2012

Transfer pricing and the arm's length principle

The growth of international commerce has led more and more countries to have an active interest in transfer pricing, Joseph Andrus points out

Some estimates suggest that 30 percent or more of world trade occurs between affiliates of the same global MNE group. In today's globalised economy, it is typical that production of components for an MNE's products will occur in one country and final assembly of products in another country. Sales and marketing functions may well take place in local markets, far removed from the place of production, and with rapidly increasing frequency can take place over the internet from remote locations. Group management activities may be decentralised or occur in matrixed organisations with participating managers located in numerous jurisdictions around the globe. Research and development activities leading to the creation of valuable intangibles may similarly be geographically dispersed. Service transactions where the service provider and the beneficiary of the service are geographically separated are also common.

Where transactions in goods and services move between associated enterprises across country borders it is necessary for companies to establish transfer prices with respect to those transactions. The prices set determine in large measure the way an MNE group's income will be allocated among the various members of the MNE group and among the taxing jurisdictions that host their operations.

Accordingly, companies and tax administrations have a lively interest in transfer pricing determinations related to all types of cross-border transactions. Moreover, the growth of international commerce has led more and more countries to have an active interest in transfer pricing as developing economies have become important participants in the international flow of goods and services and have accordingly found it necessary to protect their local tax bases with well enforced transfer pricing rules.

The OECD Transfer Pricing Guidelines establish principles for establishing intercompany transfer prices. They are based on the arm's length principle, ie. the notion that the best guide to how associated enterprises should price transactions and allocate income can be found in arm's length dealings between unrelated parties. This arm's length principle forms the basis for transfer pricing legislation and enforcement in virtually all countries.

Questions often arise, however, regarding the effectiveness and practicality of transfer pricing rules based on the arm's length principle. Some critics have argued that the existing rules are too easily manipulated by MNE groups intent on shifting income into lower-tax jurisdictions for financial advantages. Those critics point to some highly publicised instances where transfer pricing outcomes and the underlying economics of MNE group operations seem not to be aligned and seem designed to isolate more income in low-tax jurisdictions than the economic activity in those jurisdictions can justify.

... companies and tax administrations have a lively interest in transfer pricing determinations related to all types of cross-border transactions

Developing countries sometimes express concern that the existing rules are too complex for tax administrations with limited resources to apply, or that their application requires access to data on comparable unrelated transactions that simply does not exist in their jurisdictions. Others argue that the increasing importance of internet based commerce, and in particular the growing importance of intangibles in driving corporate profitability, require new approaches for allocating the corporate tax pie among countries. These varying criticisms of existing rules based on the arm's length standard have created increased pressures for countries to adopt inconsistent approaches and to seek more arbitrary and superficially simpler rules that, it may be argued, will protect the local tax base more effectively and at lower cost.

The OECD strongly believes that in today's rapidly globalising economy it is more important than ever that countries around the world follow a consistent standard in determining transfer prices. The proliferation of different rules and principles will give rise to the taxation of income in more than one jurisdiction. This double taxation has the potential of distorting investment decisions and inhibiting the free flow of goods across borders, to the detriment of all. Just as importantly, the proliferation of different approaches to transfer pricing issues can easily lead to double non-taxation, ie. situations where corporate income can be sheltered entirely from tax in the interstices between different individual country rules. Moreover, the OECD continues to be of the view that the arm's length principle provides the most sound and effective underpinning for a consistent global approach to transfer pricing.

This commitment to a single set of guiding transfer pricing standards based on the arm's length principle does not mean, however, that the current rules work perfectly or that they cannot be improved. Rather, there is a strong need to improve the current system in at least three ways: (i) rules on the most difficult transfer pricing issues need to be continually updated and clarified so that countries and taxpayers are clear as to the guiding principles; (ii) ways need to be found to simplify existing transfer pricing practices in order to limit the administrative burdens on tax administrations and taxpayers alike and to find ways to address the most straight-forward transfer pricing issues in a less labour intensive fashion; and (iii) transfer pricing dispute resolution mechanisms need to be continuously improved so that taxpayers and tax administrations alike can achieve certain outcomes that relieve double taxation in reasonable amounts of time and at reasonable cost.

The transfer pricing work programme at the OECD is focused on these objectives. Pursuing the objective of developing clearer rules for the most difficult transfer pricing issues, the OECD recently published a discussion draft on transfer pricing aspects of intangibles. The discussion draft addresses the definition of intangibles, the manner in which intangible related returns are allocated among members of an MNE group, and the manner in which arm's length prices can be established for transactions in both goods and services where intangibles are used by one or both parties to the transaction, and for transactions involving transfers of intangibles and interests in intangibles. The discussion draft seeks to make clear that taxpayers may not use transactions in intangibles to separate income from the functions, assets and risks that give rise to that income under the arm's length transfer pricing principle.

At the same time, the OECD has embarked on a substantial project aimed at simplifying transfer pricing rules and administration. The first element of this project resulted in the recent publication of a discussion draft of revised guidance on transfer pricing safe harbours. That discussion draft emphasises that safe harbours can be used in many instances by countries to resolve lower-risk cases and to limit administrative burdens. It also provides country competent authorities with tools that can be used to develop bilateral safe harbours in appropriate circumstances. It is believed that these tools will have particular application in some developing countries and may provide an avenue for developing countries to find transfer pricing solutions in common cases in a way that can simultaneously protect their tax bases and limit their administrative burdens.

Future work on the simplification project will focus on transfer pricing documentation, charges for routine head and regional office costs, and APA processes. In particular, the documentation work will seek to find ways to more effectively provide tax administrations with the information they need to assess transfer pricing risk at the beginning of an audit, while limiting the proliferation of document production rules that create heavy compliance burdens for taxpayers.

OECD work on dispute resolution is discussed in greater detail in another article in this issue.

In adopting this three pronged approach to transfer pricing issues, the OECD believes that some of the shortcomings of current practice can be addressed and transfer pricing rules and administration can become more streamlined and effective. Success in these endeavours will require the active involvement of all interested parties, including OECD member countries, emerging and developing economies that are not currently OECD members, taxpayers, development organisations and other interested parties. OECD processes are designed to be open to all affected parties and many non-OECD countries are taking an active role in the elaboration of the rules on simplification measures and intangibles.

In March of this year, 90 countries and organizations met in the first meeting of the OECD Global Forum on Transfer Pricing to improve transfer pricing skills and discuss how the OECD work programme on transfer pricing can most appropriately be taken forward. Business and other interested persons have been asked to comment on the recently released discussion drafts by 14 September 2012 and to participate in a public consultation on these topics in November. This sort of open dialogue around challenging transfer pricing issues will continue to be the hallmark of OECD work in this area. ■

Joseph Andrus is Head of Transfer Pricing Unit at the OECD