for determining the profit to be split in the absence of harmonized tax accounting standards'. However, it is clear that much more focused and detailed attention will need to be devoted to this topic. We hope that this will result from the work on the Country-by-Country reporting template, which in our view must include a requirement for global consolidated accounts.

Work is also needed to identify appropriate allocation keys for profit apportionment. We hope that this may result from the project on Intangibles and the other action points on transfer pricing in the BEPS project. A key issue is the level of aggregation of accounts. A major limitation of the current approach to profit-split is that it is generally used just for `residual' profits. Hence, it does not avoid the need for extensive and intensive research on comparables. In our view, profit-split should either be applied to consolidated profits at the corporate group level, or in conjunction with easily administered comparable profit methods based on functional analysis, in a two-step procedure.

In our view, it would not be cost-effective for developing countries to train transfer pricing specialists to apply arm's length price methods based on non-existent comparables. Scrutiny of transfer pricing should not be dealt with separately from other anti-avoidance techniques. Instead, transfer pricing should be organized within teams applying a variety of techniques to ensure appropriate levels of taxation of multinational business, including limitation of deductions and anti-abuse rules.

5. Advance Pricing Agreements and Mutual Agreement Proceedings

Advance Pricing Agreements (APAs) may provide an alternative, in view of the unsuitability of current transfer pricing regulations. Indeed, there is evidence that in developed countries they tend to be used when a non-standard method is adopted.[7] However, developing countries need to approach them with caution. The experience of some such countries is that an APA can be entered into unwisely if staff are inexperienced and lack sufficient information about the firm and the economic sector in question. Hence, they may lock the tax authority into an inappropriate settlement.

Similar considerations apply to Mutual Agreement Procedures. In the absence of clear rules or criteria for assessment or apportionment of the tax base of integrated corporate groups, such procedures can become a matter of crude bargaining. It is not surprising that both the number of conflicts and the time taken by these procedures have been increasing. These are clear symptoms of the lack of effective transfer pricing rules, which in our view is due to the mistaken emphasis on methods based on comparables, and the reluctance to systematize and regularize the profit-split method. The suggestion that the problems of the system could be resolved by instituting compulsory arbitration of MAP disputes is therefore also ill-founded. It would be inappropriate to rely on arbitrators to fix the problems caused by lack of clear, fair, and easily administered rules.

All the reports and other details of the BEPS Monitoring Group are available at http://bepsmonitoringgroup.wordpress.com/

[7] For the UK see Rogers and Oats (2013), `The use of advance pricing agreements in transfer pricing management' *British Tax Review*: 76-94.