OECD TASK FORCE SUGGESTS CHANGES TO PROPOSED TRANSFER PRICING REGULATIONS IN THE UNITED STATES

The OECD’s Committee on Fiscal Affairs has just approved a Report outlining the concerns and recommendations of other Member countries on the proposed Transfer Pricing Regulations on Section 482 of the United States Internal Revenue Code. The Report will be published by the OECD on the 10th January and provides the United States administration with the collective views of the other OECD Member countries on the proposed Regulations.

Background

The spread of the activities of Multinational Enterprises (MNEs) poses particularly difficult problems for all tax authorities in that it is not easy to determine the allocation of taxable profits in highly integrated groups. Whenever goods or services are transferred across national boundaries within a MNE, the determination of the transfer price will influence the division of the tax base between the countries in which the MNE is operating. Because that transfer price may be manipulated in order to affect the division of the tax base between the different countries involved, it is generally agreed that, for tax purposes, it may be appropriate to correct the allocation of profits between members of a corporate group to eliminate the effect of such manipulations. However, determining a proper allocation of profits is – both for the taxpayers and tax administrators – particularly difficult for intangible property and it is primarily this problem which the United States has sought to address in its proposed regulations relating to intercompany transfer pricing and cost-sharing arrangements under Section 482 of the U.S. Internal Revenue Code.

The proposed Regulations have been discussed among Member countries of the OECD and by the Committee on Fiscal Affairs – the main tax policy body of the OECD. The Committee, recognizing the urgency of working with the United States to reach internationally acceptable solutions to the problems addressed by the Regulations, decided to establish a special Task Force to undertake a detailed examination of the proposed Regulations. The Task Force was
commissioned to report by the end of 1992 in order for the Committee to make its views and concerns known to the United States before the Regulations were finalized. The United States was not a member of the Task Force but was represented by observers.

As emphasized in the Report, the problems currently being encountered in the transfer pricing area by the United States are not new and are similar to those encountered by the other Member countries of the OECD. These difficulties, which are inherently global in nature, cannot be resolved unilaterally. A multilateral approach is required which builds upon widely accepted principles of international taxation.

The importance of maintaining an international consensus

Over the years an international consensus has been built up on the application of the arm’s length principle to cross-border transfers within MNEs. The Committee on Fiscal Affairs believes that the implementation of the proposed United States Regulations could undermine this consensus since these Regulations rely heavily on comparisons of the profits earned by similar independent entities in order to establish whether such intra-group transactions are taking place at arm’s length terms. Whilst such a comparison is not necessarily inconsistent with the arm’s length principle, it may increase the danger of arriving at a transfer price which would not accord with the price that would have been agreed by unrelated parties, especially where data has not been drawn from the same or similar markets. Consequently, there is a real danger that the proposed Regulations, if finalised as presently drafted, might result in adjustments that would not be accepted by other countries, which would lead to double taxation and a disruption of international trade.

Recommendations by the Committee on Fiscal Affairs

Whilst the OECD countries share the objective of the United States to counter abusive transfer pricing practices, the Report notes that any regime for preventing abuses of transfer pricing should operate fairly and should not lead to double taxation or impose excessive compliance or administrative burdens on taxpayers and other tax administrations. The Report sets out specific recommendations for changes to the proposed Regulations, as well as a number of general suggestions. It also notes areas where further work is required by the OECD. The following are some of the most important recommendations:

a) The comparable profits approach to adjust transfer prices must remain a method of last resort and should be explicitly directed towards abusive cases.

b) The Regulations should be drawn up and implemented in a more flexible manner and should allow the evidence of all methods to be used in conjunction to determine transfer pricing adjustments in accordance with the arm’s length principle, with greater weight being given to satisfactory evidence provided by transaction-based methods.
c) The use of periodic adjustments to a transfer price may introduce an element of hindsight which would conflict with the arm’s length principle and it is recommended that the exceptions provided by the Regulations should be broadened in order that such adjustments be confined to abusive cases.

d) The extension of the proposed Regulations to the transfer of goods should be limited to cases where the goods derive their value primarily from their intangible components.

e) In assessing whether a transaction was made on arm’s length terms, it is recommended that the sound business judgement test in the proposed Regulations extend only to contemporaneous facts which were known by the taxpayer or which the taxpayer could reasonably be expected to have known at the time the transaction was entered into.

f) The Report considers that at least some of the problems addressed by the proposed Regulations and the risks of double taxation could be alleviated by increasing the levels of co-operation and collaboration between tax authorities.

Whilst the treaty partners of the United States acknowledge that profit comparisons have a legitimate role in reviewing transfer pricing cases and that the comparable profit methodology suggested in the proposed Regulations presents a new perspective on these issues, the work in this area remains at the experimental stage and requires further testing before its precise impact in the transfer pricing area can be determined. Therefore, it is considered that the importance of these concerns requires that the proposed Regulations, amended as suggested in the Report, should ideally be implemented on a temporary basis and, in any event, be subject to a review after a short period of time and that the treaty partners of the United States should collaborate in this review process through the work of the OECD’s Committee on Fiscal Affairs.