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Wolfgang Schön  
Kai A. Konrad  
*Editors*

# Fundamentals of International Transfer Pricing in Law and Economics

 Springer

# Max Planck Institute for Tax Law and Public Finance

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Volume 1

*Edited by*

Kai A. Konrad  
Wolfgang Schön

Wolfgang Schön • Kai A. Konrad  
(Editors)

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# Fundamentals of International Transfer Pricing in Law and Economics

 Springer

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## Preface

Taxation of multinational corporate groups has become a major concern in the academic and political debate on the future of domestic and international tax law. This is particularly true in the field of transfer pricing where the arm's-length standard has provided a widely used yardstick for decades but has come under increasing pressure in recent years. In July 2010 the U.S. Congress held a hearing on the use of transfer prices for profit shifting to the detriment of the U. S. corporate tax base. In March 2011 the European Commission has published its draft directive on a Common Consolidated Corporate Tax Base which is meant to do away with the traditional transfer pricing regime within the European Union, using formulary apportionment as an alternative mechanism for the allocation of taxing rights among its Member States. Case law in major jurisdictions shows the increasing complexity of transfer pricing analysis, in particular in the field of intangibles, capital and risk allocation.

Against this background, the Max Planck Institute for Tax Law and Public Finance held an interdisciplinary conference in December 2010 on the fundamentals of transfer pricing in law and economics. The papers presented at this conference are (to a large extent) assembled in this book. Starting from the basic function of transfer prices to steer efficient allocation of resources within a multi-unit firm, the different aspects of transfer pricing under tax law (and corporate law) are explored, addressing also mutual distortions between the tax and the non-tax goals of transfer pricing. The merits of the traditional OECD approach and alternative concepts for the allocation of the international tax base are highlighted and discussed in several papers. Some articles deal with specific practical aspects of transfer pricing, including recent case law from different parts of the world. Taken together, this book offers the reader a concise presentation and analysis of transfer pricing in the international tax arena which is – in our view – hard to find elsewhere.

The conference has been set up in the context of the International Network on Tax Research. The editors are specifically thankful to Hugh Ault, Mary Bennett and Caroline Silbersztein from OECD for their substantial help in the design of this conference. Mauritz von Einem deserves our gratitude for his editing work. Our foremost expression of gratitude goes to the speakers and authors who have enabled us to assemble a collection of papers which we hope will provide readers with a full and current account of the fundamentals of international transfer pricing in law and economics.

Munich, October 2011

Kai A. Konrad

Wolfgang Schön



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## **Part 1:**

# **The Roles and Functions of Transfer Pricing in Organisations**

# Transfer Pricing in Multinational Corporations: An Integrated Management- and Tax Perspective

Moritz Hiemann and Stefan Reichelstein

## Abstract

*Transfer prices play a central role for both managerial accounting and tax reporting purposes in vertically integrated firms. Common to these purposes is that transfer prices ultimately determine the distribution of reported income across different segments (divisions) of the firm. The managerial accounting literature has long viewed transfer prices as an instrument for coordinating the production and sales decisions of different business segments. The tax-oriented literature on transfer pricing, in contrast, has largely viewed the transactions between business segments of the firm as given. The major focus in this literature has been on how a firm can minimize its worldwide tax liability within the confines of the arm's-length standard. In this article, we take an integrated view of managerial and tax considerations by analyzing how the optimal internal transfer prices depends on the admissible arm's length price and the applicable tax rates.*

## 1. Introduction

In vertically integrated firms, transfer prices play a central role for both managerial accounting and tax reporting purposes. Common to these purposes is that transfer prices ultimately determine the distribution of reported income across different segments (divisions) of the firm. In terms of the stated objective of transfer pricing in Multinational Corporations (MNC's), respondents in a 2003 survey by Ernst & Young cite both "maximizing operating performance" (73%) and "optimizing tax arrangements" (68%) as either as the "main" or an "important" priority.<sup>1</sup>

The managerial accounting literature has long viewed transfer prices as an instrument for coordinating the production and sales decisions of different business segments. Transfer prices are intended to provide divisional managers with relevant information about the cost and profitability of intra-company transactions. Since performance measures for divisional managers are frequently based on the profits of the segments they manage, transfer prices have a key resource allocation function in facilitating and incentivizing the transfer of goods and services across divisions. From that perspective, the objective of transfer pricing is to enable a decentralized firm to achieve its full profit potential.

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<sup>1</sup> See Ernst & Young (2003). The same survey suggests that among German parent companies some 48% of the respondents view transfer pricing primarily as a tax compliance exercise, while 36% of the respondents believe that "achieving managerial/ operational objectives has a stronger influence on determining transfer prices than satisfying tax requirements or some other influence."

The tax-oriented literature on transfer pricing, in contrast, has largely taken a monolithic view of multinational firms. Accordingly, the internal resource allocation function of transfer prices has played a subordinated role. Instead, the transactions between business segments of the firm are viewed as given and the major focus in this literature has been on how a firm can minimize its worldwide tax liability within the confines of the arm's-length standard that is applicable in most OECD countries (Eden, 1998).

In order to address both the managerial and the tax minimization objectives of transfer pricing, some MNC's adopt a system of "two sets of books." Accordingly, the transfer prices used for internal performance- and profit measurement are "decoupled" from the ones used for tax reporting purposes. It appears that, as of now, the majority of multinational corporations prefer a unified approach, that is, a single set of transfer pricing records (Ernst & Young, 2003). The advantages of maintaining a single set of books pertain to the reduced cost of recordkeeping and the consistency between internal and tax reports. The consistency aspect is obviously relevant with regard to simplifying the planning decisions of business segment managers. Perhaps more importantly, a single set of books avoids the potential for disputes with tax authorities that can arise when internal valuations for specific transactions differ from the ones used for tax reporting purposes and tax authorities can subpoena the firm's internal records.

While a single set of transfer prices is arguably still the most prevalent practice in most MNC's, a growing number of corporations appear to question the economic relevance of prices that are determined solely to minimize the firm's overall tax liability while remaining compliant with the arm's length standard. Questions of economic relevance arise in part since in practice the criterion of a "comparable uncontrolled price" almost always requires references to transactions undertaken in the past between unrelated parties.<sup>2</sup> Studies by Wilson (1993) and Springsteel (1999) suggest an increasing trend towards decoupling. Specifically, Springsteel (1999) reports that 77% of respondents in a "best practice" group now operate with two separate sets of books, compared to only 25% of respondents outside that group.

Managerial accounting textbooks typically acknowledge the crucial tax dimension of transfer prices.<sup>3</sup> At the same time, the discussion of the most prevalent transfer pricing methods in practice, in particular, cost-based, market-based and negotiated transfer pricing, typically ignores tax considerations. This omission is usually justified with reference to the possibility of decoupling. A conceptual issue with this approach is that the tax-admissible transfer price is itself part of the economically relevant valuation of the transaction in question. Tax reporting for a particular trans-

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<sup>2</sup> See, for instance, Harris and Sansing (1998). One of the respondents in the Ernst & Young (2003) survey articulates this point in the following manner: "Part of the problem is that each operating group is compensated in accordance with their respective country's profit and this may conflict with transfer pricing prescriptions in the jurisdictions." Along similar lines, another respondent states: "We have overcome the difficulties (in incentives and performance measurement) by the accounting methods used for management incentives, i.e. bonuses. We run two sets of books; one for statutory accounting and one for management reporting."

<sup>3</sup> See, for instance, Horngren et al. (2008) and Zimmerman (2006).

action results in cash flows to the tax authorities and the corresponding after-tax cash flows determine the overall value of a transaction. Therefore, any attempt to identify suitable internal transfer prices must necessarily take account of the arm's length price used for tax reporting purposes.

This article examines three alternative transfer pricing scenarios that differ in terms of their economic fundamentals, such as the presence of comparable transactions with unrelated parties or the ability of divisional managers to enhance the value of intra-company transactions by means of relationship-specific investments. For each one of those scenarios, we take the allowable arm's length transfer price as given and examine how the preferred internal price should relate to the arm's length price.<sup>4</sup> Our normative statements are based on the criterion of *goal congruence*. Starting from the premise that divisional managers seek to maximize the profits of their own segments, a goal congruent transfer pricing rule has the property that the divisional profit metrics provide managers with incentives that are aligned with the corporate objective of maximizing the firm's overall after-tax profit.<sup>5</sup>

For the most part, our discussion in this article focuses on the transfer of tangible property (widgets). We examine both cost- and market-based transfer pricing. A particular pricing policy then meets the criterion of goal congruence if it avoids distortions in the quantity of the intermediate product traded internally. In Section 3, we also consider valuation issues in connection with the transfer of intangible assets. The main question we address in that context is to what extent an internal valuation that is decoupled from its tax treatment can improve incentives for divisions to make investments that improve the overall value of the asset in question.

## 2. Transfers of Intermediate Products and Services

### 2.1 Cost-Based Transfer Pricing

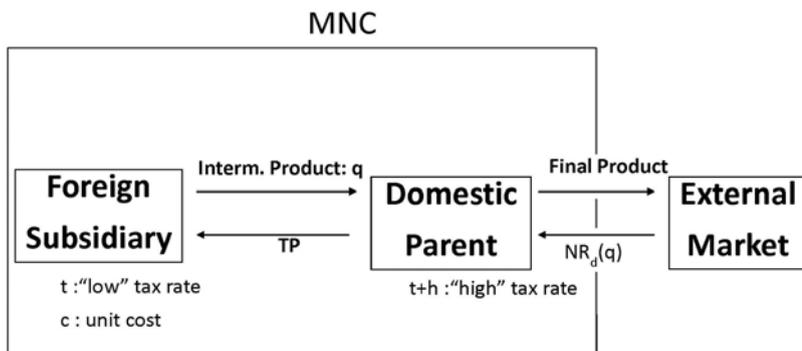
For many intermediate goods and products that are transferred from one business segment to another within the same firm, there is effectively no functioning external market that allows firms to gauge the market price for a particular transaction. In fact, the lack of a viable market for these goods may have provided the rationale for the firm to integrate vertically in the first place. Surveys and textbooks indicate that, without reference to an external valuation, firms frequently calculate internal transfer prices based on the assessed cost of the product to be transferred.<sup>6</sup>

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<sup>4</sup> Hyde and Choe (2005) and Choe and Hyde (2007) allow for the possibility that the firm chooses both the internal price and the price used for tax reporting purposes, yet it may face penalties if an audit were to reveal that the latter is not compatible with the arm's length standard.

<sup>5</sup> In particular, we ignore a more fundamental set of issues related to moral hazard and optimal incentive contracting. These issues are modeled explicitly in Vaysman (1996), Edlin and Reichelstein (1995), Narayanan and Smith (2000), and Smith (2002a, 2002b).

<sup>6</sup> Absent an external market price, some firms also resort to a regime of negotiated transfer pricing. See, for instance, Eccles and White (1988), Tang (1993), Kaplan and Atkinson (1998) and Horngren et al. (2009).



**Figure 1:** Simplified schematic diagram of a MNC

The diagram in [Figure 1](#) illustrates the simplest possible setting of an MNC consisting of two divisions.<sup>7</sup> A foreign subsidiary (the ‘upstream’ division) sells a quantity,  $q$ , of an intermediate product at an internal transfer price,  $TP$ , to a domestic parent (the ‘downstream’ division). The intermediate product is sold as part of a final product to external customers. Without loss of generality, it can be assumed that every unit of the final product requires one unit of the intermediate product. The net revenue that is available externally (sales revenue less incremental processing costs) is represented by the function  $NR_q(q)$ . Knowledge of this revenue function is assumed to reside with the downstream division. In terms of decision-making, the company adopts a “pull system,” which gives management of the downstream division unilateral authority to decide the quantity,  $q$ , to be transferred internally.

Consistent with the original Hirshleifer model, we assume that the firm’s accounting system is in a position to verify the unit cost of producing the intermediate good.<sup>8</sup> Furthermore, this unit cost,  $c$ , is assumed to be constant.<sup>9</sup> For tax purposes, the firm values the intermediate product at a unit price of  $P_{tax}$  that is compatible with the arm’s length standard. For instance, the firm may obtain  $P_{tax}$  by means of a Comparable Uncontrolled Price analysis (CUP), a cost-plus allocation, or an Advanced Pricing Agreement (APA). The internal (or managerial) transfer price,  $TP$ , is decoupled from the arm’s length price and can be chosen freely for the purpose of incentive alignment.

<sup>7</sup> Our discussion here follows the model in Baldenius et al. (2004).

<sup>8</sup> The measure of unit cost need not be confined to accounting costs but could also represent the selling division’s opportunity cost of foregone external revenues. The next section on market-based transfer pricing elaborates on this approach.

<sup>9</sup> For simplicity, our analysis assumes that the unit cost  $c$  is known ex-ante to the buying division. In addition, this cost is viewed as exogenous and uncontrollable by the selling division. The analyses of Goex and Schiller (2008) and Pfeiffer et al. (2011) relax both of these specifications. Our framework also presumes that any fixed cost charges are levied as lump-sum charges. Dutta and Reichelstein (2010) examine a model in which the upstream division makes a sequence of overlapping capacity investments. The optimal transfer price then includes depreciation charges so as to reflect the long-run marginal cost of production, which includes the cost of capacity services.

The foreign subsidiary faces a corporate income tax rate of  $t$ , while the tax rate of the domestic parent is  $t + h$ . Thus  $h$  is the tax rate differential between the corporation's country of domicile and the foreign country in which the subsidiary is located. On its tax return, the foreign subsidiary recognizes revenues of  $P_{tax}$  and cost of sales of  $c$  per unit of product transferred. On the other hand, the domestic parent internalizes a pre-tax unit cost of sales that is equal to the transfer price,  $TP$ , while its effective after-tax cost of internal transfers is:

$$TP - (t + h) \cdot P_{tax} \quad (1)$$

In order to attain goal congruence between the divisional and corporate objective, the domestic parent must have an incentive to choose  $q$  so as to maximize the overall after-tax corporate profit. This implies that the downstream division must internalize the effective after-tax marginal cost of internal transfers at the corporate level. This cost is given by:

$$(1 - t) \cdot c - h \cdot P_{tax}, \quad (2)$$

because the after-tax cost of producing the intermediate product in the upstream jurisdiction is  $(1 - t) \cdot c$ . At the same time, the transfer of one unit of the good in question entails a tax benefit of  $h \cdot P_{tax}$  because the tax expense of the downstream division is reduced by  $(t + h) \cdot P_{tax}$ , while the transaction results in a tax payment of only  $t \cdot P_{tax}$  for the upstream division.

Direct substitution from (1) into (2) shows that a goal-congruent managerial transfer price  $TP$  must be chosen so that:

$$TP = (1 - t) \cdot c + t \cdot P_{tax}. \quad (3)$$

The finding in equation (3) extends Hirshleifer's (1956) classic result to the setting of multinational firms whose divisions are subject to different income tax rates. An immediate implication of this finding is that decoupling the internal transfer price  $TP$  from the arm's length price  $P_{tax}$  does not mean that the preferred  $TP$  is independent of  $P_{tax}$ . In fact,  $TP$  should be chosen as a weighted average of the pre-tax cost of transfers,  $c$ , and the arm's length price,  $P_{tax}$ .<sup>10</sup> At first glance it may seem surprising that the formula for the optimal  $TP$  depends on the common tax rate  $t$  but not the differential  $h$ . The reason is that the domestic parent already incorporates this differential in its purchasing decision, provided its performance is measured by the divisional after-tax profit.<sup>11</sup>

<sup>10</sup> In Sahay's (2003) model, it is also desirable to choose a transfer price which entails a mark-up over marginal cost in order to provide the selling division with a profit motive to control its production cost.

<sup>11</sup> The weighted average rule in (3) applies even if there is no tax differential, that is,  $h = 0$ . The reason is that the tax-admissible transfer price  $P_{tax}$  is part of the marginal after-tax cost that the domestic parent internalizes. For example, if  $P_{tax} > c$ , transfers provide tax savings and therefore become 'cheaper' to the parent, relative to the true marginal cost at the corporate level, which reduces to  $(1 - t) \cdot c$  if  $h = 0$ . As a consequence, the parent would order an inefficiently high quantity  $q$  from the foreign subsidiary if the transfer price were set equal to  $c$ .

We note that goal congruence can also be obtained in the above setting if divisional profits are measured on a pre-tax basis.<sup>12</sup> The domestic parent then internalizes a marginal cost of  $TP$ , which is effectively the same as internalizing an after-tax marginal cost of  $(1 - t - h) \cdot TP$ . Replacing (1) with this expression and equating it with (2) shows that under a performance measure based on pre-tax income, the goal-congruent internal transfer price should be modified to

$$TP = \frac{(1 - t) \cdot c - h \cdot P_{tax}}{1 - t - h}. \quad (4)$$

The solution now depends on  $h$  directly because the parent no longer internalizes the effects of tax rate differentials automatically under a pre-tax scheme. In the limit case of  $h = 0$ , the optimal internal transfer price is simply the firm's marginal cost  $c$ .

The preceding discussion has highlighted the potential value of decoupling the internal transfer price from the arm's length price. Yet, as mentioned in the Introduction, most MNC's keep only a single set of transfer prices, both for simplicity and to avoid discrepancies between reported and internal numbers in case of a dispute with the tax authorities. It is worth noting that the tension between managerial and tax objectives is not moot even if the firm relies on a single transfer price. To illustrate, suppose that from an arm's length perspective, any transfer price in the range  $p \in [\underline{p}, \bar{p}]$  would be defensible. Provided the foreign subsidiary faces a lower tax rate, the most favorable arm's length price would clearly be  $\bar{p}$  for any given level of trade. Yet, if  $c < \bar{p}$ , the downstream division would be incentivized to buy a quantity that is inefficiently low. This poses a trade-off between pre-tax gains from trade and ex-post tax minimization. Baldenius, Melumad and Reichelstein (2004) show that, under 'reasonable' conditions on the external demand, the optimal transfer price will indeed be below the most advantageous arm's length price, that is,  $\bar{p}$ .

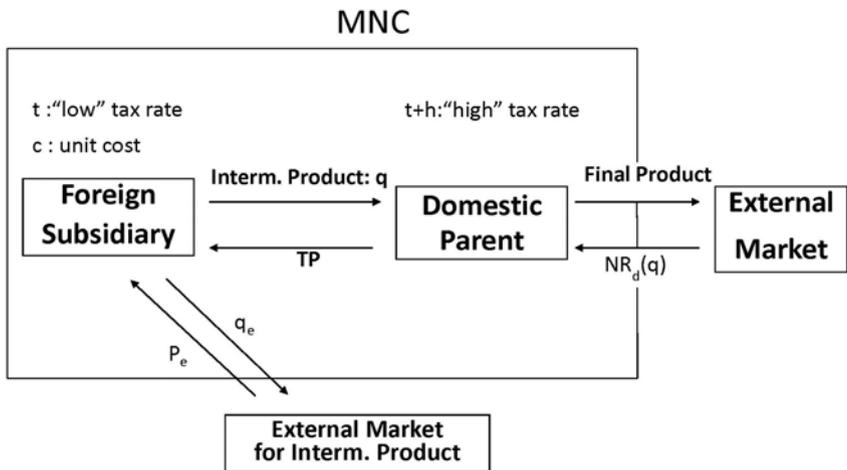
## 2.2 Market-Based Transfer Pricing

In many vertically integrated businesses, the upstream division sells an intermediate product both internally and to external customers. At the same time, the internal buyer may effectively have no other viable supplier sources other than the upstream division. This effective monopoly position of the internal seller may reflect either that the intermediate good in question is highly specialized or that the MNC has adopted a mandatory internal sourcing policy.<sup>13</sup> Figure 2 illustrates a setting in

<sup>12</sup> Some corporations, like Siemens Corporation, seek to simplify the impact of taxes at the divisional level by calculating after-tax income as pre-tax income less an "effective" (or average) tax rate for the division.

<sup>13</sup> Both of these considerations figure prominently in a case study on the Timken Company (Bastian and Reichelstein, 2005), where the upstream division supplies a specialty steel that is the raw material input for two downstream divisions that manufacture roller bearings for automotive and industrial customers, respectively.

which the foreign subsidiary sells its intermediate product to external customers in the foreign market at some price,  $P_e$ , in addition to supplying the domestic parent.



**Figure 2:** Schematic diagram of a MNC where the product in question is also sold externally

As before, we suppose that the foreign upstream division is subject to a lower income tax rate relative to the domestic downstream division. Provided external sales are “sufficiently substantial,” the market price  $P_e$  becomes a natural candidate for the arm’s length price under the Comparable Uncontrolled Price (CUP) method. Throughout this subsection, we assume that the firm adopts this market-based transfer pricing approach for tax reporting, that is,  $P_{tax} = P_e$ .<sup>14</sup>

In the benchmark case of a competitive external market, we note that the effective pre-tax marginal cost of internal transfers is given by  $P_e$ , because, by assumption, the upstream division will be operating at capacity. The conclusions from the analysis in the previous subsection then continue to apply and the optimal internal transfer price is given by:

$$TP = P_e \cdot (1 - t) + P_e \cdot t = P_e. \tag{5}$$

Thus a competitive external market and application of the CUP method ensure that the objectives of inducing efficient internal transfer quantities and minimizing the firm’s tax liability can be accomplished without decoupling the internal and from the arm’s length transfer price.

When the upstream division has pricing power externally, it is instructive to consider the transfer pricing problem depicted in [Figure 2](#) first in a setting where corporate income taxes do not play a role, possibly because both divisions are located in the same jurisdiction. Suppose also that the upstream division is not

<sup>14</sup> Our discussion here draws on material in Baldenius et al. (2004).

capacity constrained. Ideally, the firm's central office would like the upstream division to exercise its monopoly power externally and, at the same time, to supply the intermediate product at marginal cost to the internal buyer. Thus a transfer price equal to the external market price chosen by the upstream division is generally not efficient because it results in double marginalization. A natural approach to avoiding a double marginalization problem on internal transfers is to impose an intra-company discount. Such discounts can be calculated as a lump-sum amount:  $TP = P_e - \Delta$ , or as a proportional reduction:  $TP = (1 - \gamma) \cdot P_e$ .

Transfer pricing surveys document that companies frequently subject internal transfer prices to discounts relative to the external market price. A common rationale for such intra-company discounts is the absence of bad debt and the prospect of lower selling and administrative costs associated with internal transfers. Baldenius and Reichelstein (2006) demonstrate that such discounts generally improve the efficiency of external and internal pricing. The optimal intra-company discount depends on such factors as the price elasticity of demand for external sales or cost differences between internal and external sales. However, it is generally impossible to choose the intra-company discount in a manner that will lead to overall corporate profit maximization, primarily because in response to any imposed discount, the upstream division will adjust the price it charges externally so as to exercise its monopoly power.<sup>15</sup>

In the presence of corporate income taxes, intra-company discounts play an additional role via their effect on the external market price, which is also the arm's length price. *Ceteris paribus*, a higher discount will induce the foreign subsidiary to raise the external price. Like in a world of identical tax rates, this leads to a tradeoff between more efficient internal transfers and a distortion in the external price. Yet, since  $P_{tax} = P_e$ , the firm now obtains an additional tax benefit that results from higher income shown on the books of the foreign subsidiary (which enjoys a lower tax rate). This additional benefit makes higher intra-company discounts more attractive. Baldenius et al. (2004) identify conditions under which the optimal discount on internal transfers will indeed increase with the magnitude of the tax rate differential  $h$  between the domestic parent and the foreign subsidiary.

The tradeoffs involved in setting intra-company discounts are somewhat simplified in settings where the size of the external market is large relative to that of the internal market. For simplicity, suppose the external market exhibits a constant price elasticity of demand denoted by  $\epsilon$ . On a pre-tax basis, the proportionate discount  $\gamma$  should then be set equal to the inverse of the external price elasticity of demand, that is,  $\gamma = \frac{1}{\epsilon}$ . To see this, we note that if the upstream division sets the market price equal to the external monopoly price, the downstream division effectively obtains the product at the marginal cost  $c$  (we maintain the assumption that the upstream division is not capacity constrained). Furthermore, the selling division will not

<sup>15</sup> It should be noted that in this setting, the downstream division does not need to know the upstream division's external revenue curve. It only matters that the selling division anticipates how the buyer responds to alternative selling prices.

deviate far from the external monopoly price provided the volume of external sales far exceeds that of internal sales. However, with a tax rate of  $t+h$  for the buying division, the preferred discount must be deflated to  $\gamma = (1 - t - h) \cdot \frac{1}{\epsilon}$  in order for the buying division to internalize an after-tax cost of  $(1 - t - h) \cdot c$ .

In concluding this section, we note that under both cost-based and market-based transfer pricing, we obtain the same qualitative prediction: the optimal internal  $TP$  should be chosen below the arm's length price  $P_{tax}$ . Under the cost-based approach, this is true as long as the marginal cost of internal transfers is below the arm's length price, while under the market-based approach, this inequality results from the desirability of intra-company discounts.

### 3. Transfers of Intangible Assets

The internal transfer of intangible assets, such as patents, trademarks or production technology, plays an increasingly important role for many multinational corporations. In the current debate over formula apportionment versus traditional arm's length transfer pricing, advocates of formula apportionment frequently point out that the ease of transferring intangible assets has effectively rendered the arm's length standard dysfunctional.<sup>16</sup>

Intangible assets have several distinctive features. First, the costs incurred by an individual business segment in developing these assets are particularly difficult to verify for outsiders such as tax authorities. Second, from a management control perspective, the economic features of these assets tend to be difficult to specify ex-ante for the purpose of internal contracting arrangements. Third, the asset development process frequently requires sequential investments by multiple divisions. Hold-up problems may then arise because a division that has committed capital to the development of an intangible asset finds it difficult to recover the associated sunk cost when subsequently negotiating with other divisions over the price of transferring the rights to the asset. Finally, many intangible assets have "scalability" features (Lev, 2000) in the sense that the asset becomes essentially an exclusive public good, rather than a private good.

Since by definition, intangible assets are not a consumable input but instead render economic benefits over multiple periods, multinational firms can choose from various alternative forms of transactions. For example, the developing division may sell the rights to the intangible asset to the purchasing division for a lump-sum payment. Alternatively, the asset may be leased to the purchasing division in exchange for periodic royalty payments. To date, there have been relatively few attempts to model the transfer of intangible assets in MNC's formally. Our brief discussion here is based on Johnson (2006).<sup>17</sup>

<sup>16</sup> A broader perspective on this debate can be found for instance, in Schoen (2010). Drucker (2010) illustrates how Google transfers process technology across multiple European countries so as to end up with a stunningly low average tax rate on its European operations.

<sup>17</sup> See also Boos (2003) and Baldenius (2006).

Figure 3 illustrates a setting wherein a multinational corporation has two divisions, each one of which contributes to the production of an intangible asset by making relationship-specific investments. Investments are sequential, that is, after making its investment, Division 1 must transfer the asset to Division 2, where it is developed further for final use. Division  $i$ 's investment is denoted  $I_i$  and assumed to be unverifiable to the corporation's central office and to the tax authorities. For any given levels of investment, the present value of future cash inflows generated by the intangible asset is denoted by  $M(I_1, I_2)$ . These cash flows accrue to Division 2 only, while Division 1 receives a payment from Division 2 as compensation for its development effort.<sup>18</sup> The marginal returns to investment are assumed to be positive but decreasing, that is,  $\frac{\partial M}{\partial I_i} > 0$  and  $\frac{\partial^2 M}{\partial^2 I_i} < 0$  for  $i = 1, 2$ . Further, the two divisions' investments can be either complements or substitutes, in the sense that the cross-partial derivative of  $M(I_1, I_2)$  can be positive or negative.<sup>19</sup>

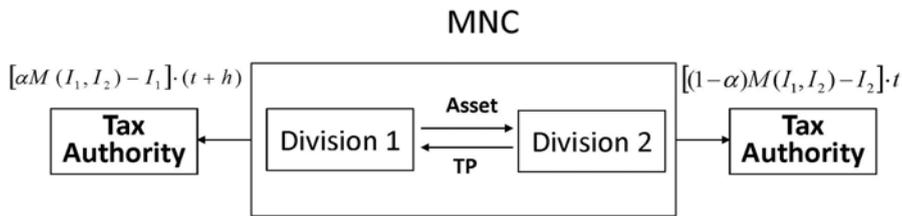


Figure 3: Schematic diagram of a MNC where an intangible asset is transferred internally

For tax reporting, the royalty payment by Division 2 to Division 1 is assumed to be based on a profit-sharing parameter  $\alpha$  that meets the standards of an arm's length transaction. Assuming as before that the two divisions are located in different tax jurisdictions, the tax liability of Division 1 related to the investment is thus

$$[\alpha \cdot M(I_1, I_2) - I_1] \cdot (t + h) \tag{6}$$

and the tax liability of Division 2 is

$$[(1 - \alpha)M(I_1, I_2) - I_2] \cdot t, \tag{7}$$

<sup>18</sup> A natural extension of this model is that the upstream division also receives a set of future cash benefits from its investment such that these benefits are independent of the contribution made by the downstream division.

<sup>19</sup> Absent tax considerations, Nöldeke and Schmidt (1998) examine how the efficiency of negotiated asset transfers is affected by complementarity or substitutability of the investments. They conclude that the divisions will have a tendency to overinvest if investments are complements and the parties negotiate a transfer payment after the upstream division has made its investment.

where  $h$  is again the difference in the tax rates faced by the two divisions. For internal accounting purposes, the central office may set a royalty-based transfer pricing scheme with a sharing parameter  $\beta$ , which need not coincide with  $\alpha$ . As in the previous section, we consider both unified accounting, that is, one set of books, and alternatively a setting wherein internal transfer payments are decoupled from the ones reported for income tax purposes.

### 3.1 Conformity between Internal and Tax Accounting

As argued above, the majority of MNC's appears to prefer a single set of transfer pricing rules, possibly because the cost of maintaining separate internal and tax accounting records is high. This cost may include disputes with tax authorities when internal royalty rates differ from the ones used for tax reporting purposes. With a single royalty rate, the internal transfer payment becomes  $TP = \alpha \cdot M(I_1, I_2)$ . Divisional after-tax profits thus are:

$$(1 - t - h)(\alpha \cdot M(I_1, I_2) - I_1) \quad (8)$$

for Division 1 and

$$(1 - t)((1 - \alpha)M(I_1, I_2) - I_2) \quad (9)$$

for Division 2. If their managers have an incentive to maximize the after-tax profit of their respective divisions, they will choose investment levels such that the marginal return equals the marginal cost of investment. For a general functional form of  $M(\cdot, \cdot)$ , this implies

$$\frac{\partial M(I_1, I_2)}{\partial I_1} + \frac{\partial M(I_1, I_2)}{\partial I_2} \frac{\partial I_2}{\partial I_1} = \frac{1}{\alpha} \quad (10)$$

for Division 1 and

$$\frac{\partial M(I_1, I_2)}{\partial I_2} = \frac{1}{1 - \alpha} \quad (11)$$

for Division 2, where  $\frac{\partial I_2}{\partial I_1}$  captures the anticipated marginal change in investment by Division 2 in response to an increase in investment by Division 1. Since investments are made sequentially,  $I_1$  is sunk by the time Division 2 makes its investment decision and therefore no response function appears in (11). It should also be noted that the investment levels in (10) and (11) are independent of the tax rates for the two divisions.

In contrast, the first-best investment levels  $I_1^*$  and  $I_2^*$ , that the central office would hypothetically choose under centralized decision making, maximize the corporate after-tax profit and therefore satisfy:

$$\frac{\partial M(I_1^*, I_2^*)}{\partial I_1} + \frac{\partial M(I_1^*, I_2^*)}{\partial I_2} \frac{\partial I_2(I_1^*)}{\partial I_1} = \frac{1-t-h}{1-t-\alpha h} \quad (12)$$

and

$$\frac{\partial M(I_1^*, I_2^*)}{\partial I_2} + \frac{\partial M(I_1^*, I_2^*)}{\partial I_1} \frac{\partial I_1(I_2^*)}{\partial I_2} = \frac{1-t}{1-t-\alpha h}. \quad (13)$$

As one would expect, the optimal investments implied by (12) and (13) depend on both tax rates in this case. While the change in  $I_1^*$  and  $I_2^*$  in response to an increase in  $h$  depends on the functional form of  $M$ , Baldenius (2006) demonstrates that if the divisions' investments are substitutes in the return function  $M(\cdot, \cdot)$ , then  $I_1^*$  increases and  $I_2^*$  decreases with  $h$  because a higher tax rate at Division 1 reduces its after-tax cost of investment.<sup>20</sup>

Goal congruence in this setting is attained if the solutions to (10) and (11) coincide with the solutions to (12) and (13). This will be obtained only in exceptional cases, but it is instructive to examine the directional bias in the investment levels chosen by divisional managers relative to the optimal values  $I_1^*$  and  $I_2^*$ . Johnson (2006) demonstrates that for additively separable investment returns (i.e.  $\frac{\partial^2 M}{\partial I_1 \partial I_2} = 0$ ), a unified royalty-based transfer pricing approach leads to underinvestment. This finding follows from the observation that  $\frac{\partial I_2}{\partial I_1} = 0$  for independent investments and that  $\frac{1-t-h}{1-t-\alpha h} < \frac{1}{\alpha}$  and  $\frac{1-t}{1-t-\alpha h} < \frac{1}{1-\alpha}$  because  $h < 1-t$ , so that  $I_i < I_i^*$  for either division, provided there are diminishing marginal returns to investment. Further, since the divisional managers' investment decisions implied by (10) and (11) are independent of  $h$ , it follows that the severity of this underinvestment problem diminishes for Division 2 as  $h$  increases while it is exacerbated for Division 1.

The underinvestment result does not necessarily hold if investment returns are not separable. If either  $\frac{\partial^2 M}{\partial I_1 \partial I_2} > 0$  or  $\frac{\partial^2 M}{\partial I_1 \partial I_2} < 0$ , Johnson observes that Division 1 may in fact overinvest due to the sequential nature of the investment process. The reason is that Division 1 has a 'first-mover' advantage and can induce any desired subsequent investment decision by Division 2. In particular, if investments are strong complements, Division 1 may overinvest strategically to induce higher investment by Division 2. Conversely, if investments are substitutes and  $\alpha$  is high, Division 1 captures a large share of  $M$  and may overinvest in order to benefit at the expense of Division 2, which faces low investment incentives in this case.<sup>21</sup> Regardless of the functional form of the investment returns, we conclude that uniform royalty rates for both internal control and tax reporting generally fail to result in goal congruence.

<sup>20</sup> Johnson shows that this result always holds for the case of additively separable investment returns.

<sup>21</sup> Baldenius (2006) provides a generalization of Johnson's result by noting that underinvestment still occurs when the cross-partial derivative is sufficiently small in absolute value.

Even in the special case of an additively separable  $M(\cdot, \cdot)$ , the tax admissible royalty rate will generally not align the incentives of the divisional managers with the corporate objective.

### 3.2 Decoupling Internal- from Tax Accounting

For the simple setting illustrated in Figure 3, decoupling the internal royalty rate from the one used for tax purposes gives the firm an additional degree of freedom in aligning the divisional managers' investment incentives with the corporate goal of profit maximization, while at the same time minimizing the firm's overall tax liability. Johnson (2006) analyzes how the preferred internal royalty rate should relate to the one used tax reporting purposes. If  $TP = \beta \cdot M(I_1, I_2)$ , the divisional after-tax profits now take the form

$$\beta \cdot M(I_1, I_2) - I_1 - (t + h)(\alpha \cdot M(I_1, I_2) - I_1) \quad (14)$$

for Division 1 and

$$(1 - \beta)M(I_1, I_2) - I_2 - t((1 - \alpha)M(I_1, I_2) - I_2) \quad (15)$$

for Division 2. As noted for the unified approach above, complementarity or substitutability of the divisional investments tends to introduce second-order complications in the desired investment levels. It will therefore be instructive to focus on a setting in which the investment returns are not only additively separable but also symmetric, that is,  $M(I_1, I_2) = m(I_1) + m(I_2)$ . If  $h = 0$ , both divisions face the same tax rate  $t$ , and the managers of Division 1 and Division 2 choose investment levels  $I_1$  and  $I_2$  such that

$$\frac{\partial m(I_1)}{\partial I_1} = \frac{1 - t}{\beta - \alpha t} \quad (16)$$

and

$$\frac{\partial m(I_2)}{\partial I_2} = \frac{1 - t}{1 - \beta - (1 - \alpha)t}. \quad (17)$$

In this scenario, shifting profits between divisions does not alter the overall profit at the corporate level. The optimal profit-sharing parameter for internal transfers can be found by equating (16) and (17) and solving for  $\beta$ , which yields

$$\beta = \frac{1 - t}{2} + \alpha t. \quad (18)$$

As observed in Johnson (2006), the unified approach of setting a single royalty rate for internal and tax purposes thus only achieves the same level of corporate profit as decoupling in the special case when  $\alpha = \frac{1}{2}$ . Otherwise, the firm benefits from decoupling. Yet, consistent with the findings in the previous section, it should be noted that although the optimal royalty rate for internal transfers  $\beta$  need not coincide with the tax transfer rate  $\alpha$ , it is not independent of  $\alpha$ . Equation (18) suggests that increases in the mandated tax royalty rate  $\alpha$  also increase the optimal internal transfer rate  $\beta$ . Finally, one can observe that decoupling is found to benefit the firm even though the above argument assumes that  $h = 0$ .<sup>22</sup> The rationale behind this finding is that even in the absence of tax rate differences, the level of  $\alpha$  may induce asymmetric investment incentives for divisional managers, and the additional degree of freedom afforded by decoupling allows the firm to address this misalignment problem (see also Baldenius, 2006).

In summary, multinational corporations can generally obtain better investment incentives and higher after-tax profits by decoupling the internal royalty rate  $\beta$  from the tax-admissible rate  $\alpha$ . Of course, firms are not limited to pursuing these objectives via fixed royalty schemes but may alternatively allow their divisions to (re-)negotiate transfer prices among themselves. While this discussion is beyond the scope of our analysis here, we refer the reader to Johnson (2006), who identifies settings in which a regime of negotiated transfer pricing can result in first-best investment levels.

#### 4. Summary

In most multinational firms it is common practice to use a single set of transfer pricing rules to account for transactions between business segments that are located in different countries. These accounting rules are then used for both tax reporting purposes and for internal profit measurement purposes. The choice of transfer prices that minimize a firm's worldwide tax expense is obviously an issue of first-order importance. To the extent, however, that optimal arm's length transfer prices do not reflect the current economics of the transactions in question, it becomes likely that divisional managers receive distorted information about the economic impact of proposed transactions. A growing number of companies have taken this concern about the hidden cost of distorted internal profit measurement as a rationale for decoupling their internal transfer prices from the ones used for tax purposes.

The modeling scenarios considered in this paper illustrate the potential value of decoupling and derive a set of predictions as to how the optimal internal transfer

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<sup>22</sup> Allowing for  $h > 0$  complicates the analysis but does not generally alter the conclusions. For example, Johnson observes that for  $m(I_i) = In(I_i)$ , the optimal profit-sharing parameter is  $\beta = \frac{1-t}{2} + \alpha + \frac{ah}{2}$ , in which case the central office would set higher  $\beta$  as the tax rate differential increases and thereby encourage more investment by Division 1, consistent with the logic that higher tax rates at Division 1 reduce the after-tax cost of investment  $I_1$ .

price should relate to the preferred arm's length price. In particular, our analysis makes clear that the approach taken in most managerial accounting textbooks, i.e., ignore tax considerations because of the possibility of decoupling, is generally untenable. The preferred internal transfer price is generally a function of the tax-admissible price and the corporate income tax rates that apply in the jurisdictions the firm's divisions operates in.

Despite the obvious importance of transfer pricing in multinational firms, modeling efforts in this area are still in their infancy. Yet, we submit that more complete and satisfactory models have clear potential for providing useful guidance to both controllers and tax departments in multinational firms. This consideration applies particularly to the transfer of intangible assets, which are becoming increasingly central to the potential for value creation in multinational firms.

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# **Comment on Hiemann and Reichelstein: “Transfer Pricing in Multinational Corporations: An Integrated Management- and Tax Perspective”**

Norbert Herzig

## **Abstract**

*The role and impact of transfer prices have long been a subject of business administration research. As they are affecting both internal and external accounting, the management of such transfer prices between the diverging poles of taxation and economic targets is an aspect with growing prominence. The following comment is aimed to contribute to the important discussion on how, from a business administration perspective, a transfer price system should best be designed. As highlighted by Professor Reichelstein, such a system might be established on a “one set of books” or “two sets of books” principle. The idea of separating transfer price functions through the use of two sets of books specifically implies the introduction of differentiated transfer prices. The comment therefore discusses the perspective of decoupling transfer prices for managerial and taxation purposes. Overall, the evidence suggests that the specific management of transfer prices may contribute to solve major conflicts of interest within multinational corporations, but may lead to additional tax risks.*

## **1. Introduction**

The role and impact of transfer prices have long been a subject of business administration research. As *Hiemann/Reichelstein* pointed out in their contribution, transfer prices have the quite remarkable property of affecting both internal and external accounting. Consequently, they not merely serve to manage individual areas of responsibility within multi-component group enterprises, but are also relied upon in determining profit for the external accounting and taxation purposes of multinational organizations. As an instrument of behaviour control, i.e., an incentive-based tool for influencing the performance of in-house executives, transfer prices help to ensure an efficient use of resources and hence, ultimately assist in resolving corporate decision-making and management issues. In the field of external accounting, the current debate is focused mainly on the role of transfer prices in determining and allocating the income and expense of related business units and in the resulting appropriation of profits. Another key subject is the use of transfer prices as an instrument of tax-optimized profit allocation between different tax jurisdictions.

In view of these quite diverse and exacting requirements placed on transfer pricing, the question naturally arises whether a uniform TP can fulfill these demands or whether a more differentiated transfer price design is indeed called for. On principle, an enterprise limiting itself to the use of uniform transfer prices runs the risk

of failing to meet tax and/or economic precepts. A differentiated transfer pricing concept might provide additional options in this regard.

## **2. Transfer Prices between the Diverging Poles of Taxation and Economic Targets**

As we have seen, the roles and functions of transfer prices within multinational corporations are manifold and hence, need to meet different objectives and sets of criteria. It is therefore hardly surprising that the debate on specific transfer price design is increasingly gaining in importance in both business research and practice.

Multinational corporations typically spread their economic activities among multiple countries, and as a general rule, this makes them subject to different reference systems in terms of corporate taxation. One characterizing feature of international corporate taxation is that, to this day, the various states set different nominal rates and tax bases at their own discretion, which inevitably create different taxation effects. Against this background, transfer price taxation policy is becoming particularly important if one considers the ever-growing number of intra-company transactions in the digital age. On the other hand, it appears all but impossible to identify *all* transactions between related enterprises given the number and complexity of the exchanges involved. Still, in international tax law, the attribution of profits for tax purposes is currently carried out on the principle that individual transfer prices must be determined for every cross-boundary transfer between related enterprises – a principle which, for this very reason, is increasingly reaching its limits. A “two sets of books” system might therefore provide a solution approach with regard to key transactions.

From a tax viewpoint, transfer prices are needed for intra-company transfers between the parent company and its subsidiaries – and hence, for transactions between legally independent entities – as well as for transactions between a corporation’s headquarters and its permanent business establishments. Profits are attributed to permanent establishments in compliance with the so-called Authorized OECD Approach (AOA). The view held by the OECD in this context is that a permanent establishment is a fully independent business entity and that the arm’s length principle is therefore unreservedly applicable, on principle, to all internal transactions (so-called “dealings”).

As regards the objectives of transfer price taxation policy, an interesting trend has been emerging of late. Whereas in the past transfer prices were determined mainly with a view to optimizing the distribution of profits, companies now aim to define their transfer prices basically in consensus with the local tax authorities so as to avoid the looming spectre of dual profit taxation. A fact to be viewed as particularly problematic in this respect is that states will often adjust transfer prices unilaterally, i.e., without any matching adjustment being made by the other state involved. The justification given for such adjustments is regularly that one aims to protect one’s own tax substrate. Given today’s growing national deficits and extensive economic stimulus programs, this trend is likely to continue in the future. Conflict over the recognition of transfer prices between tax authorities and multinational compa-

nies is therefore considered a major tax risk in practice, and one which can only be resolved via the instrument of extensive documentation. Other objectives pursued via transfer pricing, such as aggressive tax strategies aimed at shifting profits to countries with low corporate taxation rates, have been on the decline, on the other hand, particularly in most recent times.

### 3. Creation of “One Set of Books” versus “Two Sets of Books” Systems

It follows that the determination of transfer prices as a statement of the value of intra-group or intra-company transfers will inevitably take place between the poles of divergent economic and taxation interests. This conflict of interests raises the important question of how, from a business administration perspective, a transfer price system should best be designed. As outlined by *Hiemann/Reichelstein*, such a system might be established on a “one set of books” or “two sets of books” principle. The idea of separating transfer price functions through the use of two sets of books specifically implies the introduction of differentiated transfer prices. Thus, different functions might be served using different transfer prices so that conflicts of interest would be effectively avoided. However, in day-to-day business practice this approach has been playing a rather insignificant role to date, as various studies have shown<sup>1</sup>. This might be due to the significant time and effort associated with the creation and maintenance of a dual system, as well as to the fact that the communication requirement vis-à-vis internal and external parties such as, e.g., the local tax authorities, should not be underestimated.

### 4. Decoupling of Transfer Prices for Managerial and Taxation Purposes

Despite practical limitations, the possibility of splitting transfer prices as outlined by Professor Reichelstein appears to be desirable, especially from the viewpoint of a corporation’s management which would thereby gain another parameter for action. This option has been discussed with reference to three different scenarios. In the first scenario, i.e. “cost-based transfer pricing”, we arrive at the quite remarkable result that it appears to be possible at first sight to map and determine transfer prices independently of the tax rate differential  $h$ . Instead, based on the goal congruent solution, the transfer price emerges as the weighted average of  $P_{\text{tax}}$  and  $c$ , meaning that it depends primarily on the lower tax rate abroad. An unsurprising finding, on the other hand, is that the optimum internal transfer price TP will not, in the final analysis, coincide with  $P_{\text{tax}}$ . The proposed decoupling of “tax-world” transfer prices from their intra-company counterparts appears to make sense especially from a tax planning perspective, since from a taxation viewpoint a significant tax rate differen-

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<sup>1</sup> cf. Ernst & Young (2003), *Transfer Pricing 2003 Global Survey*; Czechowicz/Choi/Bavishi (1982), *Assessing Foreign Subsidiary Performance: Systems & Practices of leading Multi-national Companies*, p. 59.

tial would doubtless be taken into account in assessing the transfer price. The tax burden might be reduced here by re-directing profits from cross-boundary transactions into low-tax countries while shifting potential losses to high-tax jurisdictions. However, it must be considered in this regard that an excessively large spread of transfer prices between the “tax-world” and managerial sets of books will always involve a risk of the former not being recognized within the framework of a government tax audit, so that an additional tax risk would be created. Although a separation of the transfer prices (“two sets of books” solution) may have favorable effects from a business administration perspective, it should always be accompanied as a minimum by a reconciliation of the different functional areas.

The second model, known as “market-based transfer pricing”, is characterized by the complete absence of any interdependency between the transfer price set for internal use and the one recognized for taxation purposes. Since the optimum solution in this scenario implies the granting of an “intra-company discount”, meaning that the TP will regularly fall below the arm’s length price, potential tax savings might actually be obtained from a taxation viewpoint, provided that the optimum “intra-company discount” can in fact be determined. A transfer price defined by the “comparable uncontrolled price method” would be higher, so that a tax advantage would be generated (decoupling effect). The tax risk incurred by the enterprise would be limited in this case since an external reference price is available. A problem associated with this scenario might reside in the lower transfer price established for internal purposes. To justify the deviation, one might quote different market structures or the diverging volumes of sales to internal and external customers. In conclusion, the tax advantages and additional costs associated with a “two sets of books” system need to be carefully weighed against each other.

In the third example which models transfer pricing with respect to the licensing for use of intangible assets, we find that differentiated transfer prices yield advantages in the form of higher after-tax profits or superior incentive effects, respectively. However, determining such transfer prices poses a major challenge, especially from a taxation viewpoint, due to the particular characteristics of intangibles. Thus, intangible assets often contribute very significantly to the value added within the company, yet unlike physical assets, the identification and assessment thereof is typically fraught with substantial challenges. In most cases such valuation difficulties result from the absence of comparable market transactions. Moreover, setting an “arm’s length”-compliant transfer price may be rendered difficult by special circumstances such as, e.g., the joint use of an intangible asset by multiple internal and external market participants. Such particularities will regularly cause major complications in attempting to set a transfer price acceptable to all tax authorities involved, apart from driving up documentation requirements and standards for the furnishing of evidence to the tax authorities. Multilateral agreements in the form of so-called Advance Pricing Agreements (APA) may be helpful here.

Needless to say, if a transfer price intended for internal purposes is set independently of tax requirements, this may give rise to an altogether different set of considerations and valuations. To that extent, a differentiated approach in determining internal and external transfer prices would doubtless provide additional management

flexibility, thereby further enhancing the advantages already pointed out. Still, apart from the “normal” tax risks, the specific tax risk of retroactive unilateral transfer price adjustments by the states involved would be incurred in the event of actual performance not coinciding with the expected one, so that adjustments within the meaning of section 1(3)(11) of the German Foreign Transaction Tax Act will be allowed.

## 5. Conclusions

- Uniform transfer pricing, which is still the predominant method in today’s business practice, may give rise to major conflicts of interest. The proposed decoupling of transfer prices for different internal and external accounting functions can go a long way towards resolving these conflicts of interest and is therefore attractive from an economic point of view.
- By decoupling transfer prices, it becomes possible to pursue “tax-world” and economic objectives independently of each other, at least with regard to very substantial transactions. This may enable the management to act more flexibly.
- On the other hand, a number of questions relevant from a decision-making viewpoint do arise, especially as to the tax risks potentially associated with a functional decoupling of transfer prices.
- Moreover, potential implementation problems should be noted and may impose additional cost burdens.
- The transaction-based profit allocation for taxation purposes is doubtless reaching its limits in the digital age.

# Multiple Roles of Transfer Prices: One vs. Two Books

Søren Bo Nielsen and Pascalis Raimondos-Møller\*

## Abstract

*This paper investigates multiple roles of transfer prices for shipments of goods and services between entities of a multinational enterprise. At the center is the role of transfer pricing (TP) in tax manipulation, but other roles having to do with internal operations or strategic delegation, etc. are also considered. The interesting question is to what extent and how the different roles of TPs interfere with each other. The answer depends on whether companies use one or two books, i.e. whether they (can) apply different TPs for different purposes. We illustrate, in a stylized model, the competing aims of tax manipulation and strategic delegation. Finally, we briefly look at selected reform proposals, concluding that either TP problems are not addressed, or else new distortions will be introduced instead.*

## 1. Introduction

This paper takes a look at the use of multiple transfer prices in multinational enterprises (MNEs). It recognizes that TP (we shall henceforth write ‘TP’ interchangeably for transfer pricing and transfer price) is needed in order to allocate income to different entities in a MNE, and thus eventually to different countries. This allocation of income is a necessary prerequisite for computing the tax due to national tax authorities in the countries in which the MNE is active, under the present international taxation regime. It is also desirable in order to derive the relative profitability of the various activities and activity centers of the MNE. Furthermore, TP may be utilized in order to regulate decentralized decision makers in the MNE, and it may even be employed in strategic delegation of decision making. Yet further uses of TP have been put forth.

The overall theme of the paper is the extent to which these multiple roles of TPs impinge on each other. For instance, does the fact that TP is applied to regulate decision making in a decentral unit put constraints on the use of TP to minimize tax payments? Or is it the other way around? Would any link which is present in a one-book system (where the same computation of income of an entity is used for tax and other purposes) be broken if the MNE were to transition to the use of two books instead?

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While these issues have been addressed in the international tax law literature, in economics the issue has received less attention.<sup>1</sup> Only few articles exist that deal with the (conflicting) multiple dimensions of TP. In these articles the tension between tax considerations and other uses of TP is analysed, and the same holds for the choice of one-book vs. two-book systems. At various points we shall refer to the issues and findings in these papers. In forming our own view, we shall set up an alternative model in which TP performs multiple roles, and within this model we will see how the different TPs interact. In doing so we suggest a rationale for the fact that most countries *do not have* rules that ban the use of two-books – a fact that seems counter-intuitive at first sight. Finally, we speculate whether a series of proposals for reforms of national tax systems and indeed the international system of taxation will reduce or remove the challenges involved in TP.

The article is structured as follows: Section 2 provides a short introduction to the necessity of TP. Section 3 sets up an illustrative model of multiple aims in TP; we consider tax manipulation as well as strategic delegation, and use the framework to juxtapose the situations of one book and two books. Section 4 moves on to consider other models along similar lines. Section 5 takes a look at possible reforms of the international taxation system and their eventual consequences for TP, and section 6 concludes.

## 2. The need for TP

Risking to border on the banale, we wish to start out questioning why TP is needed.

### 2.1 A World of Solely National Companies

Imagine first a world in which countries do engage in trading with each other, but where there are no multinational enterprises. Goods and services are produced to varying extent in the different countries in firms, the pattern of production reflecting comparative advantages of individual countries. Countries with a surplus (of production over consumption) of a particular good or service sell some to other countries, and in a situation of deficit (consumption exceeding production) goods or services are imported. Only national companies are involved. These companies might have multiple branches or entities, but all of these would be found in the ‘home country’.

The international system of taxation in this world could be today’s, i.e. based on separate accounting. Each country would apply the national rate of, say, corporate income tax to the income generated within that country’s borders.

Would there be any need for TP for tax purposes in this world? No. Each company would be a national unit, and its total income would be computed and subject to tax nationally. Would there be a need for TP for other purposes? Quite possibly yes. Many national companies would be divided up in different ‘profit centers’, and

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<sup>1</sup> Needless to say, the practical importance of such issues is witnessed by the enormous size of the consulting sector offering TP services to global firms.

the pricing of internal deliveries within the company would be helpful in giving top management an impression as to where income is earned and where money is burned in the company. In addition, managers of decentral units could be regulated by contracts, in which TP could play a role. So TP could indeed be an essential activity, through which earnings generated in different units could be gauged. But the overall income of the company would be immune to the precise setting of TP for internal shipments (appropriately ignoring behavioral consequences).

The upshot is that since TP is not needed for tax purposes, there can be no conflict between TP for tax purposes and TP for alternative purposes.

## 2.2 A World with Multinational Enterprises

Instead of a national company producing and exporting to other countries – as in the example just given – the company can have a foreign company undertake the production via a license and acquire income through a license fee. Under certain conditions this may be the most rational way of making sure that the company's ideas and products are brought to the attention of foreign consumers. Alternatively, the company may acquire a foreign unit; this can be done through greenfield investment or the acquisition of an already existing foreign company. Either way, the route is foreign direct investment (FDI). Having undertaken FDI, the national company has become a multinational enterprise. By generating income in both the home country and the foreign host country two sets of tax authorities will require the computation of income for corporate income taxation. The MNE must compute how much income is generated at home and how much abroad. Very likely the home and foreign entities of the MNE will be linked by flows of goods and services. In order to compute the separate income statements, these flows must be evaluated, and for that purpose prices of the transferred goods or services must be found. While TPs can be helpful for internal governance purposes, they will now be necessary for computation of tax due in the home and host countries.

## 2.3 Tax Differences and TP Manipulation

The typical MNE consists of a tightly knit network, in which the individual entities ship goods, services and technological and other expertise to each other. At the same time, the countries in which the entities are located typically have different corporate income tax rates (and different corporate tax systems). If prices of internal shipments were absolutely unambiguous for both the company and tax authorities, such tax differences would be of little interest to the MNE in regard to these internal shipments.<sup>2</sup> However, internal prices are not unambiguous. For one, there typically is a span between costs of production of the shipping entity and the value (sales price) for the receiving entity. Where in this span is the sensible TP? For another, neither the cost of production nor the value in the receiving entity need to be well-defined. For instance, the product may result from joint production in the supplying entity,

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<sup>2</sup> Of course, tax differences would impact location decisions, investment decisions and production decisions in the various entities.

and a very early insight for economics and business students is that per-unit costs of goods produced under conditions of joint production are not well defined. In sum, transfer prices are ambiguous, and usually there will be an interval, in which individual values cannot easily be rejected as unreasonable candidates for the transfer price.

This fact is recognized both by MNEs and tax authorities. When TPs start to get somewhat fuzzy, it is only natural for MNEs to consider selecting those values of TP which will assist in minimizing the MNE's overall tax burden.<sup>3</sup> So when a shipment occurs from an entity in a high-tax country to an entity in a low-tax country, charging a relatively low TP implies reducing profits in the high-tax country and raising profits in the low-tax country, thus shifting income towards the low-tax location. Clearly, the MNE's tax burden will drop in the process.

There is ample empirical evidence of such profit or income shifting. A series of empirical articles, using both indirect and direct methods, have produced evidence that MNE's engage in profit shifting. Recent surveys are provided by Gresik (2001) and Devereux (2007); see also Huizinga and Laeven (2008) and Maffini and Mokkas (2011) for the latest empirical contributions.

While economists in public finance have studied the workings of different international tax systems and the empirical facets of profit shifting, colleagues in accounting and organization have looked at transfer pricing as instruments of coordination and provision of incentives in large organizations such as MNEs. To get a clear idea of the profitability of different activities in a MNE, prices of outgoing and incoming goods and services from/to these activities are needed (see e.g. the work of Baldenius et al., 2004, and Hyde and Choe, 2006).

## 2.4 The (re)actions on the Part of Tax Authorities

The use on the part of MNEs of TP for tax minimization purposes has been known for decades. Likewise the uncertainty related to those TPs which are essential for the functioning of the separate accounting system. Accordingly, tax authorities have long had an interest in supplying methods for determining or computing TPs to settle uncertainties and disputes with corporations. A series of methods have been proposed. They rely to varying extent on measures of costs, resale values, and profitability. Hereby, the Comparable Uncontrolled Price method, the Resale Price method, the Cost-Plus method, the Profit Split method, and the Comparable Profit method have been developed. For a discussion and presentation of these various methods for computing TPs see OECD (2010); a comparative analysis is provided in Gresik and Osmundsen (2008). All member countries of OECD have issued guidelines and established practices for computing TPs, not least on the basis of OECD's own guidelines. Which methods are particularly favored seems to vary across countries and over time.

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<sup>3</sup> To the extent that tax manipulation can assist in increasing the value of a MNE to its owners, one may argue that it is the obligation of the management to exploit this opportunity in full.

## 2.5 One or Two Books?

While TPs for tax purposes thus generally would need to be computed in reliance to one of the standard methods just mentioned, in principle MNEs could apply different sets of TPs for alternative purposes within the organization. As far as we know, such practice is only ruled out in a few industrial countries,<sup>4</sup> a fact that seems counter-intuitive at first sight. If tax authorities suspected that MNEs have different books for different purposes, why don't they ban the use of it? Regardless of whether such a ban can be implemented or not, its signaling value could be important. It would highlight that tax authorities would like to know the true price that MNEs set on intra-firm transactions and not the price that MNEs want to use for tax minimizing purposes.

However, and despite the freedom that MNEs have in choosing two books, the literature on TP is not in agreement as to whether MNEs actually seize the opportunity to employ two books rather than one. Some quotes illustrate this: "... it appears that the majority of multinational firms insist on one set of prices, both for simplicity and in order to avoid the possibility that multiple transfer prices become evidence in any disputes with the tax authorities." (Baldenius et al., 2004). And: "... stricter tax regulations governing MNEs – forcing the use of numbers that may not reflect internal realities – have helped popularize the use of a second managerial set of transfer pricing numbers ... the two transfer prices are shown to be very much interdependent." (Hyde and Choe, 2006).<sup>5,6</sup>

On this background we investigate multiple-purpose TP below in both one-book and two-book settings. We start out in the next section with an illustrative model of a MNE with two TP aims (strategic delegation and tax manipulation); in the sub-

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<sup>4</sup> In fact, we only know Belgium as an example of a country that bans the use of two books.

<sup>5</sup> Czechowicz et al. (1982) reports that 89% of U.S. MNEs use the same transfer price for internal and external purposes. Even if the practice of two sets of books has increased since 1982, Eden (1998, p.295-299) finds that, at least for merchandise trade flows, MNEs do not keep two sets of books. An even more recent survey by Ernst & Young (2003) indicates that over 80% of parent companies use a single set of transfer prices for management and tax purposes. The report adds that "alignment of transfer prices with management views of the business can enhance the defensibility of the transfer prices, ease the administrative burden, and add to the effectiveness of the transfer pricing program. In fact, in many countries management accounts are the primary starting point in the determination of tax liability and differences between tax and management accounts are closely scrutinized" (p.17).

<sup>6</sup> At a recent Danish meeting on transfer pricing problems and practices we took the opportunity to inquire about the use of one or two books. The responses we received did not contribute to solving matters, as they were in rather different directions. Some underscored the genuine economic considerations in the determination of TPs, others stressed that there would only be one set of TPs in their company. One representative mentioned that TPs were only applied for tax purposes, whereas internal governance employed other mechanisms. Another representative replied that everyone else (except for the person responsible for tax accounts) was just about indifferent as to TP, since the units in which the concern was divided for internal governance were completely different from the units necessary for tax reporting. So the picture seems quite fuzzy. The participants had the impression that their companies could generally use two books in the countries in which they were active, and they could not immediately point out countries with a one-book requirement.

sequent section we continue by discussing other contributions to the literature on multiple-purpose TP.

### 3. An Illustrative Model

The model we set up and analyze in the following section serves to illustrate some of the tensions in TP when multiple purposes are involved. We build on earlier work of ours (with Guttorm Schjelderup), in particular Nielsen et al. (2008, 2010). The (headquarter of the) MNE in the model plans to use TP for two purposes: (a) strategic delegation to a subsidiary in another country;<sup>7</sup> and (b) minimization of total tax payments. Both purposes serve, of course, in the end to maximize after-tax profits of the concern as a whole.

Consider a MNE that operates in two countries: country  $A$ , where the parent firm is located, and country  $B$ , where the subsidiary firm is located. The parent produces a product that is sold directly to the consumers in country  $A$ , and is also sold to the consumers in country  $B$  through the subsidiary firm, which here takes the form of a retailer. The market in country  $A$  is assumed to be monopolistic, while the market in country  $B$  is characterized by Cournot competition between the subsidiary and a local firm.<sup>8</sup> To simplify, without bearing on qualitative results, we assume that demand in both countries is linear and all production costs are constant and normalized to zero. Based on these assumptions, expressions for the firms' profits (absent taxes) will generally be the following:<sup>9</sup>

$$\Pi^A = (1 - Q_A)Q_A + qQ_B \quad (1)$$

$$\Pi^B = (1 - Q_B - Q_B^*)Q_B - qQ_B \quad (2)$$

$$\Pi^{B^*} = (1 - Q_B - Q_B^*)Q_B^* \quad (3)$$

The quantity sold in country  $i$  ( $i = A, B$ ) is denoted by  $Q_i$ , while an asterisk (\*) denotes variables for the local competitor in country  $B$ . The transfer price involved in the expressions is denoted by  $q$ . As is seen, the parent firm has revenues from selling directly to country  $A$ 's consumers and to the subsidiary in country  $B$  (while the costs of producing  $Q_A$  and  $Q_B$  are zero by assumption). The subsidiary's revenue depends on the sales of the local competitor, while its costs are determined by the transfer price which it has to pay to the parent firm. Finally, the foreign local firm has revenues from selling in its local market (while the cost of producing  $Q_B^*$  is zero).

<sup>7</sup> For discussions of strategic delegation of decision making we refer to Vickers (1985), Sklivas (1987), Fershtman and Judd (1987) and Katz (1991); See also Schjelderup and Sørgaard (1997).

<sup>8</sup> This set-up is probably the simplest possible way to portray the strategic considerations involved in setting transfer prices. The qualitative results that we present here should not depend on the Cournot assumption.

<sup>9</sup> Since for our purpose there is no need for general intercept and slope parameters in demand expressions, we take all of them to be unity.

Accounting for taxes, the MNE maximizes after-tax global profits, while the local competitor maximizes its after-tax local profits (in effect  $\Pi^B$ ). In each country there is a company tax ( $t_A, t_B$ ) that falls on the profits of the firms that operate within the country, i.e. taxation is based on the separate accounting system.<sup>10</sup> It is also assumed that in the case where the transfer price deviates from what the relevant tax authorities believe to be its ‘arm’s length’ value of zero, the MNE faces a non-tax-deductible transfer pricing cost. We carefully specify this cost below.<sup>11</sup>

In principle, costs associated with transfer pricing can take the form of fines when transfer pricing abuse is detected by authorities. Moreover, there can be resource costs associated with hiring lawyers and accountants to defend the chosen transfer prices, or resource costs stem from management having to devote time and attention to setting (manipulating) TPs.

Seeking to take institutions in TP manipulation into account, we explicitly portray costs of the first type while arguing that the other types of costs are in effect also well covered by our specification.

Accordingly, we assume that distorted transfer pricing involves the probability of a fine (at a rate  $z$ ) set by the country which is cheated against, i.e. the high tax country. Throughout the analysis we shall assume that country  $A$  is the high tax country.<sup>12</sup> Accordingly there is a clear tax motive for setting a low (negative) TP,  $q$ , in order to shift taxable income from the parent firm to the subsidiary firm. The probability of being detected for distorted transfer pricing is taken to be a convex function of the *numerical* deviation of the transfer price from the marginal cost of zero (considered its ‘true’ value by tax authorities). That is, the probability of detection is given by  $p(-q)$ ; here,  $-q$  measures the extent of underpricing. If detected, the fine  $z$  is levied on the size of the shipment ( $Q_B$ ) times the underpricing ( $-q$ ) times the high tax rate ( $t_A$ ), i.e., altogether  $zQ_B(-q)t_A$ . The expected cost of transfer pricing abuse is the product of the detection probability and the fine. We can write this product as  $zQ_B t_A \Phi$ , where the  $\Phi$  function contains both the degree of abuse ( $-q$ ) as well as the probability of detection  $p$ , so that  $\Phi = (-q)p(-q)$ . Assuming  $p(0) = 0$ ,  $p' < 0$  when  $q < 0$ , implies that  $\Phi(0) = 0$ , while  $\Phi'' > 0$ . Note that

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<sup>10</sup> In addition, we assume that the exemption principle of international taxation is in force, so that the subsidiary’s income is not liable to tax in the parent’s country. In essence, this requires the subsidiary to be a separate legal entity.

<sup>11</sup> In principle, the MNE could be exclusively run from the parent company, i.e. completely centralized. Alternatively, it could be decentralized in such a way that the subsidiary in country  $B$ , faced with an appropriate TP set by the headquarter in  $A$ , has the right to decide on the quantity  $Q_B$  to maximize subsidiary profits. In Nielsen et al. (2008) it is demonstrated, in a one-book situation, i.e. with a sole TP available, that the MNE will under some tax constellations opt for decentralization. For other constellations centralization is the best choice. The trade-off involved is between strategic delegation in order to strengthen the subsidiary’s position in the market in country  $B$ , and tax manipulation. When the twin purposes do not lead to too much conflict in TP setting, decentralization is preferred. However, when the conflict becomes larger, centralization is preferred. Below, the tax constellation we investigate conforms with the findings in Nielsen et al. (2008).

<sup>12</sup> In line with the analysis mentioned in the previous footnote.

$zQ_B t_A \Phi$  includes the evaded tax, so that the fine parameter  $z$  is greater than unity ( $z > 1$ ).

If tax authorities in country  $A$  detect transfer pricing and adjust taxable income of the MNE in  $A$ , it is possible that authorities in country  $B$  undertake a so-called corresponding correction of the MNE's taxable income there. If it does happen, it implies a reduction of taxable income in country  $B$  of  $(-q)Q_B$ . The extent to which this is expected to happen is indicated by  $x$  ( $0 \leq x \leq 1$ ). The expected addition to after-tax profits of the entity in country  $B$  associated with this corresponding correction is then  $xQ_B t_B \Phi$ ,  $t_B$  being country  $B$ 's tax rate.<sup>13</sup>

Having described the basic model structure we can now proceed in analyzing the optimal choices of TP under one- and two-book systems. We start with the latter for expositional reasons. With two books, separate TPs can be assigned to strategic delegation, respectively tax manipulation. With one book, one single TP must be used. The one-TP situation obviously involves a trade-off in setting the single transfer price between strategic delegation and tax manipulation. Contrary to this, the two-TP situation appears to allow superior opportunities to pursue the two aims individually with one TP assigned to each. Nevertheless, as we will show, the settings of the two TPs are interrelated. In particular, the TP for tax purposes will impinge on the TP for strategic delegation.

### 3.1 MNE Setting of TPs with Two Books

We first consider the case where the MNE chooses two transfer prices. One TP, to be denoted by  $q^D$  ('D' for delegation), is intended to control the strategic delegation to the subsidiary in  $B$ . Hence,  $q^D$  is used to compute subsidiary profits as  $\Pi^B = (1 - Q_B - Q_B^*)Q_B - q^D Q_B$ . This expression the subsidiary then maximizes with respect to  $Q_B$ , taking the competitor's quantity into account.<sup>14</sup> The Cournot-Nash equilibrium for the two duopolists will be given by

$$Q_B = \frac{1 - 2q^D}{3}, \quad Q_B^* = \frac{1 + q^D}{3} \quad (4)$$

<sup>13</sup> For more alternative specifications see Nielsen et al. (2010).

<sup>14</sup> Note that we assume that the organizational arrangement of the MNE is such that the management of the subsidiary is supposed to maximize its pre-tax profits. Alternatively, its task could be to maximize after-tax profits, taking into account the tax-TP, and perhaps even the likelihood of a corresponding correction of MNE income. These alternatives would greatly complicate the analysis without altering the conclusion that the TP for strategic delegation purposes will depend on tax manipulation opportunities. It is an open question which of the possible formulations of delegation would correspond best to actual practice. Wilson (1993) shows that firms choose incentive schemes based on performance measures that are not affected by transfer prices so as to avoid conflicts between tax and non-tax objectives. Baldenius et al. (2004) first presume that divisional managers are evaluated on the basis of their divisional after-tax income, but then write "In some multinational firms, however, divisional performance evaluation is based on pre-tax income, yet others base their performance evaluation on 'effective tax rates'." (Baldenius et al., 2004, p. 596.)

The other TP, labelled  $q^T$  ('T' for tax), is intended for tax manipulation. With  $q^T$ , the MNE's after tax profits can be computed at

$$\begin{aligned} \Pi^T = & (1 - t_A)(1 - Q_A)Q_A + (1 - t_B)(1 - Q_B - Q_B^*)Q_B \\ & + (t_B - t_A)q^T Q_B - (zt_A - xt_B)Q_B\Phi \end{aligned} \quad (5)$$

The first couple of terms cover sales revenues in the two countries. The third term stands for tax savings associated with selecting a TP less than zero. Finally, the fourth term covers the expected net cost of engaging in distorted TP.

In the following we assume for convenience that the probability of detection increases in a linear fashion with the extent of distortion in TP, i.e.  $p(-q^T) = -(u/2)q^T$ . In this manner,  $\Phi = (u/2)(q^T)^2$ . Note that then  $\partial\Phi/\partial q^T = uq^T$ .

The headquarter of the MNE now wishes to maximize after tax profits  $\Pi^T$  with respect to  $(Q_A, q^T, q^D)$ , taking into account the decentral setting of  $Q_B$ . The first order condition for the TP aimed at tax manipulation can be written

$$-(t_B - t_A) = -(zt_A - xt_B) \partial\Phi / \partial q^T \quad (6)$$

The marginal tax saving associated with a further reduction in the tax-TP should equal the expected marginal cost of detection and fine. Introducing the functional form for  $\Phi$ , we can derive an explicit formula for  $q^T$ ,

$$q^T = \frac{t_B - t_A}{u(zt_A - xt_B)} \quad (7)$$

The bigger the difference between tax rates; the smaller the detection parameter  $u$ ; the smaller the fine  $z$ ; and the greater the chance of a corresponding correction, the greater the scope for tax-related TP distortion.

The other TP which controls delegation is found to be

$$q^D = -\frac{1}{4} - \frac{3}{2} \left[ \frac{(t_B - t_A)q^T - (zt_A - xt_B)(u/2)(q^T)^2}{1 - t_B} \right] = -\frac{1}{4} - \frac{3}{4} \frac{(t_B - t_A)q^T}{1 - t_B} \quad (8)$$

where we have likewise employed the functional form for  $\Phi$ , and in addition the formula for  $q^T$ .

It is well worth dwelling a bit on this expression. First of all, it is easily seen that in general the two TPs will be different from each other.<sup>15</sup> To see this note that if the tax rates in the two countries are identical,  $t_B = t_A$ , there is no scope for tax manipulation, rendering  $q^T = 0$  (i.e. equal to the arms' length price). In this case, the

<sup>15</sup> Of course, one can derive a particular constellation of the parameters of the model  $(t_A, t_B, z, x, u)$  that renders  $q^D = q^T$ . In general, however, the two TPs are genuinely different.

delegation-TP will be set at  $(-1/4)$ , the value which secures the subsidiary the best possible position in the oligopolistic market in country  $B$ , i.e. the MNE behaves as a Stackelberg leader serving half of the total market ( $Q_B = \frac{1}{2}$ ) while the local competitor serves the residual demand ( $Q_B^* = \frac{1}{4}$ ). However, once taxes in the two countries are no longer equal, setting  $q^D$  will become more involved. We see that when country  $A$  is the high-tax country, delegation will be interfered with and  $q^D$  will be reduced further. Why? Decreasing the delegation-TP beyond  $(-1/4)$  will on one hand reduce subsidiary before-tax profits, but it will at the same time raise tax savings for the MNE, as the 'base' for profit shifting, i.e. the quantity  $Q_B$  supplied from the parent to the subsidiary, widens. Basically, a low transfer price makes the MNE subsidiary win the market share game in the host country and thus earn higher profits. Earning higher profits in country  $B$  makes sense when the tax rate is lower than in country  $A$ . Thus, the tax manipulation effect goes hand-in-hand with the strategic effect and the MNE intensifies its aggressive TP setting. The optimal value of the delegation-TP reflects these considerations.<sup>16</sup>

We sum up our findings in

**RESULT 1:** *When the MNE carries two books and has two TPs available for, respectively, strategic delegation and tax manipulation, then (i) the tax-TP is set so as to maximize the net savings stemming from tax manipulation, while (ii) the delegation-TP is set so as to balance the effect of quantity transferred on sales revenue and on tax savings. All in all, TPs for tax and delegation purposes are inter-related.*

### 3.2 MNE Setting of TP with Merely One Book

Next consider the case in which the MNE merely carries one book. That is, even though several aims are pursued, only one TP will be available. Call this TP  $q^S$  ('S' for single).

The subsidiary, instructed to compute its profits with this transfer price, does so taking the competitor's actions into account, resulting in the quantity  $Q_B = (1 - 2q^S)/3$  being shipped from the parent. The MNE's after tax profits are now expressed as

$$\begin{aligned} \Pi^T = & (1 - t_A)(1 - Q_A)Q_A + (1 - t_B)(1 - Q_B - Q_B^*)Q_B \\ & + (t_B - t_A)q^S Q_B - (zt_A - xt_B)Q_B \Phi \end{aligned} \quad (9)$$

and the headquarter maximizes this with respect to  $(Q_A, q^S)$ , again taking the decentral setting of  $Q_B$  into account.

<sup>16</sup> This result depends on the particular fine scheme that we have employed. An alternative fine scheme which we consider below relates the fine to the difference between the twin TPs; in turn, this difference ends up being governed by the tax rate difference.

The first order condition for the TP becomes a second order polynomial,

$$\frac{\partial \Pi^T}{\partial q^S} = \frac{(1-t_B)(-1-4q^S)}{9} + \frac{(t_B-t_A)(1-4q^S)}{3} - \frac{(zt_A-xt_B)uq^S(1-3q^S)}{3} = 0 \quad (10)$$

The expression is not that intuitive as is. (But it is easily checked that the optimal TP must be negative.) Instead, define the following expressions:

$$R(Q_B) = (1-t_B)(1-Q_B-Q_B^*)Q_B, \quad S(Q_B, q) = (t_B-t_A)qQ_B - (zt_A-xt_B)Q_B(u/2)(q)^2$$

Hence, these are after-tax revenue in country  $B$  and net tax savings, respectively. The former depends on the transfer price  $q$  via  $Q_B$ , and the latter depends on  $q$  both directly and via  $Q_B$ . With this notation, the optimal single TP can be expressed through the equation

$$\frac{dR}{dQ_B} \frac{dQ_B}{dq^S} + \frac{\partial S(Q_B, q^S)}{dQ_B} \frac{dQ_B}{dq^S} + \frac{\partial S(Q_B, q^S)}{\partial q^S} = 0$$

Next, introduce that particular value of the TP, called  $q^R$ , for which marginal after-tax revenue is zero. Hence this and the two TPs from the preceding subsection can be characterized via

$$\frac{dR}{dQ_B} \frac{dQ_B}{dq^R} = 0, \quad \frac{\partial S(Q_B, q^T)}{\partial q^T} = 0, \quad \frac{dR}{dQ_B} \frac{dQ_B}{dq^D} + \frac{\partial S(Q_B, q^T)}{dQ_B} \frac{dQ_B}{dq^D} = 0$$

(Note here that the last partial derivative of  $S$  wrt.  $Q_B$  is taken in the TP  $q^T$ .)

It is tempting to ask whether these properties can be used to characterize  $q^S$  relative to the other TPs. Some investigation leads to Result 2 and Lemma 3.

**RESULT 2:** *When the MNE carries only one book and thus has a single TP available for the twin purposes of strategic delegation and tax manipulation, the compromise TP will attain a negative value.*

**LEMMA 3:** *The relative size of the optimal TP in the one-book case can be compared to the other TPs in the following way:*

- (i) *When  $q^D = q^T$ , i.e. when the two two-book TPs are identical, then  $q^S = q^T = q^D$ . (In this situation,  $q^R$  is greater than this common value.)*
- (ii) *When  $q^T = q^R$ ,  $q^D < q^S < q^T = q^R$ . (In this situation, the single TP lies between the two two-book TPs.)*
- (iii) *When  $q^R < q^T$ ,  $q^D < q^S < q^T$ . (Same conclusion as under (ii).)*

When  $q^T < q^R$ , the relationships between  $q^D$ ,  $q^S$  and  $q^T$  appear unclear. Despite this, the feeling one gets from the one-book situation is that the single TP becomes a compromise between the two TPs in the two-book case which were assigned to, respectively, strategic delegation and tax manipulation.

Will the MNE be worse off in the one-book case than in the two-book case? Generally yes (unless of course in the special case (i) in the Lemma). With no distortions it pays to have an extra instrument to pursue the two different goals. The gains from two books are going to be greater, the greater is the difference in tax rates between the two countries, and the smaller are fines and detection possibilities.

On the other hand, there are also additional costs related to keeping two sets of books. Both in terms of the extra accounting taking place and probably also in terms of added frustration within the organization (for instance, divisional managers may have to respect one set of TPs while realizing that a different set of TPs is used for tax purposes). However, such costs have not been modelled here. Thus, from our analysis we conclude the expected result that two books is better than one book.

### 3.3 Extention 1: Switching the High and Low Tax Countries

The analysis has until now been carried out for the case where country *A* is the high tax country and *B* the low tax country. It is instructive to entertain the opposite assumption.

Accordingly, assume instead that  $t_B > t_A$ . All the formulas above continue to apply, with the exception that the fine factor must be altered to  $(zt_B - xt_A)$ . After all, profit shifting, if any, should change direction, and thus country *B*'s tax authorities must be on their toes with detection and fines, with country *A*'s authorities merely considering whether to offer corresponding corrections.

Formula (7), appropriately altered, now shows that a positive tax-TP will be set, and it will be the greater, the larger is the difference between tax rates, and the smaller are detection probability and fine. The delegation-TP does not really change – the product of tax rate difference and tax-TP will be positive as before, implying that the delegation-TP will be pushed below  $(-1/4)$  once more, again in order to widen the 'base' for profit shifting.

Above, with country *A* the high tax country, both TPs would be negative. Hence, moving from two to one book might not cause much of a loss; as we noted, the single TP would likely be found somewhere between the tax-TP and the delegation-TP. If instead country *B* is the high tax country, things are different. Now the tax-TP and the delegation-TP have different sign; thus, the single TP in the one-book case will be straddled between two TPs which could be far away from each other. The compromise value of the single TP can obviously be of either sign, and in any case one would expect the loss of the MNE from being constrained to apply only one TP to be relatively large in the situation  $t_B > t_A$ .<sup>17</sup>

### 3.4 Extention 2: An Alternative Formulation of Detection and Fine

Until now, we have assumed that tax authorities maintain that the most reasonable TP for the transaction between parent and subsidiary is the marginal cost of production of zero, i.e. the arm's length. However, inspired by the quote in section 2 from

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<sup>17</sup> As suggested in Nielsen et al. (2008), the MNE might be tempted to forgo strategic delegation in this case in order to focus the single TP on tax manipulation exclusively.

Baldenius et al. (2004), we may alternatively postulate that authorities become suspicious when TPs for different purposes differ and define over- or underpricing accordingly.

Thus, we now assume that authorities measure the extent of manipulation of the tax-TP by the numerical difference between  $q^T$  and  $q^D$ , and in addition that the likelihood of detection becomes a function of the same numerical difference,  $p = p(|q^T - q^D|)$ . Proceeding as before, the function  $\Phi$ , the product of the detection likelihood and the extent of mispricing, becomes a function of  $|q^T - q^D|$ . Again, we assume a simple functional form,  $\Phi = (u/2)(q^T - q^D)^2$ .

Decentral optimization wrt.  $Q_B$  is unaltered; a fortiori,  $Q_B = (1 - 2q^D)/3$ . Total after-tax income on the part of the MNE formally looks as in formula (5); remember, though, that the  $\Phi$  function has changed. Maximization of after-tax profits wrt. the two TPs and the rule for the choice of  $Q_B$  produces, first,

$$q^T - q^D = \frac{t_B - t_A}{u(zt_A - xt_B)} \quad (11)$$

Now it is the difference between the two TPs which will be governed by the difference in tax rates and the fine and detection parameters. Next, the delegation-TP can be derived as

$$q^D = -\frac{1}{4} - \frac{3}{4} \frac{(t_B - t_A)}{1 - t_B} [q^T - q^D - 1] \quad (12)$$

The ‘fix-point’ for the delegation-TP is still  $(-1/4)$ . This is the value chosen in the absence of tax rate differences between the two countries. If country  $A$  has the higher tax, the delegation-TP will be set even lower. And in this case, as we can see from the formula for the difference between TPs,  $q^T$  will be lower yet.

In fact, the alternative approach on the part of authorities vis-a-vis TP represents almost a windfall gain for the MNE, if the high-tax country is  $A$ . The MNE can costlessly reduce the tax-TP down to its preferred delegation-TP and gain from the associated tax savings. In the opposite situation of country  $B$  being the high tax country, the MNE would, however, face a major difficulty. It would prefer a negative delegation-TP in order to exploit market power, but attempts to minimize tax payments, causing  $q^T$  to become positive, would then possibly result in strong punishment from tax authorities, as they would identify a substantial margin between the two TPs. In fact, if the MNE only had one TP available, the conflict between tax and delegation considerations would be especially pronounced, and the MNE might as a result opt to forget about strategic delegation altogether and revert to centralized decision making in order to concentrate on tax minimization (again, see the analysis in Nielsen et al., 2008, on this point).

**RESULT 3:** *When tax authorities base their fine scheme on any difference between the transfer prices, the MNE will internalize this and choose the two TPs in accordance with the tax difference it faces. Such a setting may well benefit the MNE on the whole compared to a setting where the fine scheme is based on arms’ length considerations.*

(The last part of the Result holds when  $t_B < t_A$ .) All in all, the particular fine strategy tax authorities adopt seems to be important in the MNE's setting of TPs. Of course, one could go further and endogenize the fine system by allowing the tax authorities to maximize tax revenue (or welfare) and derive the non-cooperative implications of this. Such a study of optimal TP fines is totally absent from the literature and is worth pursuing.

#### 4. Related Literature on Multiple TPs

In the above we have proposed a model that can be used to analyse the multiple roles of TPs. We believe we have uncovered some interesting properties and point to future developments of that literature. However, and as mentioned in the introductory sections, we are not the first to point to the conflicting roles of TPs. This section briefly explores additional settings in which there might be multiple purposes associated with transfer pricing.

One of the first articles to combine TP with a tax competition setting was Elitzur and Mintz (1996). The authors claim in their abstract that "... the parent chooses an optimal transfer pricing taking into account incentives for the subsidiary's managing partner and taxes." On the basis of this sentence the reader expects to see an optimally derived TP which forms a compromise between tax manipulation and the provision of incentives to the manager of the subsidiary. However, this is actually not the case in their article; instead, the TP is simply derived on the basis of a cost-plus formula (as requested in the model by home tax authorities).

Hyde and Choe (2006) look at TPs in two sets of books. One TP is to be used for tax savings, the other for incentive purposes. A model is set up, in which pre-tax profits thus are calculated for both tax and internal reasons. The model differs in a few places from ours in the previous section. The subsidiary is a monopolist, and total costs of producing the good for both markets are possibly non-linear. The parent delegates responsibility to the subsidiary for purchasing the quantity of the good for sales to customers in the foreign country ( $B$ ), and the subsidiary there seeks to maximize its own profit. *Ceteris paribus*, the transfer of control is to the detriment of the parent. Hyde and Choe explain that their model adequately describes reality, and they state that the deeper reasons for delegation will be informational asymmetries which the parent faces in assessing offshore market conditions. All the same, they do not explicitly model such information asymmetries. But they do provide reasons why the compensation of subsidiary management should be tied to own profits rather than consolidated profits for the MNE as a whole.

Having set up their model, Hyde and Choe derive first-order conditions for the two TPs (one tax-TP, one incentive-TP). It is clear that the two will generally differ, and they characterize how the two TPs vary with model parameters such as the penalty for non-arm's length pricing and the probability of being penalized. Their results are reminiscent of the ones we derived in the previous section.

Baldenius et al. (2004) take as their point of departure that TP usually is portrayed as an instrument for achieving decentralization and coordination in multidivisional firms. In particular, TPs provide valuations for intermediate products and

services in order to facilitate transactions across profit centers within a firm. Yet, they claim that the choice of transfer prices for tax purposes is typically portrayed as a tax compliance issue, conceptually separate from the managerial and economic decisions of transfer pricing. Accordingly, they go on to analyze the interrelation between the preferred managerial transfer price and the “arm’s length” price used for tax purposes.

The model they set up considers the interactions of two divisions (profit centers) in a MNE. A foreign division supplies an intermediate product to a domestic division that utilizes it as a component in a final product sold in the domestic market. A range of allowable arm’s length prices is identified. With a tax rate difference between the two countries, an arm’s length price (the tax-TP) at one end of the interval will minimize the MNE’s overall tax burden.

The ‘managerial’ (as opposed to ‘tax’) TP will instead serve to align the objectives of the domestic division with the corporate objective. Their first proposition states that cost-based TP results in efficient quantity transfers if, and only if, the internal transfer price is given by a weighted average of the marginal cost of the product and the tax minimizing TP. A main conclusion to draw, then, is that TP for operational purposes comes to depend on TP for tax minimization; we derived the same conclusion in our model in the previous section. The proposition presumes that divisional managers are evaluated on the basis of their divisional after-tax income. If the relevant performance measure is pre-tax income instead, a slight modification to the formula is required, but still the TP is to be found somewhere between marginal cost and the tax-minimizing TP.

Baldenius et al. also study the case where the firm in the model has to choose a single TP for the internal and tax purposes. In this case, the optimal TP may well be different from (lower/higher than, depending on the exact tax rate difference) the tax-minimizing TP. They go on to characterize the loss of expected after-tax profits resulting from the requirement of conformity between internal and arm’s length transfer prices. Looking at the impact of model fundamentals will aid in understanding which firms are more likely to incur the cost of implementing two sets of books and bear the potential cost of disputes with the tax authorities.

Throughout their paper, Baldenius et al. take it as given that divisional managers seek to maximize (after-tax) income of their divisions. This is an add-hoc element in their model. The authors stress that it would be desirable to embed their framework into an explicit principal-agent model.

Smith (2002) also looks at tax and incentive trade-offs in MNE transfer pricing in a principal-agent model. In essence, Smith’s model contains a headquarter of a MNE which receives a good produced by a subsidiary in another country. The good is then sold to customers in the headquarter’s country. The quantity produced in the subsidiary is partly affected by the effort of the subsidiary’s manager and by a stochastic disturbance. Since the headquarter cannot verify the manager’s effort, a classical moral hazard problem ensues.

While the manager decides on her effort, the headquarter has to determine (a) the TP(s) applicable to units of the good received from the subsidiary; and (b) the share of the subsidiary’s profit which will enter the manager’s remuneration scheme

(together with a fixed payment to ensure her participation). Concerning (a), there are three cases to consider. One, in which only a single TP is available; one, in which two, unconstrained, TPs can be applied; and one, in which two TPs can be used, but a regulator will impose a penalty to the extent that the two TPs differ.

When a single TP has to be employed, it will become a complicated function of the non-effort, non-stochastic part of production, the tax rate difference, the productivity of the manager's effort (relative to the cost of effort), the variance of the stochastic element of production, and the manager's risk aversion parameter. The optimal profit share will depend on the same parameters. Two unconstrained TPs allow the headquarter to set the tax-TP at its upper or lower limit to minimize taxes as much as possible. At the same time, the incentive-TP does vary with tax rates in the two countries. With two, constrained and separate, TPs, a series of situations may result, depending on how tough regulation of the TPs is. If regulation is very strict, a single TP may be selected. Otherwise, tax- and incentive-TPs will vary, to a different extent, with model fundamentals such as tax rates. Towards the end of the article, Smith investigates an alternative combination of a TP for tax minimization purposes and a non-TP incentive mechanism. He concludes that if tax authorities can 'back out' the implicit incentive-TP from the incentive mechanism and thereafter compare it with the tax-TP, they can still question the tax-TP and demand a modification of it.

One advantage of the article by Smith (2002) is that it characterizes in full the incentive problem which TP is supposed to contribute to alleviating. A disadvantage is, though, that no closed-form solution for the single TP (or incentive-TPs in the other situations) can be found. The way the model is defined one expects a TP a bit lower than unity, but this conjecture is hard to check. Another disadvantage is that simple model changes (such as a risk-neutral manager plus no tax difference) seemingly can lead to indeterminate profit share and TP.<sup>18</sup>

A recent article along somewhat different lines is Devereux and Keuschnigg (2009). This article aims to put forth a critique against TPs defined according to the arm's length principle. The authors set up a model of two regions, North and South. North producers offshore the production of components to the South either by means of subcontracting (with royalties) or by establishing a wholly owned foreign subsidiary via FDI; this choice is endogenized in the model. Contracts regulate the relation between North firms and subcontractors, respectively subsidiaries. External funding of subcontractors and subsidiaries is subject to finance constraints as emphasized in the corporate finance literature. But since MNEs can shift profits to a subsidiary by paying higher prices for components, pledgeable income in subsidiaries can be strengthened, thus facilitating their external financing.

In this situation, the application of arm's length TPs in the taxation of MNEs forces these to value intermediate inputs at lower TPs than they would prefer

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<sup>18</sup> Baldenius et al. (2004) are aware of the article of Smith. They recognize that it identifies a tension between taxes and managerial incentives, but "...the transfer price does not coordinate interdivisional transactions in his model." (note 7, p. 593) They probably refer to the fact that there is no explicit formulation of production costs, to which the TP could be linked.

for overcoming financing constraints. Further, organizational choice and production efficiency are distorted, and in their general equilibrium framework the authors can derive a loss for the world as a whole, if arm's length prices are prescribed.

A series of papers finally examine the workings of specific transfer pricing methods such as those advocated by US authorities. Harris and Sansing (1998) consider the effects of price-based and profit-based transfer pricing methods on the allocation of taxable income in a model, in which organizational structure has a bearing on relationship-specific investments. Sansing 1999 investigates the workings of the Comparable Uncontrolled Price method to allocate income between a manufacturing entity and a selling entity. And Gresik and Osmundsen (2008) study how various TP methods function in a setting with strategic linkages between vertically integrated firms operating in the same final good market. They find that the Cost-Plus method turns out to be the most effective in limiting the equilibrium amount of profit shifting out of the model's high tax country.

## 5. TP and Tax Reform Proposals

The general impression, nay fact, in the current international system of business taxation is that TP constitutes a major complication for both businesses and tax authorities. It is therefore natural to inquire whether various proposals for reform which have been put forth during the past couple of decades or more recently will contribute to solving or removing some of these obstacles and problems.

In our discussion we shall distinguish between what we may call minor and major reforms. Minor reforms keep the system of separate accounting (SA) in place, but alter the particular specification of the base for corporate taxation. Major reforms change the international tax regime by introducing alternatives to separate accounting.

Among the minor reforms (i.e. modification of the tax base within the existing SA system) we shall briefly comment on the following:

### 5.1 Cash Flow Tax<sup>19</sup>

The cash flow tax on businesses will impose a tax on their cash flow, not their income, however computed. Hence, incoming minus outgoing payments become the base. It can be shown that the CF tax will exempt the ordinary return to (equity) capital in firms from tax and only subject extraordinary return to tax. However, in order to isolate revenue and expenditures of a particular firm, TPs for MNE-internal shipments will a fortiori be required, and thus problems of deriving or manipulating TPs will continue to exist.

It is an open question to what extent the existing corporate income tax system in effect taxes the ordinary return to capital. Several articles have pointed out that in the

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<sup>19</sup> Perhaps as part of a 'flat tax' of the Hall-Rabushka type; cfr. Hall and Rabushka, 1985

US there was previously little effective tax on capital (see e.g. Gordon et al., 2004). In any case, a transition to CF taxation will not affect TP problems and might even aggravate them, if the CF base is indeed more narrow than the base of today's corporate income tax system, implying the need to raise the rate of corporate tax (or, alternatively, some other tax in the tax system).

## 5.2 ACE Tax

The Allowance for Corporate Equity tax (cfr. Gammie, 1992) will, compared to today's tax, allow an extra deduction in taxable income equal to equity in the firm multiplied by an imputed rate of return (in the neighborhood of the interest rate on bonds, probably). The effect of this deduction is similar to the effect of the CF tax – only the extraordinary return to capital will be subject to tax, while the ordinary return will be exempt. Again, no consequences for TP issues, except possibly for the need to raise the corporate income tax rate.

## 5.3 CBIT Tax

The Comprehensive Business Income Tax, as proposed by the US Treasury, implies the elimination of the deduction for interest payments on debt (see US Department of the Treasury, 1991). Hence, the entire capital base of firms, be it equity or debt, will be taxed by the corporate income tax. Apart from this, no consequences for TP, except possibly for an opportunity to reduce the corporate income tax rate, since the base of the CBIT will be broader than today's tax. (On the other hand, as all (non-housing) capital will be taxed at the level of firms, the need for personal capital income taxation is reduced, and in principle it could be eliminated, save for the taxation of imputed return on housing.)

## 5.4 Presumptive Taxation of Capital

A possible response to the difficulty of computing business income and taxing the equity of firms by means of the corporate income tax could be the replacement of it by a direct tax on the capital stock. Hence, a tax would be applied to some measure of the capital in place in firms (measured according to accounting practices). This type of tax is not uncommon in developing countries, and several developed economies have taxes of this type as well.<sup>20</sup> The general idea is as follows: If you cannot adequately compute the return to capital in firms, you tax the stock of capital itself on the expectation that the owner of the capital will seek a satisfactory rate of return. Then, a certain revenue is guaranteed, while the marginal tax on the return is zero. And should the return be zero or very low, there will be no tax rebate.

Will such a presumptive tax on capital cure TP problems? Yes, to some extent, if it becomes possible to eliminate the corporate income tax and only rely on the presumptive tax on capital. As soon as capital in place can be measured, the national tax

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<sup>20</sup> Such as the German local 'Gewerbesteuer', for instance.

can be applied and revenue harvested. However, the tax does constitute a major breach with the desire to assess incomes on the part of individuals and firms.<sup>21</sup>

## 5.5 Common Corporate Tax Base

Starting with the so-called Bolkestein report from the EU Commission (2001), the Commission has investigated the opportunities for introducing common methods of computing taxable income for businesses across EU, as a step towards introducing a **CCCTB corporate tax** (see below). What such a common corporate tax base would look like is still not quite clear. The advantage of having one set of rules for computing taxable income of MNEs in various countries is clear, though: within EU, a MNE would only have to know one set of tax rules, and instances of double taxation or double non-taxation of incomes would be obviated. The disadvantage would be that individual member countries would have to give up on the freedom to shape their corporate income tax system (in particular rules concerning depreciation, research and development expenses, etc.).

A common base for the corporate income tax would not in itself address TP issues and problems. Entities of a MNE would still need TPs to compute revenues and expenditures, and thus profits. Only a full move to CCCTB would change matters.

Among major reforms we shall briefly mention a couple.

### 5.5.1 CCCTB with Formula Apportionment (FA)

If a transition, within EU, to a common consolidated corporate tax base is coupled with the so-called formula apportionment system, a new international tax regime will ensue, with major implications for TP. This CCCTB-cum-FA business tax is indeed what the EU Commission is working on at the moment (a Working Group has been set up to investigate all sorts of issues related to the introduction of such a tax regime). With the CCCTB, each MNE entity will compute its taxable income according to the unique set of rules. After this, the MNE's profits in the EU area can be computed by summing over all EU-based entities, resulting in EU-wide income of the MNE. Next, this sum will be apportioned to individual member countries according to FA. The formula to be used should express the relative economic activity in a given country and can include measures of (a) relative capital stock; (b) relative payroll; and (c) relative sales revenue in a given member country. In the end, the formula will determine how much of EU-wide income will be apportioned to that country which then will apply its own national tax rate to it.

Such an international tax regime does not require the computation of TPs for intra-EU shipments between entities of a MNE.<sup>22</sup> As long as only total profits in the

<sup>21</sup> It should be mentioned, though, that the application of a presumptive capital tax presupposes a reasonable valuation of capital in place. In entities of a MNE, tangible and intangible capital may well result from internal shipments, and thus the need for proper TPs appears in a new guise.

<sup>22</sup> If product markets are oligopolistic, TPs could still be useful for strategic reasons (see Nielsen et al., 2003).

EU-area are needed, the particular pricing of some internal shipment within EU becomes irrelevant. Hence, gone are the TP complications and manipulation and an important source of worry for national tax authorities. But a new set of distortions will be introduced with the CCCTB-cum-FA regime. To the extent that there will still be differences between national tax rates, there will be incentives to locate relatively much economic activity in low-tax countries at the expense of high-tax countries in order to reduce the average effective tax rate for the MNE in question. Hence, investment, employment and sales patterns will be interfered with. No free lunch here.<sup>23</sup>

### 5.5.2 A European Corporate Income Tax

Another possible and rather dramatic proposal for business income tax reform would be to substitute national corporate income taxes by a European corporate income tax. The idea would be to compute individual entities' incomes and thus MNEs' total incomes in the EU area and subject these to a given rate of tax, after which the revenue would accrue directly to the EU. This would entail a new source of finance for EU, which could in principle lead to less reliance on or removal of existing sources of finance. And in any case, since no division of MNEs' EU-wide income between countries will take place, the need for TP disappears, and so do the problems and complications.

The disadvantages of a European corporate income tax would be many. It would mean a complete breach with tax autonomy of individual member countries. It would be difficult to render it compatible with countries' personal income tax systems, and there would, of course, remain problems of TP when shipments between entities respectively within and outside EU are involved. On the other hand, the current financing system in EU is certainly not perfect either.

## 6. Conclusions

In this paper we have considered possible multiple uses of transfer prices in multinational enterprises. There is a small literature on the possible tensions in TP between such alternative aims, and there are also contributions discussing the use of two books vs. one book in MNEs.

We started out trying to approach these alternative uses of TP. To get a firmer grip of the issues we set up an illustrative model of a simple MNE, in which a parent produces and sells a good, both in its own country and to a subsidiary in another. TP serves two purposes in this MNE: First, minimize the overall tax burden; second, endow the subsidiary with a strategic advantage vis-a-vis its competitor. Hence, ideally the MNE would like to employ two different TPs. Even if it did so, the two were shown to be dependent. Their dependence was shown to be affected by the particular fine system tax authorities adopt. If only one TP was available, this transfer price would be hung between the twin purposes of tax minimization and strategic delegation and it would be a compromise with subsequent efficiency losses for the firm.

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<sup>23</sup> See, for example, the analysis in Nielsen et al. (2010).

Such a result seems to rationalize the absence of tax laws that force MNEs to use a single TP. However, and given that we have not modeled the incentives that tax authorities may have, an analysis of this issue must be relegated to future work.

We also looked at a series of articles in the literature which have modeled the possible tensions between managerial and tax aims in TP. A preliminary conclusion from considering these contributions is that the exact alternative purposes of TP have not been that well spelled out, especially when ‘performance’, ‘incentives’ etc. are stated as the supplementary aims of TP. In short, there seems to be scope for future modeling in the area to nail down exactly when multiple TPs would be desirable, and what the costs of single-TP constraints would be.

All the problems faced by MNEs as well as tax authorities in the area of transfer pricing in today’s international tax system are rooted in the so-called separate accounting system. This basic principle in the regime stipulates that a company (or an entity of a MNE) needs to compute its own income for taxation in its country of location. Towards the end of the paper we looked at a series of minor and major proposals for reform of the international tax system. In particular we asked whether these reforms would alleviate problems related to TP. With the exception of a transition to much less sophisticated taxes such as presumptive taxes on capital, none of the minor reforms had anything to offer. Major reforms are needed in order to remove or dull problems of TP. These included the EU Commission’s proposal for a CCCTB-cum-FA system – Common Consolidated Corporate Tax Base cum Formula Apportionment – and, at the extreme, an EU-wide corporate tax. But the outlook for either of these is gloomy; and should they be enacted, they would surely bring along new problems and distortions to the international tax system.

In the meantime, the OECD (and with it many member countries) are taking a close look at their transfer pricing guidelines (for an account of the exchange between OECD and the business world, see Lucas Mas and Cottani (2010)).

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# Transfer Pricing – Business Incentives, International Taxation and Corporate Law

Wolfgang Schön

## Abstract

*Transfer pricing is a concept applied for three different purposes. From the business perspective, transfer prices are employed to increase the efficiency of intra-firm supplies between separate business units, taking into account the asymmetry of information among different agents. From the corporate law perspective, pricing in related-party transactions has to be controlled in order to prevent “tunnelling” to the detriment of creditors or minority shareholders. In the area of international taxation, transfer pricing under the “arm’s length”-standard serves the role of allocating profits to the different units of a multinational enterprise and of allocating taxing rights to the involved jurisdictions.*

*The main thrust of this article is to show that these heterogeneous purposes of transfer pricing plead for a realignment. Transfer prices should basically be employed as incentives to improve the efficiency of the firm. International taxation should accept the outcome of business transfer pricing; if the ensuing profit allocation to a group company resident in a state does not satisfy the tax claims of this state, there should be an extension of limited tax liability of the foreign group company. Corporate law should only intervene if this is necessary to protect creditors and shareholders; compensating benefits which arise from the group situation should be taken into account.*

## 1. Introduction

Transfer Pricing, meaning the “setting, analysis, documentation, and adjustment of charges made between related parties for goods, services, or use of property (including intangible property)”,<sup>1</sup> lies at the intersection of three fields of research and regulation: Business research focuses on the use of transfer prices to provide incentives for efficient resource allocation within a multi-divisional firm; taxation rules strive to control transfer prices between head office, subsidiaries and permanent establishments within a multinational enterprise in order to allocate profits and ensuing tax revenue among the countries where the firm operates; corporate law uses a panoply of strategies to monitor related-party transactions between corporate entities and their dominant shareholders as these might result in the diversion of the company’s assets to the detriment of minority shareholders or company creditors.<sup>2</sup>

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<sup>1</sup> Wikipedia “Transfer Pricing” (14th November 2010)

<sup>2</sup> Another area which deserves attention in this context is competition law; for a perspective from the U. S. see: Johnson, “Antitrust, Gray Market, and Other Nontax Transfer Pricing Considerations”, in: Feinschreiber (Ed.), *Transfer Pricing Handbook*, 3<sup>rd</sup> Ed., Vol.2 (2001), Chapter 85.

Currently the state of the debate can be organized as follows:

- In the field of business research, the seminal work by *Schmalenbach*<sup>3</sup> and *Hirshleifer*<sup>4</sup> on transfer pricing has been enriched over the years by economic research on incentives meant to mitigate the deficiencies frequently encountered within organizations (as opposed to contracts in the open market).<sup>5</sup> The task of “incentive transfer pricing” is optimization. While the corporate headquarters intends to increase overall efficiency within the firm (and thereby the overall profit), managers of subdivisions are subject to the “usual” fallacies of principal-agent-relationships like information asymmetries, the non-observability of their effort, the existence of over- and underinvestment or of over- and underproduction as they endeavor to increase the part of the overall profit allocable to “their” subdivision. It is well established that the solution for this optimization problem depends on a lot of variables, such as the specificity of upfront investment,<sup>6</sup> the existence of proprietary intangibles, the complementarity between the internal and the outside market and so on. In particular, there is no clear answer when to use marginal cost, average cost, historical cost, real or notional market prices etc. in order to promote efficient behavior.
- In the field of taxation of multinational enterprises, transfer pricing rules try to ensure that each involved country will be able to tax corporate income generated within its territory.<sup>7</sup> This is meant to further inter-jurisdictional equity between states while not distorting the competitive situation for independent companies on the one hand and companies belonging to an international group on the other hand. The starting point for transfer pricing analysis is the application of the “arm’s-length” price on intra-group transactions, i. e. the conditions of these transactions are examined as to their comparability with dealings between unrelated business entities (Art.9 OECD Model DTC). The allocation of profits to entities within a corporate group as different taxpayers pre-empts the allocation of profits to the jurisdiction of the territory where these entities are resident.<sup>8</sup> The

<sup>3</sup> Schmalenbach, “Über Verrechnungspreise”, 3 *Zeitschrift für handelswissenschaftliche Forschung* (1908/09), p.165 – 185.

<sup>4</sup> Hirshleifer, “On the Economics of Transfer Pricing”, *Journal of Business* (1956), p.172 – 184.

<sup>5</sup> Amershi/Cheng, “Intrafirm resource allocation: the economics of transfer pricing and cost allocations in accounting”, 7 *Contemporary Accounting Research* (1990), p.61 – 99; Grossman/Hart, “The Cost and Benefits of Ownership: A Theory of Vertical and Lateral Integration”, 94 *Journal of Political Economy* (1986), p.691 – 719; Holmstrom/Tirole, “Transfer Pricing and Organizational Form”, 7 *Journal of Law, Economics and Organization* (1991), p.201 – 228; the most recent summary can be found in: Hart, “Thinking about the Firm: A Review of Daniel Spulber’s *The Theory of the Firm*”, 49 *Journal of Economic Literature* (2011), p.101 – 113.

<sup>6</sup> See: Edlin/Reichelstein, “Specific Investment Under Negotiated Transfer Pricing: An Efficiency Result”, 70 *Accounting Review* (1995), p.275 – 291; Dutta/Reichelstein, “Decentralized capacity management and internal pricing”, 15 *Review of Accounting Studies* (2010), p.442 – 478.

<sup>7</sup> OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, Paris (2010), Preface, para 5 – 12; Schön, “International Tax Coordination for a Second-Best World (Part III)”, 2 *World Tax Journal* (2010), p.227 – 261.

<sup>8</sup> Schön, “Persons and Territories – on the international allocation of taxing rights”, *British Tax Review* (2010), p.554 – 562.

theory underlying the arm's length price suggests that transactions governed by arm's length prices do not only indicate the "right" profit for the particular group company but also the "right" split of revenue for the involved countries.

- In the field of corporate law the main thrust of the debate is focused on the protection of minority shareholders against exploitation of the corporate firm by controlling shareholders.<sup>9</sup> Against this background, the regulation and the research on related-party transactions is concentrated on listed corporations where portfolio shareholders face problems of asymmetric information and collective action while dominant shareholders are able to extract "private benefits of control"<sup>10</sup> from their influence on the management of the firm. In recent years, several major studies<sup>11</sup> have analyzed the different legal strategies for monitoring related-party transactions, comparing rules and standards on disclosure of such transactions, on approval for these transactions by shareholders or supervisory bodies and on *ex-post* sanctions like personal liability or criminal sanctions. For non-listed companies, the abuse of power by majority shareholders is relevant as well but not covered in similar detail by most corporate laws.
- The relevance of transfer pricing for the purpose of creditor protection comes up when related-party transactions are used to transfer corporate assets to shareholders under the guise of third-party contracting. These "concealed distributions" can be rendered illegal both under the rules of corporate law such as rules on "legal capital"<sup>12</sup> and under the rules of insolvency law as these transactions may involve "fraudulent trading".<sup>13</sup> The scope of application for these rules and standards governing the protection of creditors against the diversion of corporate assets is simultaneously wider and narrower when compared to the rules and standards governing the protection of minority shareholders. They are wider in scope because they also address the diversion of assets from wholly-owned subsidiaries where no minority shareholders exist (a case very common in a multinational corporate group) and they are narrower in scope because they exert their force only when a related-party transaction actually endangers the full satisfac-

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<sup>9</sup> Enriques/Hertig/Kanda, "Related-Party Transactions", in: Kraakman et al., "The Anatomy of Corporate Law: A comparative and functional approach", 2<sup>nd</sup> Ed., Oxford (2009), p.153 – 182.

<sup>10</sup> Dyck/Zingales, "Private Benefits of Control: An International Comparison", 59 Journal of Finance (2004), p.537 – 600.

<sup>11</sup> Djankov/La Porta/Lopez-de Silanes/Shleifer, "The law and economics of self-dealing", 88 Journal of Financial Economics (2008), p.430 – 465; Johnson/La Porta/Lopez-de Silanes/Shleifer, "Tunneling", 90 American Economic Review (2000), p.22 – 27; Conac/Enriques/Gelter, "Constraining Dominant Shareholders' Self-Dealing: The Legal Framework in France, Germany and Italy", European Financial and Company Law Review (2007), p.491 – 528.

<sup>12</sup> Fleischer, "Disguised Distributions and Capital Maintenance in European Company Law", in: Lutter (Ed.), "Legal Capital in Europe", Berlin (2006), p.94 – 111.

<sup>13</sup> Baird, "Legal Approaches to Restricting Distributions to Shareholders: The Role of Fraudulent Transfer Law", in: Eidenmüller/Schön, "The Law and Economics of Creditor Protection: A Transatlantic Perspective", The Hague (2008), p.199 – 216; Eidenmüller/Engert, "Insolvenzrechtliche Ausschüttungssperren", in: Bitter (Ed.), Festschrift für K. Schmidt, Cologne (2009), p.305 – 330.

tion of creditors, e. g. when a company operates on the brink of insolvency or (when applicable) its legal capital is diminished by the transaction.

While these three aspects of transfer pricing are subject to intensive controversies within their respective disciplines, the mutual interaction has not gained much attention. The state of the art is the following:

- Tax law starts from the assumption that the application of the arm’s length standard will reduce the interference of tax effects with *bona fide* business decisions taken by the corporate management.<sup>14</sup> Insofar it presupposes that *ceteris paribus*, in a non-tax world, managers of a corporate firm would basically enter into arm’s length transactions anyhow. Tax law seems to hypothecate a pre-stabilized harmony between standards of good management and international revenue allocation. Business research, on the other hand, has shown in recent years that transfer prices as applied by tax authorities to intra-group dealings diverge in many cases from the transfer prices meant to enhance efficient decisions in multi-divisional firms, thus leading to a mutual trade-off between tax benefits and business deficiencies and vice versa.<sup>15</sup> The setting of a transfer price transforms into an optimization of the overall after-tax profit of the firm.
- Corporate law influences business decisions on transfer pricing in two respects: On the one hand, corporate law rules on the protection of minority shareholders and creditors provide a framework for intra-group transactions which the management is not allowed to transgress. Within this framework, the management is bound by law to pursue the goal of profit maximization, meaning on the one hand to increase to overall profit of the corporate group and on the other hand to reduce the overall tax burden of the corporate group. Insofar, the interaction of tax and business transfer pricing is governed by corporate law requirements. Managers will seek a balance between tax benefits and “tunneling” of profits to large shareholders.<sup>16</sup>
- Tax law and corporate law interact in two other ways: Firstly, intra-group transactions which violate corporate law requirements are prone to non-recognition by tax authorities as well. This is particularly true when corporate law involves an outright prohibition of the transaction. While this assumption seems to put corporate law in the front row, the reality shows otherwise. In several jurisdictions, the application of transfer pricing discipline to corporate groups by tax authorities works as an enforcement device for protection of minority shareholders and

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<sup>14</sup> OECD, Transfer Pricing Guidelines supra (note 7), para 1.8: “Because the arm’s length principle puts associated and independent enterprises on a more equal footing for tax purposes, it avoids the creation of tax advantages or disadvantages that would otherwise distort the relative competitive positions of either type of entity. In so removing these tax considerations from economic decisions, the arm’s length principle promotes the growth of international trade and investment”.

<sup>15</sup> See below at para. 2.1.2.

<sup>16</sup> For a recent example see: Lo/Wong/Firth, “Tax, Financial Reporting, and Tunneling Incentives for Income Shifting: An Empirical Analyses of the Transfer Pricing Behavior of Chinese-Listed Companies”, 32 Journal of the American Taxation Association (2010), p.1 – 26.

company creditors: dominant shareholders and managers will refrain from extracting private benefits of control if tax authorities will sanction this behavior as tax avoidance or tax evasion.<sup>17</sup>

## 2. The Duties of the Management

What does this mean for the duties of the management of the parent company in a multinational firm when it comes to the question of whether to enter into a contractual relationship with a subsidiary or to arrange contractual relationships between different subsidiaries at a lower level?

### 2.1 Profit Maximization within a Single Corporation

Corporate law requires the directors of a corporation to focus on the overall profitability of the firm. This is due to the agency relationship between directors and shareholders, which obliges the management to optimize the return on the investment for their principals, i.e. the shareholders of the company.

#### 2.1.1 The Choice of Business Units and the Setting of Transfer Prices

The starting point for the analysis of profit maximization and transfer pricing is the single corporation which combines all business activities of the firm under the roof of one legal entity. The “business judgment rule” as applied in many jurisdictions renders the management to a large extent immune against claims that they have violated their “duty of care” when organizational matters are concerned.<sup>18</sup> This is where corporate law meets business research. The corporate officers have to show that they informed themselves about current standards of good governance, that they established a risk management system and that they are aware of the existing state-of-the-art methods of how to lead a successful firm. But they are not bound by law to follow a specific organizational pattern.

This legal framework confers upon the management a wide leeway to organize the enterprise, setting up different business units (without separate legal personality) for different functions within the company. The shifting of resources between these different units, the employment of transfer prices and the scope of discretion awarded to sub-divisional managers are hardly constrained by corporate law rules. The outer limitation to this organizational freedom is the company objective laid down in the corporate charter which circumscribes the main field of activity for the firm, in particular the nature of its business. Against this background, the management is also to a large extent at liberty whether to “make or buy” components of its

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<sup>17</sup> Dyck/Zingales *supra* (note 10), p.578 – 579; Schön, “Tax and Corporate Governance: the Legal Approach”, in: Schön (Ed.), *Tax and Corporate Governance*, Heidelberg (2008), p.31 – 61, at p.58 – 60.

<sup>18</sup> Enriques/Hansmann/Kraakman, *The Basic Governance Structure: The Interest of Shareholders as a Class*, in: Kraakman et al., “*The Anatomy of Corporate Law: A Comparative and Functional Approach*”, 2<sup>nd</sup> Ed. (2009), p.55 – 87, at p.79 – 81.

main product as long as the control of the value chain and the nature of the final product are not in question.

This basic freedom does not only address the organizational structure of the firm, it is also extended to the steering of the different business units. As far as resource allocation for different business units is concerned, it is evident that no legal rules require the management to use internal transfer prices at all. In a highly centralized firm, the top management is free to allocate resources by fixed quantities/budgets top-down.<sup>19</sup> If transfer prices are used in order to steer the sub-central units, business research leaves open whether it is preferred that these transfer prices are administered by the top management,<sup>20</sup> calculated unilaterally by the producing or the receiving unit or freely negotiated between the involved business divisions.<sup>21</sup> Last not least, transfer prices – whether set by one actor or negotiated freely – do not have to reflect outside market prices if there are good business reasons to choose otherwise. The market “within the firm” is driven by specific benefits for the involved actors (mutual trust and a common information base in a long-term relationship) and specific drawbacks (substantial upfront investment and a mutual dependence which lead to a bilateral monopoly).<sup>22</sup> Given the existence of upfront investment, transfer pricing at marginal cost will often be preferable.<sup>23</sup> This will particularly hold true if closing down a business unit is not a realistic option.<sup>24</sup> On the other hand, business practice seems to contradict the predictions made by theory: observed transfer prices often exceed marginal cost; it is unclear how far this is due to further-reaching strategic objectives like “signaling” vis-à-vis competitors.<sup>25</sup>

The only clear message from corporate law to the directors organizing the firm is the following: the paramount aim of all organizational activities is to increase the overall profit of the firm. The introduction of a transfer pricing policy which is meant to favor one particular business unit within the firm (and consequentially the local

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<sup>19</sup> Weitzman, “Prices vs. quantities”, 41 *Review of Economic Studies* (1974), p.477 – 491; Pfeiffer/Wagner, “Internal markets or hierarchies: transfer prices or budgets?”, 59 *Journal of Economics and Business* (2007), p.241 – 255.

<sup>20</sup> Top management administering transfer prices may either set the price as such or set rules according to which the price has to be calculated (cost-based approach, market-based approach etc.); see e. g. Vaysman, “A model of cost-based transfer pricing”, 1 *Review of Accounting Studies* (1996), p.73 – 108.

<sup>21</sup> Baldenius/Reichelstein/Sahay, “Negotiated versus cost-based transfer pricing”, 4 *Review of Accounting Studies* (1999), p.67 – 91; Edlin/Reichelstein *supra* (note 6), p.287 – 288; Antcil/Dutta, “Negotiated transfer-pricing and divisional vs. firm-wide performance evaluation”, 74 *Accounting Review* (1999), p.87 – 104.

<sup>22</sup> This critique of “market prices” dates back to Schmalenbach *supra* (note 3), p.175 – 177.

<sup>23</sup> Hirshleifer *supra* (note 4), p.176 – 180; Schmalenbach *supra* (note 3), p.177 – 185.

<sup>24</sup> Hirshleifer *supra* (note 4), p.180; Schmalenbach *supra* (note 3), p.177 – 185; Pfeiffer/Schiller/Wagner, “Cost-based Transfer Pricing”, 16 *Review of Accounting Studies* (2011), p.219 – 246.

<sup>25</sup> Alles/Datar, “Strategic Transfer Pricing”, 44 *Management Science* (1998), p.451 – 461; the interaction of incentive transfer pricing, tax transfer pricing and collusion between competitors in a duopoly is discussed by Narayanan/Smith, “Impact of competition and taxes on responsibility center organization and transfer prices”, 17 *Contemporary Accounting Research* (2000), p.497 – 529.

managers with profit-contingent salaries) would violate the “duty of care” of the top management.

## 2.1.2 International Taxation and Transfer Prices

### 2.1.2.1 *The Conceptual Difference between Business and Tax Transfer Prices*

Besides business organization, transfer prices are of paramount importance in the field of international taxation. They determine the profit of each involved business unit of the firm; business units which qualify as “permanent establishments” under double taxation conventions will be taxed according to the tax statutes of the country where they are located. Leaving aside technical matters like cross-border loss compensation, transfer pricing gains particular relevance when tax rates in the involved jurisdictions differ. It has been established early enough that firms show a genuine interest in shifting profits by means of transfer pricing to low-tax countries. This has led governments to provide constraints under domestic and international tax law. The most common rule is that transfer prices have to be set following the “arm’s length” standard which requires a hypothetical analysis of how the involved business units would have negotiated assuming they are independent from each other. Transfer prices simply “set” by the top management or established under an administered framework are not accepted by the tax authorities unless they reflect the outcome of hypothetical negotiations. This leads to a conceptual deviation from transfer pricing as required by business-oriented governance:

- The business function of transfer prices requires the management to choose transfer prices which provide incentives to maximize the overall profit of the firm; tax law requires business units to choose transfer prices which maximize their respective share of the overall business profit of the firm. Management science shows that free negotiation of transfer prices between sub-central business units is not universally applicable when it comes to efficiency-enhancing governance of the business. In many situations quantity-driven or cost-driven pricing will prevail from a management perspective even if one or some of the involved business units will lose when compared to freely negotiated prices.
- The business function of transfer prices requires the management to take into account the economic underpinnings of intra-firm trade in the first place. Within a firm, business units are meant to cater to other business units within the firm; this is reflected in upfront specific investment, in the creation of proprietary intangibles, in long-term contracting and so on.<sup>26</sup> This brings about “synergies” which contribute to the overall profit of the firm. It is doubtful to what extent these synergies have to be accounted for under the “arm’s length” standard.
- For an existing firm business research has established marginal cost as the regular starting point for optimal transfer pricing. While it is evident that there are exceptions from this rule, it is evident as well that international tax rules start from the

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<sup>26</sup> Sansing, “Relationship-specific investments and the transfer pricing paradox”, 4 Review of Accounting Studies (1999), p.119 – 134.

opposing end, i.e. taking the market price of a good or service as the best estimate for intra-firm trade pricing (“comparable uncontrolled price”).

From these conceptual differences we can draw the conclusion that efficient business transfer prices and legally required taxation transfer prices will only in rare cases coincide. What does this mean for the choice of transfer prices by the top management of the firm?

### 2.1.2.2 *Choices for the Management in the Tax and in the Business Sphere*

The management of the firm is obliged to maximize the overall profit of the firm. It has been laid out elsewhere, that also from a legal point of view this exercise has to focus on the after-tax profit as dividends to shareholders are paid out of after-tax profits and as the value of the shares reflects the amount of existing and latent tax liabilities at the level of the corporate entity.<sup>27</sup> The agency relationship between corporate managers and shareholders requires the former to take into account the corporate tax burden as it contributes to the overall outcome of the business activities.

#### 2.1.2.2.1 No Legal Conformity for Managerial and Tax Transfer Prices

The starting point for the analysis is the fact that the law does not require any conformity of transfer prices used as incentives and transfer prices used in the tax area. Against this background, there are studies which fully decouple both from each other. They take a fixed transfer price for tax purposes as given and focus on the management’s unrestricted choice of transfer prices for incentive matters. The notable result is that the transfer price chosen for management purposes does not simply duplicate the transfer price chosen in a tax-free world. The differential between low-tax and high-tax countries where the involved business units are located shows an indirect influence on the choice of the incentive transfer price as the incentive transfer price will determine the size of business activity in the involved jurisdictions which themselves are taxed according to the tax-only transfer price. Against this background it has been proposed that the optimal transfer price for business purposes will be “a weighted average of the pre-tax marginal cost and the most favorable arm’s length price”.<sup>28</sup>

Another influence of tax rules on transfer pricing on business decisions, which arises irrespective of the full decoupling of managerial and tax transfer prices concerns business decisions which influence the calculation of the tax-relevant transfer prices. If and so far as tax law requires the firm to include certain factors into the transfer price (e. g. investment cost), the management will see an incentive to reduce the relevant factor in the country where the tax rate is higher than in the other

<sup>27</sup> Schön supra (note 17), p.46 – 57; see also Morton, “Does transfer pricing affect shareholder value? What are the real priorities for an in-house tax director?”, *Tax Journal* (September 2010), Supplement, *Transfer Pricing Review*, p.7.

<sup>28</sup> Baldenius/Melamud/Reichelstein, “Integrating Managerial and Tax Objectives in Transfer Pricing”, 79 *The Accounting Review* (2004), p.591 – 615; Choe/Hyde, “Multinational Transfer Pricing, Tax Arbitrage and the Arm’s Length Principle”, 83 *Economic Record* (2007), p.398 – 404.

involved countries.<sup>29</sup> Both for the “cost-plus” method and for the “resale method” the influence on the size of sales or the cost structure of a business unit has been shown.<sup>30</sup> In this respect, transfer pricing for tax purposes determines the size of the taxable profit of a business unit, thus contributing to the effective tax burden of that specific unit.

#### 2.1.2.2 Limited Conformity for Managerial and Tax Transfer Prices

Going beyond what the law requires, many firms perceive a necessity to align transfer prices for managerial and tax purposes. This is traced back to a desire to avoid double book-keeping which involves substantial compliance costs and may support a critical stance taken by the tax authorities, as these will have the opportunity to use the “managerial books” as evidence in transfer pricing disputes. Any deviation from tax transfer pricing might lead to adjustments and penalties to the detriment of the corporation and even to double taxation when the foreign state does not counter-adjust in full under Art.9 par.2 OECD Model. The management will have to evaluate the “legal risk” following from the choice of two different sets of transfer prices. When the management reaches the conclusion that full conformity should be envisaged, they have to select a transfer price within the “range” typically available for “arm’s length” prices. In this exercise, the management faces a well-researched trade-off between tax effects resulting from a choice of a particular transfer price and the incentive-effects of this transfer price.<sup>31</sup> When the management reaches the conclusion that different sets should be employed, the penalty risk will gain influence on the choice of the two transfer prices as well.<sup>32</sup>

#### 2.1.2.3 Consequences for International Tax Policy

It becomes clear from the afore-described interaction of tax and managerial goals for the choice of transfer prices that the existence of tax concepts like the “arm’s length” principle and in particular the high reputation of the “market price” as a starting point for tax-oriented transfer pricing analysis damage the overall efficiency within business organizations. It is well known that this result – among other factors – has given rise to the claim that transfer pricing in the tax world

<sup>29</sup> Samuelson, “The multinational firm with arm’s length transfer price limits”, 13 *Journal of International Economics* (1982), p.365 – 374; Elitzur/Mintz, “Transfer pricing rules and corporate tax competition”, 60 *Journal of Public Economics* (1996), p.401 – 422; Smith, “Ex Ante and Ex Post discretion over arm’s length transfer prices”, 77 *Accounting Review* (2002), p.161 – 184.

<sup>30</sup> Halperin/Srinidhi, “The effects of the U. S. Income Tax regulations’ transfer pricing rules on allocative efficiency”, 62 *Accounting Review* (1987), p.686 – 706; Harris/Sansing, “Distortions caused by the use of arm’s-length transfer prices”, 20 *Journal of the American Taxation Association* (1998), Supplement p.40 – 50.

<sup>31</sup> Halperin/Srinidhi, “U. S. Income Tax transfer-pricing rules and resource allocation: the case of decentralized multinational firms”, 66 *Accounting Review* (1991), p.141 – 157; Smith, “Tax and Incentive Trade-Offs in Multinational Transfer Pricing”, 17 *Journal of Accounting, Auditing & Finance* (2002), p.209 – 236.

<sup>32</sup> Hyde/Choe, “Keeping two sets of books: the relationship between tax and incentive transfer prices”, 14 *Journal of Economics & Management Strategy* (2005), p.165 – 186; Choe/Hyde *supra* (note 28), p.402.

should be scrapped altogether in order to replace it with a formula-based apportionment system of profits for multinational enterprises. This is not what this article is going to plead for. Rather it invites to consider a full alignment of tax and managerial transfer pricing – but delinking the outcome of the transfer pricing process from the assertion of tax jurisdiction over the overall corporate profit.<sup>33</sup>

International tax law starts from the assumption that the allocation of income to a certain taxpayer pre-empts the allocation of the right to tax this income to the country where the taxpayer resides. For permanent establishments, this general rule is modified to the extent that profits which are attributable to a permanent establishment are taxed in the country of source. For this purpose, the permanent establishment is treated as a fictitious taxpayer and “dealings” between the permanent establishment and the head office are controlled under the “arm’s length” principle. The transfer price is established in general under the CUP method, the cost-plus method or the resale-minus method. Transfer pricing at marginal cost is generally not accepted by traditional transfer pricing tax rules.

The use of transfer prices for taxation purposes which deviate from those transfer prices which enhance efficiency from the perspective of managerial accounting is evidently linked to the intention of both involved countries to get a “fair share” of the overall outcome of the joint efforts by the business unit belonging to a single firm. If one tries to reconsider the underlying tension between tax and business goals, it becomes obvious that the “dividing line” should not be drawn between transfer prices in the tax and in the business world but between transfer prices set by private business on the one hand and taxing rights allocated to jurisdictions on the other hand.

This becomes clear when we decide to use managerial transfer prices for tax purposes as well.<sup>34</sup> This will lead to an allocation of profits between the involved business divisions, which follows in full the line necessary to enhance the overall profit of the firm. This will make it possible for some business units to extract rents from the existence of other business units within the firm. These rents will have their economic foundation in specific investment effected by those other business units, by the use of proprietary intangibles, by long-term commitments and mutual trust and so on. From a tax point of view, these rents should not simply be allocated to the country where the “winning” business unit is located. These rents are due to the fact that the “losing” business unit provides a specific business opportunity to the other divisions of the firm. In other words: the “winning” business unit should be taxed not only in its location country but also in the jurisdiction where the other unit resides. Insofar, the “source” of the revenue in the involved countries does not simply follow the delineations between the involved companies.

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<sup>33</sup> The following outline builds on Schön *supra* (note 7), p.241 – 251.

<sup>34</sup> See also: Schneider, “Wider Marktpreise als Verrechnungspreise in der Besteuerung internationaler Konzerne”, 56 *Der Betrieb* (2004), p.53 – 58.

## 2.2 Profit Maximization in a Corporate Group

### 2.2.1 The Corporate Law Framework for Related-Party Transactions

The concept of transfer pricing gains a completely different character when we are not looking at divisions or dependent units within a single corporation but when these units are incorporated as separate legal entities. In this case we do not perceive notional dealings and notional prices which work as mere calculation devices; to the contrary, transfer prices become hard-wired “real” prices accompanying “real” contracts which affect the financial situation of the involved corporations, thus influencing the size of the corporate profit available for shareholders and the size of the corporate assets available for creditors. The view of corporate law on transfer pricing is therefore framed by the necessity to protect creditors and minority shareholders from self-interested treatment by dominant shareholders (colluding with the management).

The inherent conflict of interest is a constant source of concern.<sup>35</sup> Nevertheless corporate law accepts related-party transactions in general. The instrument of dealings between a corporation and its dominant shareholder generates efficiency-enhancing synergies and may therefore provide a reward to the dominant shareholder who incurs monitoring cost.<sup>36</sup> Therefore, no corporate law system in the world contains an outright prohibition of self-dealing.

The strategies adopted in different legal systems to establish a certain level of control when it comes to related-party transactions show a great variety.<sup>37</sup> The most prominent examples are:

- Approval of related-party transactions by shareholders or disinterested directors (excluding the involved parties from voting),<sup>38</sup> this instrument is used in particular in the United Kingdom;<sup>39</sup>
- Disclosure of related-party transactions; both US-GAAP<sup>40</sup> and IFRS<sup>41</sup> provide that the existence of these transactions has to be reported to investors. Furthermore, the 4<sup>th</sup> and 7<sup>th</sup> Directive of the European Union in the field of corporate law require all companies (and groups) to disclose “transactions which have been entered into with related parties by the company, including the amount of such transactions, the nature of the related party relationship and other information about the transactions necessary for an understanding of the financial position of

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<sup>35</sup> Gilson, “Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy”, 119 *Harvard Law Review* (2006), p.1641 - 1679

<sup>36</sup> Enriques et al. (note 9), p.154 et seq.; Djankov et al. (note 11), p.431; Shleifer/Vishny, “Large Shareholders and Corporate Control”, 94 *Journal of Political Economy* (1986), p.461 – 488.

<sup>37</sup> For the relevant comparative studies see supra (note 11); a recent proposal to monitor self-dealing see: Gutiérrez/Saez, “A Carrot and Stick Approach to Discipline Self-Dealing by Controlling Shareholders”, ecgi Law Working Paper No.138/2010 (January 2010), pleading for call options and put options for minority shareholders in order to secure ex post compensation for the outcome of the related-party transaction.

<sup>38</sup> Enriques et al. (note 9), p.162 – 169.

<sup>39</sup> Davies, Gower and Davies’ *Principles of Modern Company Law*, 8<sup>th</sup> Ed. (2008), p.529 – 557.

<sup>40</sup> SFAS No.57 (1982).

<sup>41</sup> IAS 24 (2003).

the company”<sup>42</sup> For self-dealing within a corporate group, these disclosure rules are particularly relevant when the individual accounts of the involved companies are drawn up while the consolidated accounts will not show intra-group dealings at all.<sup>43</sup>

- Liability of shareholders and directors for “breach of loyalty” when self-dealing amounts to unfair treatment of minority shareholders. This standard-based approach (applied both in the United States, Canada, and in continental Europe) is founded on the agency relationship between directors and shareholders when it comes to the administration of the company’s assets and opportunities. Insofar, it is widely acknowledged that also the controlling shareholder who employs his power over the management to enter into a related-party transaction on favorable terms with the corporation is liable. In a famous German derivative shareholder suit case a U.S. parent company (“ITT”) had to pay damages to its German subsidiary for an “unfair” service fee<sup>44</sup> levied from all group companies; in a recent Canadian case Ford U.S.A. was held liable for “oppression” of minority shareholders in this subsidiary as the long-term sales contract between Ford U. S. and one of its Canadian subsidiaries had led to enduring losses for the latter.<sup>45</sup> Moreover, such self-dealings are not rendered immune against the courts’ scrutiny under the “business judgment rule”. In order to counter the extant conflict of interest the directors have to show the “intrinsic” or “entire” fairness of related-party transactions.<sup>46</sup>
- Finally, disguised distributions are subject to creditor-protecting rules like insolvency law provisions on “fraudulent trading” and capital maintenance rules (the latter in jurisdictions where the concept of legal capital still prevails).<sup>47</sup> But these rules only bite when asset diversion either leads to insolvency of the company or when the assets of the company do not fully cover the subscribed capital.<sup>48</sup> While these rules have a strong tradition in Germany, recent years have seen an evolving jurisprudence in the United Kingdom as well.<sup>49</sup>

<sup>42</sup> Art.43(1)(7b) Council Directive 78/660/EEC as amended by Art.1(6) of the Directive 2006/46/EC of the European Parliament and of the Council of 14th June 2006 (O.J. L 224/1 of 16th August 2006); see also Art.34 (7b) of Directive 83/549/EEC as amended by Art.2(1) of Directive 2006/46/EC.

<sup>43</sup> See Art.34(7b) of Directive 83/549/EEC supra (note 42): “The transactions, save for intra-group transactions, entered into by the parent undertaking, or by other undertakings included in the consolidation, with related parties ...”.

<sup>44</sup> Federal Court of Justice (Bundesgerichtshof), judgment of 5<sup>th</sup> June 1975 (II ZR 23/74), Official Gazette (Entscheidungen des Bundesgerichtshofs in Zivilsachen - BGHZ) Vol.65, p.15 – 21.

<sup>45</sup> Ontario Supreme Court of Justice, Ford Motor Company of Canada Ltd. v. Ontario Municipal Employees Retirement Board, judgment of 13<sup>th</sup> February 2004, Court File No.98-CL-3075, 6 International Tax Law Reports (2004), p.776 – 871.

<sup>46</sup> Allen/Kraakman/Subramanian, Commentaries and Cases on the Law of Business Organization, 3rd Ed., Aspen (2009), p.309 – 314 (Controlling Shareholders and the Fairness Standard).

<sup>47</sup> Supra (note 12).

<sup>48</sup> For the UK situation see: Davies supra (note 39), p.289 – 292; Ferran, Company Law and Corporate Finance, Oxford (1999), p.426 – 429.

<sup>49</sup> Micheler, “Disguised Returns of Capital – an Arm’s Length Approach”, 69 Cambridge Law Journal (2010), p.151 – 185; see also the recent decision by the UK Supreme Court in: Progress Property Co Ltd v. Moorgarth Group Ltd (2010) UKSC 55.

One point deserves to be mentioned: A third avenue of corporate law reasoning goes beyond shareholder and creditor protection and pleads for a full protection of the company “in itself” against unfavorable contracting with dominant shareholders. This view is particularly relevant in jurisdictions where a corporate entity is not merely regarded as an instrument to further “shareholder value” but as a self-standing organization which caters to different stakeholder groups. Against this background, the German law of stock corporations is applied in such a way as to prohibit any non-arm’s-length transaction between a wholly-owned stock corporation (public or not) and its shareholder irrespective of the existence of minority shareholders and the necessity to protect the creditors’ interest.<sup>50</sup> From a comparative perspective, though, this approach seems to present a minority view which will not be pursued further in this article.

What does this mean for the leeway the managers of the parent company have when it comes to transfer-pricing policies within the firm? It means that there are two completely different categories of companies to be addressed: For wholly-owned subsidiaries where no creditors are in danger, corporate law hardly sets limits to the choice of transfer prices. But if there are outside shareholders or if the company is on the brink of insolvency, transfer prices have to be “fair” in order to avoid liability of the directors and of the dominant shareholder.

### 2.2.2 The “Arm’s-Length” Standard under Corporate Law

While it is evident that transfer prices in related-party transactions shall be “fair” in theory, it remains unclear what this means in practice, in particular, whether the “arm’s-length” standard shall be applied for intra-group dealings.

An incoherent starting point is offered by accounting rules and standards. In this respect, International Standards and European directives seem to have different viewpoints. US-GAAP starts from the assumption, that related-party transactions are not typically priced at “arm’s length” as they reflect the specific conditions for dealings within the firm.<sup>51</sup> Against this background, neither IFRS nor US-GAAP mandate an outright “adjustment” of transfer prices under the arm’s-length standard; they simply provide for disclosure of the material substance of the dealing in order to let the recipient of the information form his own judgment on the economic effects of an arrangement.<sup>52</sup> The European accounting directives, to the contrary, require disclosure of related-party transactions only “if such transactions are material and

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<sup>50</sup> For a critical assessment of this view see: Schön, “Vermögensbindung und Kapitalschutz in der AG – Versuch einer Differenzierung”, in: Crezelius et al., “Festschrift für V. Röhrich zum 65. Geburtstag: Gesellschaftsrecht, Rechnungslegung, Sportrecht”, Cologne (2005), p.559 – 570.

<sup>51</sup> SFAS No.57 para 3: “Transactions involving related parties cannot be presumed to be carried out on an arm’s-length basis, as the requisite conditions of competitive, free-market dealings may not exist. Representations about transactions with related parties, if made, shall not imply that the related party transactions were consummated on terms equivalent to those that prevail in arm’s-length transactions unless such representations can be substantiated.

<sup>52</sup> Ernst & Young, International GAAP, Vol.2 (2009), Chapter 38, para 1.2.1; Josh Siegel et al., GAAP 2010: Handbook of Policies and Procedure, (2009), chapter 8, p.8.09 – 8.12.

have not been concluded under normal market conditions”.<sup>53</sup> The preamble of the most recent directive amending existing law purports that disclosure is necessary “only where such transactions are (...) not carried out at arm’s length. Disclosure of material transactions with related parties that are not carried out under normal market conditions can assist users of annual accounts to assess the financial position of the company as well as, when the company belongs to a group, the financial situation of the group as a whole”.<sup>54</sup>

The same distinction shows up when it comes to the requirement of *ex ante* shareholder approval. UK law very rigidly demands disclosure and/or upfront approval by disinterested directors or shareholders for all related-party transactions as the UK tradition does not confer upon the courts the power to interfere with intra-company dealings under an unclear distinction between “fair” and “unfair”.<sup>55</sup> French law – on the other hand – only provides for separate approval of dealings which deviate from “normal” conditions,<sup>56</sup> thus hypothesizing the arm’s length standard as a carve-out for the control of related-party transactions.

While the *ex ante* requirements on disclosure and shareholder/board approval can refrain from the distinction between fair and unfair transactions, the application of the “duty of loyalty” *ex post* standard for directors and dominant shareholders has to commit itself to a material framework for intra-group transactions. In this respect, most corporate law systems seem to prefer the “arm’s length” standard in order to test the “fairness” of a related-party transaction. This is conceptually wise as minority shareholders only participate in the economic success of the company they belong to, not in the economic success of the parent company or other related parties. Therefore, the minority shareholders are entitled to a profit share which reflects the self-standing profitability of the company they have invested in. With respect to the allocation of the profit generated within this particular corporate entity, minority shareholders are entitled to “equal treatment”; dominant shareholders are not allowed to expropriate them by self-dealing. Against this background, the “arm’s-length” standard provides the right starting point for the analysis.<sup>57</sup> According to court practice and literature, the U.S. test on the “entire fairness” of a related-party transaction seems to support the arm’s length standard<sup>58</sup>. The same holds true for Germany, where the courts apply the notion of a “fictitious independent director” acting in the best interest of the subsidiary company only.<sup>59</sup> In Canada, the arm’s

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<sup>53</sup> See the provisions quoted in note 42 and note 43.

<sup>54</sup> Preamble, Paragraph 6, Directive 2006/46/EEC supra (note 42); for a similar rule under French law see Art. L 225-40 Code de Commerce.

<sup>55</sup> See Davies supra (note 39), p.529 – 533.

<sup>56</sup> Art. L 225-38 Code de Commerce; Djankov supra (note 11), p.442 et seq.; Conac/Enriques/Gelter supra (note 11), p.498 – 500.

<sup>57</sup> Contrary to this, in Italy, it is sufficient that no “harm” is done to the company, i.e. that the transfer price reflects the “reservation price” (Enriques et al. supra (note 9), p.173).

<sup>58</sup> Enriques et al. supra (note 9), p.173.

<sup>59</sup> Fleischer in: Schmidt/Lutter (Ed.), Aktiengesetz Kommentar, 2nd Ed., Cologne (2010), Vol. I, § 57 AktG para 12.

length standard was explicitly transferred to corporate law in the above mentioned judgment in “Ford Canada” where the court held:

“Why would the management of a truly independent entity in Ford Canada’s position continue to tolerate an inter-corporate pricing agreement that leaves it with a staggering aggregation of losses carried forward and with the only reasonable expectation for the future being that of continuing mammoth losses”.<sup>60</sup>

### 2.2.3 Arm’s Length Pricing and the Group Situation

The real problem lies elsewhere: how far does the “arm’s length” standard take into account the particular situation of a group company which – according to its corporate charter, its financial and human resources and its business model – specializes on intra-group transactions in order to contribute to the overall outcome of the group and to benefit from synergies existing within the group. Taking a closer look, there are three different topics to be discerned:

- Firstly, one has to ask, whether the “fairness” of intra-group dealings has to be judged on a separate basis for every transaction, or whether the treatment of a subsidiary by its parent company is viewed in its entirety.<sup>61</sup> In this respect, German law, French law and Italian law have developed rules and principles granting some flexibility to the parent company. Under German law, the parent company is in the position to force the directors of the subsidiary to enter into disadvantageous dealings within the group if there is some financial compensation by the end of the year (§ 311 Stock Corporation Act).<sup>62</sup> For this purpose, advantageous and disadvantageous measures taken during the year are mutually set-off. Under French law, the so-called *Rozenblum* doctrine renders legal any asset diversion by a corporate parent as long as three conditions are met: the structure of the group is stable, the parent is implementing a coherent group policy, and there is an overall equitable intra-group distribution of costs and revenues.<sup>63</sup> Similarly, in Italy, parent companies are not held liable if there is no damage in the light of the overall results of the management and co-ordination activity. When these conditions are fulfilled, the individual transaction does not have to comply with the arm’s-length standard on a stand-alone basis.
- Secondly one has to ask whether the economics within the firm justify the decision of the management of a subsidiary to deliver goods or services to another group company at marginal cost or at a price between marginal cost and the outside market price. As intra-group dealings often build on specific investment, proprietary intangibles and long-term contracting, the directors of a group company will often find it in the best interest of the subsidiary to enter into such a con-

<sup>60</sup> Supra (note 45), para 300.

<sup>61</sup> Enriques et al. supra (note 9), p.176 – 178; Forum Europaeum Corporate Group Law, “Corporate Group Law for Europe”, 1 European Organization Business Law Review (2000), p.165 – 264, at p.202 – 204.

<sup>62</sup> See also: Bayer in: Goette/Habersack (Ed.), Aktiengesetz, 3rd. Ed., Munich (2008), § 57 AktG para 37.

<sup>63</sup> Mémento Pratique Francis Lefebvre, Groupes des Sociétés 2007-08, para 2370 – 2378.

tract in order to secure a long-term “customer base” within the group. There are hardly any corporate law precedents for this, but at least in Germany, the majority view seems to accept that “good business reasons” can justify the management’s decision to accept intra-group prices below market price on an arm’s length basis.<sup>64</sup>

- Thirdly one has to find out whether the parent company might be obliged to share any “synergy rents” with the subsidiary or whether arm’s length pricing has to be judged on a stand-alone basis for the subsidiary, not regarding positive effects of the group situation for the parent company and other members of the corporate group. To put it differently: Are subsidiaries entitled to a “profit split” under corporate law? The OECD Transfer Pricing Guidelines seem to assume this as they regard the profit split as an “arm’s-length” solution chosen by independent companies as well. In corporate law practice, there is no clear evidence for this when it comes to dealings between group companies. U.S. academic literature seems to assume that the minority shareholders are entitled to a proportional share in the “synergy gains”.<sup>65</sup> On the other hand, when in the course of a corporate takeover minority shareholders are “squeezed out” of a group, the whole “synergy rent” is left to the controlling shareholder.<sup>66</sup> Also German law sees no legal basis for a participation of exiting minority shareholders in the future synergy gains.<sup>67</sup>

## 2.2.4 The Interaction of Incentives, Tax and Corporate Law for Transfer Pricing

Starting from the assumption that the directors of the parent company of a corporate group are obliged to further the profitability of the group as a whole (as reflected in profits and capital gains arising at the level of the parent company) they will have a threefold view on transfer prices:

- In the first place, transfer prices will be used to contribute to the overall efficiency of the firm. Insofar, transfer pricing is about increasing the size of the cake.
- In the second place, transfer prices will be used to slice the cake among tax jurisdictions. Insofar, transfer pricing is about decreasing the effective tax burden. It has been said before that in order to ensure efficient use of transfer prices, inter-

<sup>64</sup> Cahn/Senger, in: Spindler/Stilz (Ed.), *Aktiengesetz*, Vol.1, Munich (2007), § 57 AktG para 21.

<sup>65</sup> Gilson/Gordon, “Controlling Controlling Shareholders”, 152 *University of Pennsylvania Law Review* (2003) p.752 – 843, at p.795 and 804.

<sup>66</sup> Sec.262 (h) s.1 Delaware General Corporate Law: “After determining the stockholders entitled to appraisal, the Court shall appraise the shares, determining their fair value exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation (...)”. For a closer analysis see the judgments in: *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983); *Cede & Co. v. Technicolor*, 684 A.2d 289 (Del.1996); Maynard, *Mergers and Acquisitions: Cases, Materials and Problems*, 2<sup>nd</sup> Ed., Aspen (2009), p.186 – 208; Carney, *Mergers and Acquisitions*, 2<sup>nd</sup> Ed. (2007), p.832 – 845; Choper/Coffee/Gilson, *Cases and Materials on Corporations*, 7<sup>th</sup> Ed. (2008), p.1088 – 1126.

<sup>67</sup> For a comparative view see: Fleischer, “Die Barabfindung außenstehender Aktionäre nach den §§ 305 und 320b AktG: Stand-Alone-Prinzip oder Verbundberücksichtigungsprinzip”, 26 *Zeitschrift für Gesellschafts- und Unternehmensrecht* (1997), p.368 – 400.

national tax should refrain from coupling incentive transfer pricing and tax rules on international tax allocation. International tax allocation should be built on two elements instead: transfer pricing will be the starting point for profit allocation to the involved companies but synergy rents drawn by a group company from dealings with another group company shall be taxed in the “source country” as well.

- In the third place, transfer prices have to be consistent with the framework set by corporate law. Insofar one has to verify to what extent corporate law sets limitations to free-wheeling incentive transfer pricing. In the light of the foregoing analysis the following conclusions can be drawn:
  - For dealings with (or between) subsidiaries which are wholly-owned by the parent company and where creditors’ claims are not put at risk, there is virtually no corporate law limitation for transfer pricing. These can be administered by the parent company, set by the servicing or receiving party or simply left to free negotiations between the involved group companies.
  - For dealings with (or between) subsidiaries where minority shareholders exist and/or creditors’ claims have to be protected, some countries apply the arm’s-length standard as a “fairness test”. This seems to pre-empt other modes of using transfer prices as business incentives. On the other hand, it has been shown that in corporate groups, there are different techniques to extend the leeway for the group management. They can
    - show that the internal economics of the firm justify the employment of specific non-arm’s length prices for the subsidiary on a stand-alone basis;
    - arrange a coherent group policy which evenly hands out benefits and disadvantages for group companies even if the arm’s length standard is not met for individual transactions.
    - use incentive transfer prices in the first place and “compensate” the subsidiary for ensuing losses *ex post*.

Against this background, corporate law does not enforce strict discipline on transfer pricing. Transfer prices for related party transactions can be tailor-made to increase efficiency if some basic mechanisms to protect minority shareholders and company creditors are established.

### 3. Relevant Case Law

The foregoing position that the different goals for efficiency-oriented transfer pricing, allocation of governmental taxing rights and corporate law protection for shareholders and creditors plead for better “distinguishing” between these purposes and the instruments used to achieve them. In order to make this case clear one should have a look at the following cases which have been decided recently by courts in Canada, the United Kingdom and the United States.

#### 3.1 DSG Retail Limited et al. vs. HMRC

In a case decided by Special Commissioners *John F. Avery Jones* and *Charles Hellier* a UK company selling goods to customers entertained an insurance contract

for warranties with an affiliate company located in the Isle of Man.<sup>68</sup> It was disputed whether the premiums paid to the captive insurance company were in line with the arm's length principle. The Special Commissioners found that while the premiums passed the arm's length test, it was evident that the parent company (and other group members) had offered to the captive insurance company a "business facility" which it would not have found outside the group. Therefore, taking into account the "bargaining power" of the parent company, the insurance premiums paid to the capital insurer had to be reduced by an offsetting consideration for the "business opportunity" as such.

From the point of view taken in this article, the case clearly shows the necessity to apply different concepts for different purposes. From an efficiency point of view it makes sense to employ the "market price" in order to fully show the risk exposure generated by the warranties. From a tax point of view, one has to notice that the captive insurance company used a business opportunity located in the United Kingdom which should give rise to source taxation in this country. From the corporate law point of view it makes sense to fully compensate the captive insurance company for the risk assumed in the course of its business without deducting a set-off for the business opportunity. Otherwise, minority shareholders or creditors of the insurance company might feel excess downside risk from the operation of the insurance company.

### 3.2 Glaxo SmithKline (Canada)

In the "Canadian" Glaxo case<sup>69</sup> a Canadian subsidiary of the British GlaxoSmithKline group produced pharmaceuticals in Canada under a far-reaching licensing agreement with a British group company. Part of the agreement was to purchase raw material from a Swiss group company at a price five times the market price. While the Tax Court held the purchase price to be far above arm's length and therefore confirmed the transfer pricing adjustment effected by the tax authorities,<sup>70</sup> the Federal Court of Appeals took the opposite view. They found that from the perspective of an independent company it was reasonable to accept the exaggerated purchase price as this was "part of the package" pre-arranged with the British parent company which gave access to the manufacturing and distribution of the high-value pharmaceutical product.

<sup>68</sup> (1) DSG Retail Limited (2) Mastercare Coverplan Service Agreements Limited (3) Mastercare Service and Distribution Limited vs. The Commissioners for Her Majesty's Revenue and Customs [2009] UKFTT 31 (TC); Casley/Sinclair, "DSG Retail Limited v. the Commissioners for Her Majesty's Revenue and Customs", *International Transfer Pricing Journal* (2009), p.378 – 385.

<sup>69</sup> *GlaxoSmithKline Inc vs. HMQ* (2010 FCA 201), 13 *International Tax Law Reports* (2010), p.33 – 58, (with annotation by Nikolakakis, p.34 – 38).

<sup>70</sup> *GlaxoSmithKline Inc v. HMQ* (2008 TCC 324); see the critical comment by Dujic/Goldberg/Barsalo/Fleming, "Digesting the Glaxo Decision: A Difficult Pill to Swallow for Transfer Pricing Practitioners", *International Transfer Pricing Journal* (2008), p.203 – 212; Jean-Pierre Vidal, "The Achilles' Heel of the Arm's Length Principle and the Canadian GlaxoSmithKline Case", 37 *Intertax* (2009), p.512 – 528.

From an efficiency point of view it seems evident that the administered transfer price for the raw materials runs foul of good incentive policy. This arrangement will possibly reduce the Canadian subsidiary's effort to increase the production up to the optimal point. On the other hand, if this pricing arrangement goes hand in hand with a compensatory reduction of the license fee payable to the British group companies, the incentive function might be restored.

From a corporate law view, the first question is whether the transaction with the Swiss company has to be examined irrespective of the overall contractual arrangement. Insofar it has been laid out that several national laws support a broad perspective which allows us to assess an individual transaction on the basis of the aggregate contractual framework. Therefore, corporate law might come to the result that the directors of the Canadian subsidiary acted in line with the duties of care and of loyalty.

From a tax law point of view, one cannot doubt that an inflated profit attribution to the Swiss company cannot hold – even if from the perspective of the Canadian subsidiary there is a balanced outcome in line with the arm's length principle – shall not be allocated to Switzerland. This is outright profit shifting. Rather, the larger part of the profit made by the Swiss company has to be taxed in Canada or in the United Kingdom. Either one can argue that the Swiss company has exploited a monopolistic situation in Canada which was created by the pre-ordained contractual arrangements to the detriment of the Canadian company – then it makes sense to tax this monopoly rent in Canada. Or one can argue that the purchase price paid to the Swiss company has to be re-characterized as a “disguised license fee” which is generated by the business activity of the UK company and therefore taxable in Great Britain unless Canada is in the position to levy a withholding tax on the royalties. In order to come to this conclusion, tax law has to leave behind both the connection with corporate law and with efficiency-oriented incentives.

### 3.3 GE Capital (Canada)

In the GE Capital case,<sup>71</sup> the Canadian subsidiary of GE Capital (U.S.) had to pay a fee to the U.S. parent for granting a guarantee covering the subsidiary's debt issues. The tax authorities did not allow the deduction of this fee as the Canadian subsidiary would have benefitted from the reputation of the parent company in any case. The Tax Court held that while part of the subsidiary's AAA rating was simply due to an “implicit guarantee” stemming from its position as a group member of General Electric, another part of this rating was created by the explicit guarantee given by the

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<sup>71</sup> General Electric Capital Canada Inc vs. HMQ (2009 TCC 563), 12 International Tax Law Reports (2010), p.508 – 602; the judgment has been confirmed by the Federal Court of Appeal in: General Electric Capital Canada Inc vs. HMQ (2010 FCA 344), 13 International Tax Law Reports (2011), p.432 – 453; see also: Borraccia/Raybould/Segal, “Canadian Ruling on guarantee fee”, Transfer Pricing Tax Planning (2010) No.2. p.28 – 31; Dujsic, “GE Capital Canada: Crown clarifies grounds for appeal in guarantee fees case”, Transfer Pricing International Journal (2010), No.8, p.24 – 25; Dale C. Hill, “In transfer pricing size does matter: General Electric Capital Canada v. CRA”, Transfer Pricing International Journal (2010), No.1, p.7 – 9.

parent company. An arm's length fee – the Tax Court concluded and the Federal Court of Appeal confirmed – would cover the “explicit guarantee” but not the “implicit” portion.

This case gives rise to the question of whether subsidiaries can be forced to pay a consideration for a synergy benefit which stems from the accumulation of economic power within the corporate group as a whole. From an incentive point of view, it makes sense to pay a compensation for these involuntary “spillovers” in order to exert some discipline on financial behavior of subsidiaries. From a corporate law point of view, there is no clear evidence whether a consideration can be claimed for such a synergy effect.

Most interestingly, the allocation of a taxing right in such a situation should take into account the “location” of this rent. As both the “implicit” and the “explicit” guarantee provided to the Canadian subsidiary have their territorial point of reference in the United States where the parent company and its assets are located, the Canadian subsidiary benefits from an economic factor which is largely connected with the United States. Insofar, it makes sense to allocate the whole revenue from the fee to the U. S. tax authorities. This should not be dependent on the question of whether the subsidiary – guided by its own interest – would actually pay the full fee under the arm's length principle. The allocation of profits under the arm's-length principle does not give the final answer to the problem of where to allocate taxing rights for intra-group profits.

#### **4. Prioritizing the Incentive Function of Transfer Prices over Tax and Corporate Law**

Given the overall goal of business organization, corporate and tax law to foster welfare by increasing efficient allocation of resources, it makes sense to arrange tax law and corporate law in a way that does not interfere with efficient pricing from a business organization point of view. This involves the following:

- Transfer prices should be set in principle from a business administration perspective, optimizing the internal incentive structure for the firm in order to achieve an optimal allocation of the given resources.
- Transfer prices should not be the final measuring rod for allocation of taxing rights between countries. They are meant to allocate profits between business units but not to define the framework of territorial source taxation. Insofar, profits derived by a local company according to the transfer prices set or negotiated from a business perspective do not give the final answer to the allocation of taxing rights. Moreover, any synergy rents drawn by members of a corporate group from dealings with the local company should be allocated to the country where the synergy is located (e.g. from the use of specific investment in a country) not to the country where the corporation receiving the rent resides.
- Corporate group law should be employed in a way that does fully compensate creditors and minority shareholders for losses from a group strategy which damages local profitability of a particular subsidiary in order to foster the overall

profitability of the group. But transfer prices should not pre-empt creditor and shareholder protection if there are other modes of compensation available to the parent company.

This “unbundling” of business, tax and corporate law considerations in the setting of transfer prices may lead to a reduction in distortive effects, to a fairer allocation of taxing rights and to a sensible treatment of minority shareholders and creditors from a corporate law perspective.

## **Part 2:**

# **The OECD Approach to Transfer Pricing**

# Soft Law, Hard Realities and Pragmatic Suggestions: Critiquing the OECD Transfer Pricing Guidelines

Jinyan Li \*

## Abstract

*This paper briefly reviews and critiques the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2010). It comments on the political, economic and legal contexts in which transfer pricing issues arise and the “soft law” nature of the Guidelines.*

*Among the hard realities are that soft law depends on domestic law to take effect and MNE’s are able to shift income to low-tax jurisdictions through transfer pricing strategies. The paper suggests that the Guidelines be revised in order to “harden” the impact of the soft law and to make the transfer pricing rules more effective in preventing double taxation as well as preventing income shifting.*

## 1. Introduction

The *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010) (the “Guidelines”) provide guidance to multinational enterprises (MNEs) and tax administrations in the application of the arm’s length principle. They enjoy the status of “soft law” but are arguably more influential than any sources of “hard law” on transfer pricing. This paper is a critique of the Guidelines. After an overview of the highlights in the Guidelines, the paper briefly comments on the nature of the *Guidelines* and the political, economic and legal contexts in which transfer pricing issues arise and transfer pricing law operates. Among the hard realities are that soft law depends on domestic law to take effect and the MNE’s are able to shift income to low-tax jurisdictions through transfer pricing strategies. The paper suggests that the *Guidelines* be revised in order to “harden” the impact of the soft law and to make the transfer pricing rules more effective in preventing double taxation as well as preventing income shifting.

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## 2. Highlights of the Guidelines

### 2.1 Intentions

The 2010 *Guidelines* represent a revision and compilation of previous transfer pricing reports by the OECD Committee on Fiscal Affairs. They do not deviate from the long standing position of the OECD that the arm's length principle is the basis for international consensus on transfer pricing. They are not intended to be comprehensive. Instead, the focus is on the main issues of the arm's length principle. Further revisions can be expected to address such issues as the application of the arm's length principle to intangibles, services, cost contribution arrangements, permanent establishment, and thin capitalization.

The *Guidelines* aim at helping "tax administrations (of both OECD member countries and non-member countries) and MNEs by indicating ways to find mutually satisfactory solutions to transfer pricing cases, thereby minimizing conflict among tax administrations and between tax administrations and MNEs and avoiding costly litigation." (para. 15) The objectives of this endeavor are the allocation of international tax base and the avoidance of double taxation. (para. 7) Preventing tax avoidance or artificial income shifting through transfer pricing is not a primary objective of the *Guidelines*.

### 2.2 Structure and Notable Changes

There are IX chapters in the *Guidelines*: I, The Arm's Length Principle; II, Transfer Pricing Methods; III, Comparability Analysis; IV, Administrative Approaches to Avoiding and Resolving Transfer Pricing Disputes; V, Documentation; VI, Special Considerations for Intangible Property; VII, Special Consideration for Intra-Group Services; VIII, Cost Contribution Arrangements; and IX, Transfer Pricing Aspects of Business Restructurings. In addition, there is a preface, glossary, seven annexes and an appendix. The entire document runs 371 pages.

Chapters I – III were substantially revised with the addition of new guidance on the selection of the most appropriate transfer pricing method, how to apply transactional profit methods (the transactional net margin method and the profit split method) and how to perform a comparability analysis. New Chapter III is devoted to comparability analysis – the "heart of the application of the arm's-length principle." (para. 1.6) It does not require for an exhaustive search of all possible sources of comparables and defines "reasonably reliable comparables" as the "most reliable comparables in the circumstances of the case, keeping in mind the limitations in the availability of information and compliance costs. New Chapter IX deals with the transfer pricing aspects of business restructurings.

The most significant change is the substitution of the hierarchy of transfer pricing methods with the principle of the "most appropriate method." (para. 2.2) Whether a profit-based method is the most appropriate method is determined by: the appropriateness of the method considered in view of the nature of the controlled transaction determined in particular through a functional analysis, the availability of reliable

information, and the degree of comparability between controlled and uncontrolled transactions.

### 2.3 The Arm's-Length Principle and Global Formulary Apportionment

The *Guidelines* state that the arm's-length principle is the international standard that OECD member countries have agreed to be used for determining transfer prices for tax purposes (page 23). Instead of defining this principle, the *Guidelines* simply state that it is set forth in Article 9 of the OECD Model Tax Convention, which reads:

Where conditions are made or imposed between the two enterprises in their commercial or financial relations which 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.

The *Guidelines* further state that by seeking to adjust profits by reference to the conditions which would have obtained between independent enterprises in comparable circumstances, the arm's length principle follows the approach of treating the members of an MNE group as operating as separate entities rather than as inseparable parts of a single unified business. Such separate entity approach focuses on the nature of the transactions between those members of a MNE group and on whether the conditions thereof differ from the conditions that would be obtained in comparable uncontrolled transactions. Such an analysis of the controlled and uncontrolled transactions, or the comparability analysis, is the critical part of the application of the principle.

Why have the OECD member countries adopted the arm's length principle? The *Guidelines* offer several reasons in paragraphs 1.8 to 1.9. The most important reason is "parity" or "neutrality" of tax treatment for members of MNE groups and independent enterprises. Another reason is that the principle has been found "to work effectively in the vast majority of cases", such as the purchase and sale of commodities and the lending of money where arm's length prices may readily be available. In cases where it is difficult to apply the principle (such as where MNE groups dealing in the integrated production of highly specialized goods, in unique intangibles, and/or in the provision of specialized services", the profit split method and other solutions exist to deal with such difficult cases.

While acknowledging that transfer pricing is not an exact science and there are practical difficulties in implementing the arm's length principle, the *Guidelines* maintain that the principle is "sound in theory since it provides the closest approximation of the workings of the open market", it "does generally produce appropriate levels of income between members of MNE groups, acceptable to tax administrations", and it "reflects the economic realities of the controlled taxpayer's particular facts and circumstances." (para. 1.14) A move away from the principle would "threaten the international consensus, thereby substantially increasing the risk of double taxation." (para. 1.15)

The global formulary apportionment is described in paragraph 1.17 as a method that “would allocate the global profits of an MNE group on a consolidated basis among the associated enterprises in different countries on the basis of a predetermined and mechanistic formula.” According to the *Guidelines*, the application of this method requires the determination of the taxable unit (i.e., which of the subsidiaries and branches of an MNE group are part of the global entity), the global profits and the formula to be used to allocate the global profits of the unit. The *Guidelines* reject this method as “the theoretical alternative” to the arm’s length principle for several reasons. (paras. 1.21 – 1.32) First, it is difficult to implement this method in a manner that both protects against double taxation and ensure single taxation for lack of international coordination and consensus on the predetermined formulae to be used and on the composition of the group in question. Second, the transition to a formulary apportionment system would present enormous political and administrative complexity and require a level of international cooperation that is unrealistic to expect in the field of international taxation. Third, there are significant difficulties in implementing a global formulary apportionment system in terms of exchange rate movement, intolerable compliance costs and data requirements, and the determination of sales and value of assets under different national accounting standards and currencies. More importantly, because the global formulary apportionment system would have the effect of taxing an MNE group on a consolidated basis and therefore abandon the separate entity approach, it would run contrast to the arm’s length principle, which recognizes each associated enterprise as a separate entity. The *Guidelines* also note that by disregarding intra-group transactions, the global formulary apportionment system would raise questions about the relevance of imposing withholding taxes on cross-border payments between group members and would render a number of provisions in the OECD Model Convention redundant.

## 2.4 Profit-Based Methods

As noted above, the *Guidelines* now give a higher profile to profit-based methods. More guidance on the use of profit-based methods and comparability are provided in Chapters II and III. Three new annexes provide a practical illustration of issues in relation to the application of transactional profit methods and an example of working capital adjustments to improve comparability.

“Profit arising from a controlled transaction can be a relevant indicator of whether the transaction was affected by conditions that differ from those that would have been made by independent enterprises in otherwise comparable circumstances.” (para. 2.57). Profit-based methods are considered to be consistent with Article 9 because they require a comparison between conditions (including prices, but not only prices) made or imposed between associated enterprises and those which would be made between independent enterprises and a determination of the profits which would have accrued at arm’s length. (para. 1.7) In other words, comparability is the key. The *Guidelines* adopt a pragmatic approach to applying the comparability requirement in cases where no comparable data is available. For

example, it is stated that “a transaction profit split method “might in appropriate circumstances be considered without comparable data, e.g., where the absence of comparable data is due to the presence of valuable, unique intangibles contributed by each party to the transaction.” (para. 2.109) Where comparable uncontrolled transactions of sufficient reliability are lacking to support the allocation of the combined profits, profit split can be based on internal data. (para. 2.141)

In applying the profit split method, the *Guidelines* allow the use of allocation keys based on assets/capital, costs and other factors such as sales, headcounts. As long as the allocation keys are not fixed or predetermined in the manner suggested under the formulary apportionment and account for the facts and circumstances of the case, dividing combined profit of a controlled group of enterprises according to the allocation keys is consistent with the arm’s length principle. (paras. 1.18 and 2.140) The *Guidelines* thus distinguish the formulary apportionment of profit under the global formulary apportionment and a case-by-case profit allocation according to a formula under the profit-based methods. The latter is used in mutual agreement procedures, advance pricing agreements or other bilateral or multilateral determination of profit split.

## 2.5 Disregarding Transactions

An important starting point for any transfer pricing analysis is to properly identify and characterize the controlled transaction under review. The *Guidelines* state that “MNEs are free to organize their business operations as they see fit” and “tax administrations do not have the right to dictate to an MNE how to design its structure or where to locate its business operations”. (para. 9.163) However, tax administrations have the right to determine the tax consequences of the structure put in place by an MNE and taxpayers’ transactions may be disregarded in “exceptional circumstances.” (para. 1.64 – 1.69)

One exceptional circumstance arises where the economic substance of a transaction differs from its form. “The economic substance of a transaction or arrangement is determined by examining all of the facts and circumstances, such as the economic and commercial context of the transaction or arrangement, its object and effect from a practical and business point of view, and the conduct of the parties, including the functions performed, assets used and risks assumed by them.” (para. 9.170) An example would be an investment in an associated enterprise in the form of interest-bearing debt when, at arm’s length, having regard to the economic circumstances of the borrowing company, the investment would not be expected to be structured in this way. (para. 1.65)

Another exceptional circumstance arises where the arrangement made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner and the actual structure practically impedes the tax administration from determining an appropriate transfer price. Paragraph 1.65 of the *Guidelines* gives the example of a sale under a long-term contract, for a lump sum payment, of unlimited entitlement to the intellectual property rights arising as a result of future research for the term of

the contract. It further states: “While in this case it may be proper to respect the transaction as a transfer of commercial property, it would nevertheless be appropriate for a tax administration to conform the terms of that transfer in their entirety (and not simply by reference to pricing) to those that might reasonably have been expected had the transfer of property been the subject of a transaction involving independent enterprises.”

The non-recognition of the actual/formal transactions in the exceptional circumstances described above is consistent with Article 9 on the ground that “the character of the transaction may derive from the relationship between the parties rather than be determined by normal commercial conditions and may have been structured by the taxpayer to avoid or minimize tax.” (para. 1.66) The *Guidelines* further state in paragraph 1.66 that:

*In such case, the totality of its terms would be the result of a condition that would not have been made if the parties had been engaged in arm’s length transactions. Article 9 would thus allow an adjustment of conditions to reflect those which the parties would have attained had the transaction been structured in accordance with the economic and commercial reality of parties transacting at arm’s length.*

It is important for tax administrations to determine what the underlying reality is behind a contractual arrangement because “contracts within an MNE could be quite easily altered, suspended, extended, or terminated according to the overall strategies of the MNE as a whole, and such alterations may even be made retroactively.” (para. 1.67)

## 2.6 Intangibles

Firm-specific intangibles are at the heart of transfer pricing. The OECD recognizes the fact that many key issues need to be addressed, such as the definition and scope of “marketing intangibles”, the identification and characterization of intangible transfers, the legal and economic ownership of intangibles, and the valuation of intangibles. The *Guidelines* do not address these issues. The OECD hopes to release a discussion draft of revised Chapters VI and VIII in 2013.

## 2.7 Business Restructurings

The notion of “business restructuring” is defined as “the cross-border redeployment by a multinational enterprise of functions, assets and/or risks.” (para. 9.1) It may involve cross-border transfers of valuable intangibles and/or the termination or substantial renegotiation of existing arrangements. The *Guidelines* deal with restructurings that primarily consist of internal reallocation of functions, assets and risks within an MNE. Paragraph 9.2 lists three common types of restructurings:

- Conversion of full-fledged distributors into limited-risk distributors or commissionaires for a foreign associated enterprise that may operate as a principal,
- Conversion of full-fledged manufacturers into contract-manufacturers or toll-manufacturers for a foreign associated enterprise that may operate as a principal,

- Transfer of intangible property rights to a central entity (e.g. a so-called “IP company”) within the group.

Four sets of transfer pricing issues are addressed in Chapter IX. One issue relates to the circumstances in which tax authorities may disregard the contractual allocation of risks between related parties. The *Guidelines* authorize the disregarding of contractual terms in cases where a contractual allocation of risks does not reflect economic reality, which can be determined on the basis of the parties’ conduct, whether the party formally bearing the risk has relatively more control over the risk and has the financial capacity to bear it. (paras. 9.12 – 9.33) In assessing whether independent enterprises would agree to the conditions of the transaction, tax administrations can look at whether alternative options are realistically available and whether there is commercial rationality of a restructuring as a whole. Since business restructuring often lead MNEs groups to implement global business models that are hardly ever found between independent enterprises, the *Guidelines* emphasize that what is being tested is whether the outcome (the arrangements adopted) accords with what would result from normal commercial behaviors of independent enterprises. (paras. 9.171 – 9.180)

A second question is whether arm’s length compensation should be paid for the restructuring transaction itself. This is a key question in business restructurings. The *Guidelines* confirm that the arm’s length principle does not require compensation for a mere decrease in the expectation of an entity’s future profits. Such decrease would not necessarily be compensated between independent parties at arm’s length. Profit potential is not an asset per se. However, compensation might be paid if the restructuring results in a transfer of valuable rights or other assets or a termination or renegotiation of existing arrangements which would be compensated between independent parties at arm’s length.

A third question is whether there should be any remuneration for post-restructuring arrangements. The *Guidelines* take the position that post-restructuring arrangements and similar arrangements structured as such from the beginning are treated the same for transfer pricing purposes. There is no reason to treat the transactions of entities that have been through a restructuring differently.

A final transfer pricing issue arising from restructuring is whether actual transactions undertaken should be recognized for tax purposes. The *Guidelines* recognize that fact that MNEs are free to organize their business operations as they see fit. A basic principle is that a tax administration’s examination of a controlled transaction ordinarily should be based on the transaction actually undertaken by the associated enterprises as it has been structured by them. As long as functions, assets and/or risks are actually transferred, the *Guidelines* state that it can be commercially rational for an MNE group to restructure in order to obtain tax savings. Having a tax motive does not of itself justify non-recognition (paras. 9.181 – 182) Furthermore, the *Guidelines* also state that the arm’s length standard does not require tax authorities to observe third parties engaging in similar transactions, as this will be rare, if at all possible, but the real question is what third parties would have agreed to as the arm’s length consideration in a similar situation.

### 3. Soft Law

#### 3.1 Guidelines are Guidelines

The *Guidelines* do not have the status of law. The OECD is not a law-making body. The *Guidelines* are not based on an agreement signed by OECD member countries and do not bind national tax administrations or taxpayers. They are only guidelines.

#### 3.2 Soft Law with Powerful Influence

The term “soft law” has no universally accepted definition. In the context of international taxation, it can be used to describe a quasi-legal instrument which does not have any legally binding force, but is intended to have a direct influence on the practice of states and taxpayers.<sup>1</sup> The *Guidelines* are clearly a type of soft law and represent, arguably, the most important source of information on transfer pricing.

Several reasons may explain the importance of the *Guidelines*. First, the *Guidelines* interpret the meaning of the arm’s length principle expressed in Article 9, which has been included in virtually every bilateral tax treaty. Therefore, reference to the *Guidelines* can be made through reference to OECD Commentary in treaty interpretation. In practice, the *Guidelines* may even be regarded as the extension of the Commentary. Recent developments in treaty interpretation confirm that not only the “existing” Commentary/*Guidelines* and “later” Commentary/*Guidelines* are considered relevant in interpreting the meaning of terms found in bilateral tax treaties.<sup>2</sup>

Moreover, the arm’s length principle articulated in the *Guidelines* underlies the domestic law of OECD member countries as well as non-member countries to a

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<sup>1</sup> Christians, *Hard Law and Soft Law in International Taxation*, 25 *Wisconsin International Law Journal* 2 (2007); For more general discussion, see Guzman/Meyer, *International Soft Law*, 2 *J. Legal Analysis* 171 (2010), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1353444](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1353444).

<sup>2</sup> See, for example, Ault, *The Role of the OECD Commentaries in the Interpretation of Tax Treaties*, *Intertax* 4 (1994), 144; Lang, *Later Commentaries of the OECD Committee on Fiscal Affairs not to affect the interpretation of previously concluded tax treaties*, 25 *Intertax* 1 (1997), 7; Sassville, *Court Decisions and the Commentary*, in Maisto (ed.), *Courts and Tax Treaty Law* (Amsterdam, 2007), 189 – 200; Vogel, *The Influence of the OECD Commentaries on Treaty Interpretation*, 54 *Bulletin for International Fiscal Documentation* 12 (2000), 614; Ward, *References by domestic courts to decisions of foreign courts in interpreting tax treaties*, in Maisto (ed.), *Courts and Tax Treaty Law*, Amsterdam (2007), 161 – 187; Ward et al., *The Interpretation of Income Tax Treaties with Particular Reference to the Commentaries on the OECD Model* (Amsterdam, 2005); For an interesting exchange of views on the role of the Commentaries, see Ward, *The Role of the Commentaries on the OECD Model in the Tax Treaty Interpretation Process*, 60 *Bulletin for Fiscal Documentation* 3 (2006), 97; Engelen, *Some Observations on the Legal Status of the Commentaries on the OECD Model*, 60 *Bulletin for Fiscal Documentation* 3 (2006), 205; Ellis, *The Role of the Commentaries on the OECD Model in the Tax Treaty Interpretation Process – Responses to David Ward*, 60 *Bulletin for International Fiscal Documentation* 3 (2006), 103.

greater or lesser degree of particularity.<sup>3</sup> In the United Kingdom, the *Guidelines* are explicitly referenced in the domestic law.<sup>4</sup> Tax administrations rely on the *Guidelines* in practice. This can be the case even when domestic tax law does not explicitly codify the arm's length principle. Some courts adopt a similar approach. For example, Canadian courts in the *GlaxoSmithKline* case<sup>5</sup> referred to the *Guidelines* in interpreting the predecessor of the Canadian transfer pricing rule (section 247 of the Canadian ITA) which required payments between related parties to be reasonable in the circumstances. In practice, taxpayers are not likely to challenge the quasi-binding nature of the *Guidelines* when the *Guidelines* are relied upon in tax planning.

For the reasons mentioned above, even though the *Guidelines* are of “soft law” in nature, they are arguably more important than any “hard law” on transfer pricing. The arm's length principle is arguably the only “universal” tax principle because of the influence of the *Guidelines*. The dominance of transfer pricing issue in cross-border trade and investment means that the application of the arm's length principle has significant implications for MNEs and national treasuries. It is virtually impossible to separate the issue of transfer pricing from the *Guidelines*.

### 3.3 Importance of Soft Law

In the face of economic globalization, political borders are becoming less and less relevant to MNEs, but remain fundamentally important to nation-states in setting tax policy and enforcing tax laws. The notion of sovereignty remains deeply rooted in tax law.<sup>6</sup> It is unlikely that nation states would agree to cede their tax sovereignty in order to create a supranational tax organization. It is also unlikely that nation states would enter into a multinational tax treaty, even though the OECD Model is the basis for the majority of the existing bilateral tax treaties.

In the meantime, as discussed below, the transfer pricing is a real issue. Any transfer pricing issue involves at least four parties, representing different interests: the two associated enterprises (Party A and Party B); the tax administration of the two countries (Country A and Country B) in which transfer pricing transactions are

<sup>3</sup> See, for example, section 247 The Income Tax Act, R.S.C. 1985 (5<sup>th</sup> Supp.) (the “Canadian ITA”) and Article 41 of the Enterprise Income Tax Law of the People's Republic of China, promulgated by the 5<sup>th</sup> Session of the 10<sup>th</sup> National People's Congress (16 March 2007).

<sup>4</sup> Sch. 28AA Paragraph. 2(1)(b)) incorporates Article 9 of the OECD Model and the Transfer Pricing Guidelines into UK transfer pricing legislation. For further explanation, see [http://www.hm-treasury.gov.uk/d/transfer\\_pricing\\_application\\_of\\_oecd\\_principles.pdf](http://www.hm-treasury.gov.uk/d/transfer_pricing_application_of_oecd_principles.pdf).

<sup>5</sup> 2008 TCC 324 (Tax Court of Canada); 2010 FCA 201 (Federal Court of Appeal). Leave to appeal to the Supreme Court of Canada was granted in March 2011. For a review of this case and other transfer pricing cases, see Roin, Transfer Pricing in the Courts: A Cross-Country Comparison, (in this volume).

<sup>6</sup> No area of the law is closer to the subject of sovereignty than taxation; Richard Bird, Taxing Electronic Commerce: A Revolution in the Making, C.D. Howe Institute Commentary no. 187 (Toronto, 2003), 15; Rosenbloom, Sovereignty and the Regulation of International Business in the Tax Area, 20 Canada-United States Law Journal (1994), 267 – 72, at 267; McLure, Globalization, Tax Rules and National Tax Sovereignty, 55 Bulletin for International Fiscal Documentation 8 (2001), 328 – 41, at 329.

conducted by Part A and Party B. The relationship between Country A and Party A, or between Country B and Party B, is governed by domestic law, the relationship between Country A and Country B is governed by a tax treaty. If a third party (Party C) is located in a third country (Country C), there is no legal instrument that governs the tax relationship of the three countries. There is no international law that compels any of the three countries to enter into bilateral tax treaties with one another. In the foreseeable future, nation states and MNEs will be looking to the OECD for practical guidance.

## 4. Hard Realities

There are challenges in applying international soft law on transfer pricing in a world full of hard economic and political realities. The international consensus on the basis of the arm's length principle is not without controversy. Transfer pricing is a real problem for national tax administrations and MNEs. The taxation of synergy rents that are unique to MNEs is far from satisfactory from a policy perspective. Soft law, even as powerful as the *Guidelines*, derives its real meaning through domestic law.

### 4.1 Interpretation of Article 9 is Controversial

The *Guidelines* maintain that the arm's length principle is the basis for Article 9(1) of the Model, which, in turn, mandates a separate entity approach to taxing members of MNE group. The *Guideline* also state that allocating profit according to the arm's price established after a comparability analysis and applying one of the transfer pricing methods is consistent with the arm's length principle and global formulary apportionment is not.

Some practitioners and scholars maintain that the interpretation of the arm's length principle in the *Guidelines* is not warranted by the wording of this provision.<sup>7</sup> Article 9 does not require *pricing*. It addresses the allocation of *profit* in situations where the commercial and financial relations between associated enterprises differ from those that would exist between independent enterprises. It is not limited to transactions, or revenue and expenses, or more generally, pricing. Price and profit are obviously not the same and should not be confused with one another; although an arm's length price is one means of satisfying an arm's length principle, it is not the only means. Article 9 speaks of "conditions" between associated enterprises in their

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<sup>7</sup> Avi-Yonah, Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation, 2 *World Tax J.* 3 (2010); Avi-Yonah/Clausing/Durst, Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split, 9 *Fla. Tax Rev.* (2009) 497; Li, Reform Proposal: Uniform Source Withholding Tax and Global Profit Split, *International Taxation in the Age of Electronic Commerce: A comparative study* (Toronto, 2003) ch.13; Li, Global Profit Split: An Evolutionary Approach to International Income Allocation, 50 *Canadian Tax J.* 3 (2002), 823; Schön, International Tax Coordination for a Second-Best World, 1 *World Tax J.* (2009), 67, at 71 – 84; For an overview, see Roin, Can the Income Tax Be Saved? The Promises and Pitfalls of Adopting Worldwide Formulary Apportionment, 61 *Tax L. Rev.* (2008), 169, at 172 – 74.

commercial or financial relations which differ from those that would be made between independent enterprises and allows the adjustment of any “profits” that would, if not for those “conditions,” have accrued to one of the associated enterprises, but, by reason of those “conditions,” have not so accrued. Transactions may be a useful basis for assessing the “conditions” or “relationships,” but arguably they are not the only one. The arm’s length principle, liberally interpreted, is capable of encompassing formulary apportionment. The argument is that formulary apportionment should be viewed as a part of a continuum of methods, ranging from CUP to predetermined formulas.<sup>8</sup>

## 4.2 Transfer Pricing is a Real Problem

Transfer pricing is a real problem in terms of the role of MNEs in international trade and investment, artificial shifting of income and tax avoidance, and double taxation and compliance burdens on MNEs. About half of all international trade in goods and services is by MNEs and more than half of MNE international trade is internal.<sup>9</sup> In recent years, most global businesses are undertaking some form of business restructuring, involving changes to everything from strategic planning to supply chain. “Every business change brings transfer pricing implications.”<sup>10</sup> As such, transfer pricing is a real issue.

For national tax authorities, transfer pricing is a huge issue because MNEs can shift profit between countries through setting prices for intra-group transactions and moving profit to subsidiaries in low-tax jurisdictions in order to generate “stateless income”.<sup>11</sup> Although income shifting can be achieved through earnings stripping,

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<sup>8</sup> There is reported agreement among tax experts that the arm’s length principle and formulary apportionment should not be viewed as polar extremes; rather, they should be viewed as a part of a continuum of methods, ranging from CUPs to predetermined formulas. See Arnold/McDonnell, Report on the Invitational Conference on Transfer Pricing: The Allocation of Income and Expenses Among Countries, 41 Canadian Tax J. (1993), 899, at 907.

<sup>9</sup> Zeile (2003), Trade in Goods Within Multinational Companies: Survey-Based Data and Findings for the United States of America, paper prepared for OECD Committee on Industry and Business Environment Working Party on Statistics, Session on Globalisation Paris, France, November 3 – 4, 2003.

<sup>10</sup> 2010 Global Transfer Pricing Survey: Addressing the Challenges of Globalization, Ernst & Young, available at [http://www.ey.com/Publication/vwLUAssets/EY\\_Global\\_Transfer\\_Pricing\\_Survey\\_2010/\\$FILE/Global%20Transfer%20Pricing%20Studie%20EY%202011.pdf](http://www.ey.com/Publication/vwLUAssets/EY_Global_Transfer_Pricing_Survey_2010/$FILE/Global%20Transfer%20Pricing%20Studie%20EY%202011.pdf).

<sup>11</sup> See for example, Kleinbard, Stateless Income, USC Center in Law, Economics and Organization Research Paper No.C11-1, available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1791769](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1791769) (2011); Joint Committee on Taxation, Present Law and Background Related to Possible Income Shifting and Transfer Pricing (JCX-37-10), July 20, 2010; Brauner, Value in the Eye of the Beholder: The Valuation of Intangibles for Transfer Pricing Purposes, 28 Va. Tax Rev. (2008), 79; Clausing, Multinational Firm Tax Avoidance and Tax Policy, 57 Nat’l. Tax J. (2009), 703; Desai, New Foundations for Taxing Multinational Corporations, University of Chicago Federal Tax Conference, (November 15, 2003); Grubert, Intangible Income, Inter-company Transactions, Income Shifting, and The Choice of Location, 56 Nat’l. Tax J. (2003) 221; Sullivan, Transfer Pricing Costs U.S. At Least \$28 Billion, Tax Notes (March 22, 2010), 1078.

international tax arbitrage, and other techniques, transfer pricing strategies are particularly effective because of the central role of high value unique intangible assets as profit drivers for MNEs. Income shifting is on the rise in recent years. High-tax countries are naturally worried about the erosion of the tax base and the threat to the integrity and fairness of the tax system. Some are considering legislative changes and/or intensifying transfer pricing audit and litigation.<sup>12</sup> Developing countries are also increasingly concerned with income shifting.<sup>13</sup> For example, China, the largest recipient of FDI and considered by some as a major victim of transfer pricing has enacted transfer pricing rules and increased resources to transfer pricing audit and enforcement.<sup>14</sup>

For MNEs, transfer pricing is “the biggest tax issue”.<sup>15</sup> Transfer pricing is a double-edged sword. MNEs use transfer pricing strategies to achieve minimal global effective tax rate. On the other hand, complying with the transfer pricing laws of multiple jurisdictions can be costly. Because transfer pricing is an “art,” not “science” there can be significant uncertainties and potential for double taxation.

### 4.3 Synergy Rents May Not Be Taxed Anywhere

The term “synergy rents” is used to describe the economic value derived by MNEs from the synergy effects that are unique to MNEs. Theories of MNEs emphasize that MNEs arise in part due to organizational and internalization advantages relative to purely domestic firms.<sup>16</sup> Typically, synergy effects can be achieved only by related parties which jointly could benefit from the different characteristics of synergy.<sup>17</sup> MNEs make greater profit by directing the allocation of productive resources instead of leaving resource allocation decisions to the market, thereby benefiting from the economy of scale, savings on transaction costs, and exploitation of assets which because of their special characteristics cannot be fully exploited in the market. In simple terms, synergy rents exist because of the struc-

<sup>12</sup> 2010 Global Transfer Pricing Survey, *supra* (note 10).

<sup>13</sup> Silberztein, Transfer pricing: A challenge for developing countries, OECD Observer (No 276-277 December 2009 – January 2010), available at [http://www.oecdobserver.org/news/print-page.php/aid/3131/Transfer\\_pricing:\\_A\\_challenge\\_for\\_developing\\_countries.html](http://www.oecdobserver.org/news/print-page.php/aid/3131/Transfer_pricing:_A_challenge_for_developing_countries.html); UTTAD, Transfer Pricing, (1999) available at <http://www.unctad.org/en/docs/psiteiid11v1.en.pdf>.

<sup>14</sup> Li/Paisley, Transfer Pricing Audits in China (2007) (“Between 1996 and 2000, 60 percent to 70 percent of foreign companies reported losses. The Chinese Government estimates that 60 percent of the reported losses by these companies is attributable to transfer pricing maneuvers.” The tax havens of Hong Kong, British Virgin Islands, the Caymans and Samoa accounted for 50.18 percent of investment into China in 2005, 55.70 percent in 2006 and 61.95 percent in the first quarter of 2007. Much of this is Chinese capital on a “round trip” via the tax havens to exploit China’s tax concessions to foreign enterprises. The related parties have every incentive to use transfer pricing to shift profits out of China).

<sup>15</sup> 2010 Global Transfer Pricing Survey, *supra* (note 10).

<sup>16</sup> Coase, The Nature of the Firm, , 4 *Economica* (1937), 368 – 405; Clausing/Avi-Yonah (2007), at 8.

<sup>17</sup> Bakker, Transfer Pricing and Business Restructuring: Streamlining All the Way (Amsterdam, 2011), at 4.

ture of MNEs and the relationship between members of the MNE group.<sup>18</sup> By nature, such rents disappear when parties are not related.

MNEs have the freedom to structure their businesses under general corporate law and tax law. When global business is structured in the form of permanent establishments or wholly-owned subsidiaries, such freedom is complete. In cases where a subsidiary has minority shareholders, corporate law may impose some limitations on the fairness of the dealings between the subsidiary and its related parties.<sup>19</sup> Transfer prices are used by MNEs to achieve efficiency, including tax efficiency. Business restructurings, including “offshoring intangibles”, often involve sourcing synergy rents away from high-tax countries to holding entities in tax havens. In many cases, these tax haven entities are repositories of contractual relationships and carry on very little economic activities.<sup>20</sup> Recent international tax cases demonstrate this point: *GlaxoSmithKline*,<sup>21</sup> *Roche*,<sup>22</sup> *DSG*,<sup>23</sup> *UPS*,<sup>24</sup> as well as treaty shopping cases such as *Indofood*,<sup>25</sup> *Prevost Car*,<sup>26</sup> *Wood and Holden*,<sup>27</sup> and *MIL Investments*.<sup>28</sup>

It is the concern over the allocation of synergy rents that gives rise to different interpretations of Article 9. Proponents of global formulary apportionment have little confidence in the OECD authorized transfer pricing methods. Although the *Guidelines* have gradually shifted towards a more profit-based approach, relying on profit split as the main method, they have not authorized any specific method for allocating residual value. Adherence to the strictly interpreted arm’s length standard (i.e., comparability and transactional pricing approach) means that it is difficult, if possible at all, for tax administrations to challenge the allocation of synergy rents to entities in low-tax jurisdictions because of the absence of any arm’s length comparables. Advocates of the global formulary apportionment method suggest the use of formulary apportionment based on factors such as payroll, tangible assets, and sales so that synergy rents are taxed in jurisdictions where the economic value is derived.<sup>29</sup>

<sup>18</sup> Vann, *Taxing International Business Income: Hard-Boiled Wonderland and the End of the World*, *World Tax J.* (2010) 291, at 293 – 4.

<sup>19</sup> E.g., *Ford Motor Company of Canada Ltd. v. Ontario Municipal Employees Retirement Board* (Ont.C.A.), 263 D.L.R. (4th) 450, 79 O.R. (3d) 81.

<sup>20</sup> Palan/Murphy/Chavagneux, *Tax havens: how globalization really works* (2009), at 21.

<sup>21</sup> *Supra* (note 5).

<sup>22</sup> [2088]AATA 639 (2008).

<sup>23</sup> [2009] UKFTT 31 (TC).

<sup>24</sup> *United Parcel Service of America, Inc. v. Commissioner of Internal Revenue*, 254 F.3d 1014 (11th Cir. 06/20/2001).

<sup>25</sup> *Indofood International Finance Ltd v. JP Morgan Chase Bank NA* [2006] E.W.C.A. Civ. 158, S.T.L. 1195. For an analysis of this case and other treaty shopping cases, see Li, *Beneficial Owner in Tax Treaties: Judicial Interpretation and Case for Clarity*, in *Tax Polymath: A Life in International Taxation*, Baker and Bobbett (eds.), (Amsterdam, 2010).

<sup>26</sup> *Prévost Car Inc. v. Canada*, 2008 3080 (TCC), aff’d by FCA, 2009 DTC 5053.

<sup>27</sup> *Wood and Another v. Holden* [2006] EWCA Civ 26.

<sup>28</sup> *MIL (Investments) SA v. The Queen*, 2006 DTC 3307 (TCC), affirmed by Federal Court of Appeal, 2007 D.T.C. 5437, [2007] 4 C.T.C. 235.

<sup>29</sup> *Avi-Yonah* (2009), *supra* (note 7).

#### 4.4 The *Guidelines* Take Effect via National Law

Tax obligations are created only under national tax laws. The tax relationship between nation states is coordinated largely through tax treaties. Tax treaties are relieving in nature in that they generally allocate the tax jurisdiction between the two contracting states by limiting the tax claims of the source country and requiring the residence country to provide relief for source country tax. The effective meaning of the arm's length principle is defined by domestic law. The reality is that the *Guidelines*, as influential as they are, because "real" through national law.

Divergent national transfer pricing laws may treat the same transaction differently in different countries, resulting in either double taxation or non-taxation. National transfer pricing rules, while united at the level of endorsing the arm's length principle, diverge at various levels of technical specificity and enforcement. Take the example of Canada and the United States. The transfer pricing rules in the United States (section 482 of the Internal Revenue Code and the Regulations) are perhaps the most sophisticated and at the frontier of international development. Canada did not have any specific transfer pricing legislation until 1998 until section 247 of the ITA was enacted. Section 482 of the IRC is supplemented by detailed regulations, while s.247 of the ITA is not. In Canada, practical guidance is provided in the form of an information circular.<sup>30</sup> There is a body of transfer pricing case law in United States<sup>31</sup> and the first transfer pricing case was heard by the Tax Court of Canada in 2008.<sup>32</sup> These divergent national laws converge under the influence of the *Guidelines*, but they are not "harmonized".

In some cases, the *Guidelines* are ahead of national laws in dealing with transfer pricing issues. Because national transfer pricing laws rarely incorporate the OECD *Guidelines*, some key concepts in the *Guidelines* have no counterparts in domestic law. For example, paragraphs 1.25 to 1.27 of the *Guidelines* provide for a tax administration to compare the purported allocation of risk with the economic substance of a transaction in order to determine "the conditions each party would expect in arm's length dealings". In doing so, they are to assume that parties are generally "allocated a greater share of those risks over which they have relatively more control". Section 247 of the ITA provides no explicit reference to this approach. It is unlikely that the Canada Revenue Agency is able to rely on the *Guidelines* to disregard the structure adopted by a taxpayer in a situation where a taxpayer entered into a contract research and development with a related party that does not have the internal technical capability with which to judge the results of the research and development. In Canada, the economic substance doctrine is not recognized and the Supreme Court of Canada makes it clear that the government cannot recharacterize taxpayer's transactions

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<sup>30</sup> Canada Revenue Agency, Information Circular, 87-2R "International Transfer Pricing", September 27, 1999, which cancelled and replaced Information Circular 87-2, dated February 27, 1987.

<sup>31</sup> For a list of significant transfer pricing decisions in the United States, see <http://www.ustransferpricing.com/decisions.html>.

<sup>32</sup> 2008TCC324.

according to the economic realities or economic substance.<sup>33</sup> The gap between the *Guidelines* and domestic law highlights the point that revising the *Guidelines* is inadequate in addressing transfer pricing problems.

## 5. Pragmatic Suggestions

The current political realities provide no reason to believe that a supra national organization outside the EU will be entrusted with taxing powers. Even though the existing bilateral tax treaties are based on the OECD Model, the totality of these treaties does not create a multilateral tax treaty. There is no existing international organization that comes even close to the OECD in terms of influence and clout in international tax policy. The soft-law making by the OECD is thus very important in the current realities mentioned above. Tax issues arising from global business transactions cannot be adequately addressed by national tax laws and national tax authorities. International coordination and cooperation are crucial and can be accomplished through the leadership of OECD. The following suggestions are intended to “harden” the soft law in order to ensure a meaningful allocation of tax base arising from transfer pricing transactions, especially those generating synergy rents.

### 5.1 More “Soft law”

The soft law making by the OECD has evolved over the past several decades. In the area of transfer pricing, the soft law aspect has been quite subtle. The explicit objectives of the *Guidelines* are primarily “diagnostic” in order to assist tax administrations and MNEs in “operationalizing” the arm’s length principle. The *Guidelines* are, in essence, a “how to” guidebook on transfer pricing and are not intended to theorize or rationalize the arm’s length principle. Most of the pages are devoted to providing guidance on conducting comparability analysis, applying the most appropriate transfer pricing methods, resolving transfer pricing disputes, documentation, and practical examples. It is perhaps time for the OECD’s soft law making role be performed more publicly and more directly.

The *Guidelines* can have more direct influence on national law if the *Guidelines* emulate the approach in the OECD Commentary by suggesting “sample” provisions for adoption in domestic law. These samples are particularly helpful to national law makers in cases where the issues are new and the “big” picture is better seen at an international level. Examples are intangibles, business restructuring, and global income-shifting. National legislatures may not have the necessary information or expertise in crafting rules. Or if some countries enact rules on their own, these rules may not very effective or be perceived as violating the international consensus (past

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<sup>33</sup> For further discussion, see Arnold, Reflections on the Relationship Between Statutory Interpretation and Tax Avoidance, in Erlichman (ed.), *Tax Avoidance in Canada: The General Anti-Avoidance Rule* (Toronto, 2002), 41 – 81, at 67; Arnold/Li, Justice Bowman on Substance over Form, *Special Supp. 58 Canadian Tax J.* (2010) 127; Li, *Economic Substance: Drawing the Line Between Legitimate Tax Minimization and Abusive Tax Avoidance*, 54 *Canadian Tax J.* 1 (2006), 23.

examples of US move to profit-based methods). More specifically, the OECD may wish to recommend its member countries to ensure that key concepts are incorporated into domestic laws.<sup>34</sup> The OECD may also create a common framework for resolving transfer pricing conflicts. A precedent for that is the Tax Information Exchange Agreement.<sup>35</sup> This may be helpful in the areas advance pricing arrangements, mutual agreement procedures, or cost contribution arrangements. A more aggressive approach would be to have the Council of OECD to recommend member countries to adopt certain rules. This was done in the case of tax deductibility of cost of bribes.<sup>36</sup> Without being perceived as introducing on national tax sovereignty, the OECD may want to suggest the codification of “economic substance” principle in domestic law.

In the process of making more effective soft law, the OECD should make the consultation process more “democratic” to include the views representing public policy and public interest. Thus far, the public consultation process has been dominated by advocates for MNEs. For example, the OECD has thus heard from “business commentators” and other private sector representatives on the intangibles project, but few academic or public sector representatives can be found on the lists.<sup>37</sup>

## 5.2 More Pragmatic

To the OECD’s credit, the 2010 *Guidelines* show more flexibility and more open mindedness towards non-traditional methods of transfer pricing and more willingness to tackle emerging issues. More is certainly needed.

With respect to the interpretation of Article 9, the *Guidelines* clearly recognize that this provision is about the determination of the profits made by associated enterprises which would have accrued at arm’s length, in order to determine the quantum of any re-writing of accounts (e.g., para. 1.7). The objectives of this redetermination are to secure the appropriate tax base in each jurisdiction and to avoid double taxa-

<sup>34</sup> See Wilkie (in this volume).

<sup>35</sup> For the background and list of TIEAs, see [http://www.oecd.org/document/7/0,3746,en\\_2649\\_33767\\_38312839\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/7/0,3746,en_2649_33767_38312839_1_1_1_1,00.html)

<sup>36</sup> See OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions (1997), available at [http://www.oecd.org/document/21/0,2340,en\\_2649\\_34855\\_2017813\\_1\\_1\\_1\\_37447,00.html](http://www.oecd.org/document/21/0,2340,en_2649_34855_2017813_1_1_1_37447,00.html); Recommendation on the Tax Deductibility of Bribes to Foreign Public Officials (1996), available at [http://www.oecd.org/document/46/0,2340,en\\_2649\\_34551\\_2048174\\_119672\\_1\\_1\\_37447,00.html](http://www.oecd.org/document/46/0,2340,en_2649_34551_2048174_119672_1_1_37447,00.html).

<sup>37</sup> See OECD meets with business commentators on the scoping of its project on the transfer pricing aspects of intangibles, available at [http://www.oecd.org/document/3/0,3746,en\\_2649\\_33753\\_46376835\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/3/0,3746,en_2649_33753_46376835_1_1_1_1,00.html); a list of public comments received by the OECD on the scoping of a new project on the Transfer Pricing Aspects of Intangibles see [http://www.oecd.org/document/5/0,3746,en\\_2649\\_33753\\_46030661\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/5/0,3746,en_2649_33753_46030661_1_1_1_1,00.html); Working Party No.6s Special Session on the Transfer Pricing Aspects of Intangibles: Meeting with Private Sector Representatives on the Valuation of Intangibles for Transfer Pricing Purposes” 21-23 March 2011 at the OECD Conference Centre in Paris, For a list of public comments received by the OECD on the scoping of a new project on the Transfer Pricing Aspects of Intangibles see [http://www.oecd.org/document/5/0,3746,en\\_2649\\_33753\\_46030661\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/5/0,3746,en_2649_33753_46030661_1_1_1_1,00.html)

tion (para. 1.15). In other words, the arm's length standard is a means to achieving the end, not the end itself. The arm's length standard can be met even when there are no comparables. For example, according to paragraph 1.11 "the mere fact that a transaction may not be found between independent parties does not of itself mean that it is not arm's length." Paragraph 40 states that in cases where no comparables can be identified, the taxpayer can demonstrate a method accurately reflects the arm's length principle by reference to relevant market and financial data (including the internal data of the taxpayer). The adoption of the most appropriate method is another example of moving away from the traditional strict methodologies.

The next natural phase of the evolution in interpreting Article 9 might be the official recognition of formulary apportionment. The current *Guidelines* list several reasons for rejecting the formulary apportionment as an alternative to the arm's length principle. Instead of pitching the formulary apportionment method against the arm's length principle, it may be more constructive if the OECD were to consider formulary apportionment as an alternative method or possibly the most appropriate method for allocating synergy rent. The OECD could also consider the formulary apportionment as an allocation key under the residual profit split method. Since there are no comparables to be found, the current *Guidelines* allow allocation be made by reference to internal data under the profit split method. In principle, the formulary apportionment and the OECD authorized profit split method are not substantially different. The only difference is probably the choice of "allocation keys" or "formulae factors". This difference can be resolved if the OECD modifies its position towards the global formulary apportionment and work on "practical" solutions. If the OECD could accept formulary apportionment for allocating synergy rent, the existing methodologies can continue to apply to transactions where comparables can be found.

There are changes in the political landscape in favour of the formulary apportionment idea. The recently proposed CCCTB by the EU recommends a formulary apportionment of the common tax base.<sup>38</sup> The Obama administration is considering legislative changes to discourage income shifting to tax havens.<sup>39</sup> Developing and transitional countries may adopt safe harbours based on formulary apportionment in transfer pricing practices.<sup>40</sup> In fact, the State Administration of Taxation in China has

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<sup>38</sup> In March, the European Commission published a proposal for a Common Consolidated Corporate Tax Base (CCCTB), available at [http://ec.europa.eu/taxation\\_customs/resources/documents/taxation/company\\_tax/common\\_tax\\_base/com\\_2011\\_121\\_en.pdf](http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/common_tax_base/com_2011_121_en.pdf).

<sup>39</sup> In its 2011 and 2012 proposed budget, the Obama administration include provisions that would tax "excess returns" earned by offshore affiliates due to transfers of intangible assets (such as through cost-sharing arrangements) and limit deductions for reinsurance premiums paid by US companies to foreign affiliates to no more than 50 percent of the total direct insurance premiums received by the US taxpayer per line of business.

<sup>40</sup> Deloitte, An overview of international Safe Harbor provisions and the need for Safe Harbor in India, (2009), available at <http://www.tpweek.com/assets/pdf/Final-Safe-Harbour22Oct11-55AM.pdf>; The OECD's Committee on Fiscal Affairs has recently launched a new project on the administrative aspects of transfer pricing, including safe harbours, see [http://www.oecd.org/document/15/0,3746,en\\_2649\\_33753\\_47265231\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/15/0,3746,en_2649_33753_47265231_1_1_1_1,00.html).

explicitly requires taxpayers to provide information on the corporate group.<sup>41</sup> These changes may persuade the OECD to reconsider its hostile position towards formula apportionment.

### 5.3 More Anti-Avoidance Focused

The *Guidelines* allude to the use of transfer pricing as a strategy to artificially shift income and make some references to tax avoidance (1.2, 1.11, 1.23, 4.66, 4.115, and 4.121) and artificial income shifting (para. 1.23 and 4.116). For example, paragraph 4.115 contains the following statement in the context of “safe harbours”:

Enterprises may have an incentive to modify their transfer prices in order to shift taxable income to other jurisdictions. This may also possibly induce tax avoidance, to the extent that artificial arrangements are entered into for the purpose of exploiting the safe harbor provisions.

In the case of assessing cost contribution arrangements (CCAs), tax administrations are authorized to disregard the CCA in its entirety in circumstances that indicate an attempt to abuse the rules governing CCAs. (para. 8.30). There is also an explicit authorization of the non-recognition of transactions in paragraphs 1.64 – 1.69 for the purposes of making transfer pricing adjustments and a reference to the Commentary on Article 1 of the OECD Model Tax Convention for a discussion of the relationship between domestic anti-abuse rules and treaties. (paras 9.5, 22 and 22.1)

Arguably, however, more can be done. Transfer pricing rules are drafted as anti-avoidance rules under domestic laws. For example, the charging provision in section 247 of the ITA is drafted in a similar manner like the general anti-avoidance rule in section 245 of the ITA with the notable exception of saving clause. The transfer pricing rule applies whether or not the transaction constitutes an “abuse” or “misuse”, whereas the GAAR applies only when an avoidance transaction results in an abuse or misuse. Similarly, the transfer pricing rule under Article 41 of the Chinese Enter-

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<sup>41</sup> The Chinese adaptation of the arm’s length principle seems to be guided by the same philosophy. The arm’s length principle is a means to an end, not the end by itself. China clearly declares in Art. 41 of the EIT Law and in Art. 9 of the tax treaties that the arm’s length principle is the guiding principle in transfer pricing adjustments. At the same time, the Implementing Regulations for the EIT Law state that, in addition to the CUP, resale method, cost plus method, TNMM and profit split, there are “other reasonable methods” consistent with the arm’s length principle. A taxpayer’s profit can be determined on the basis of a reasonable proportion of the overall profit of the enterprise group if the taxpayer has failed to provide full and accurate information on transfer pricing. The contemporaneous documentation must provide information that is relevant to the determination of the reasonable profit share of the global profit of the enterprise group, including the organizational and equity ownership structure of the corporate group, the consolidated financial statement for the corporate group, and, in selecting profit split method, an explanation of the contributions by the taxpayer in China to the overall profit or residual profit of the group. During transfer pricing audits, taxpayers are increasingly being asked to provide information and data from offshore related parties. “Evidently, the reason for such requests is largely based on the belief that related parties should apportion their profit based on certain formulae.”, American Chamber of Commerce, White Paper – Taxation (2004), available at <http://www.amcham-china.org.cn/amcham/show/content.php?Id=360>.

prise Income Tax Law is one of seven anti-avoidance rules found in Chapter Six of the legislation. A more explicit anti-avoidance oriented approach in the *Guidelines* will provide tax administrations with more guidance in implementing national rules.

In its ongoing work on intangibles, the OECD is advised to consider the prevention of tax avoidance as an important objective. MNEs enjoy the freedom of contract and the freedom of organizing their global business in any manner to minimize their effective tax rate. The transfer pricing laws should not acquiesce or aid MNEs in shifting income to low-tax countries where little, if any, economic value is derived. A change in the OECD's stance on tax avoidance would signal the offensiveness of income shifting and provide a platform for national governments to coordinate their domestic laws. The existing *Guidelines* work quite well in cases where comparable arm's length transactions exist and the allocation of the tax base in a manner to avoid double taxation remains the key policy objective. In cases where no comparable arm's length transactions exist, the prevention of tax avoidance should be one of the key policy objectives.

## 6. Conclusions

This short critique makes several points about the *Guidelines*. The 2010 version of the *Guidelines* are more pragmatic in terms of the choice of transfer pricing methods and provide timely guidance on topical issues, such as business restructurings. The *Guidelines* are soft law on international transfer pricing and have the quasi-law nature in terms of actual impact on tax administrations and MNEs. As powerful as the *Guidelines* are, they need to be translated into hard law through domestic legislation. The political and economic realities pose challenges to the operation of soft law, but also create more opportunities for the *Guidelines* to play a greater role in transfer pricing. The OECD is recommended to take a more pragmatic and outcome-oriented approach in applying Article 9 of the OECD Model and to focus more on income shifting as an objective in revising the *Guidelines*.

# The OECD Approach to Transfer Pricing: A Critical Assessment and Proposal

Hagen Luckhaupt, Michael Overesch and Ulrich Schreiber

## Abstract

*The OECD approach to assessing transfer prices relies on the arm's length principle. The intra-firm transaction is compared to a market transaction. However, this comparison is conceptually flawed because market prices for intra-firm transactions rarely exist. As a consequence, the identification of comparable transactions requires data that are often unavailable. The lack of relevant data provides considerable room for maneuvering. A survey of the empirical literature confirms that the OECD approach is associated with profit-shifting opportunities and, in particular, with high double taxation risks and assessment costs. We suggest a decrease in the complexity of current transfer pricing rules. We propose a transaction-based apportionment method that combines a fixed standard profit margin with apportionment of residual profits. Reliance on a small set of easily observable and measurable factors to assess transfer prices reduces compliance and enforcement costs as well as double taxation risks.*

## 1. Introduction

International business taxation faces the problem of allocating the taxable profits of a multinational enterprise (MNE) to jurisdictions where subsidiaries and permanent establishments are located. The OECD approach to international profit allocation is based on separate entity accounting and the transfer prices of intra-firm transactions that take place within MNEs. Recently, the OECD amended the transfer pricing guidelines (OECD-TPG) and extended their scope of application to permanent establishments (OECD, 2010a, 2010b).

Transfer prices for intra-firm transactions are determined according to the arm's length principle. The essence of the OECD approach is a comparison between the transfer prices of a controlled transaction and the market prices of an uncontrolled transaction. However, direct price comparability fails if firms possess specific assets (e.g., specific knowledge based on R&D as well as production or marketing know-how) that are not traded in markets. Then the assessment of transfer prices must rely on some other type of market-related data. This creates room for discretion. Given some leeway in the assessment of transfer prices for intra-firm transactions, MNEs have the opportunity to shift profits to low-tax jurisdictions via transfer prices. Moreover, firms can allocate internal resources in terms of investments to low-tax jurisdictions to improve profit shifting opportunities.

A survey of the empirical literature supports the hypothesis that MNEs successfully shift profits to low-tax countries. Empirical evidence also indicates that profit

shifting impacts resource allocation within MNEs. In high-tax jurisdictions, profit shifting reduces the tax revenues. Nevertheless, profit shifting cushions the negative effects of high profit tax rates on internationally mobile capital investments. A high-tax jurisdiction might wish to tolerate a certain amount of international profit shifting to support its attractiveness as an investment location and to preserve comparatively higher profit tax rates. In particular, larger countries with many firms operating nationally might consider such tax policies attractive and thus might tolerate transfer pricing rules that give firms some room to maneuver.

The OECD-TPG makes considerable efforts to reduce tax planning opportunities for MNEs. Because market prices for internal transactions are rarely observed, the OECD-TPG suggests other criteria. In effect, these additional rules are designed to allocate the MNE's total profit from internal transactions according to performed economic functions. However, fair allocation of the total profit of an integrated firm according to economic functions or involved factors of production is impossible. As a result, the OECD approach is economically undetermined. Despite its theoretical weakness, the main advantage of the OECD approach is its time-honored international acceptance. The OECD rules play an important guiding role for all involved parties.

The result of the effort to assess transfer prices may be perceived as fair in terms of the international distribution of the tax base. However, inter-jurisdictional fairness comes at a price. The key issue for the OECD approach is comparability, but identification of comparable transactions requires data that are often hard to collect or insufficient (see, e.g., Durst and Culbertson, 2003; Vidal, 2009). Moreover, the transfer pricing methods permit vast discretionary powers. Although the OECD rules are designed to safeguard comparability by considering a transaction's individual facts and circumstances, the result is a pseudo-accuracy that allows for considerable leeway. Tax authorities may follow different approaches and thus expose MNEs to the risk of double taxation. Moreover, both compliance costs for MNEs and enforcement costs for the tax authorities are presumably high. These costs are obviously driven by the increasing complexity of integrated firms and the documentation requirements that tax authorities impose on MNEs to keep track of internal transactions.

From this perspective, recent amendments to the OECD-TPG may not be a step in the right direction. The new guidelines have abolished priority rules for the different methods of assessing a transfer price and thus give MNEs and tax authorities even more discretion. More importantly, the amended rules indicate a greater effort to identify business functions, involved assets and business risks assumed in a specific internal transaction. A new Chapter III, "Comparability Analysis," has been introduced. It now accounts for 20 of the OECD-TPG's 80 pages. These amendments may be rightfully perceived as an attempt to improve the fairness of the international tax base allocation. However, this attempt is likely accompanied by increasing compliance and administrative costs as well as increased double taxation risks. Tax authorities may have increasingly different opinions concerning the appropriate method and its application.

Therefore, we focus on reducing comparability requirements and relying on a small set of easily observable and measurable factors to apportion profits and assess transfer prices. The starting point is a standardized transaction-based apportionment method, which combines a fixed standard profit margin with the apportionment of residual profits to points of sales. Decreasing the complexity of the current transfer pricing rules is expected to significantly reduce compliance and enforcement costs and double taxation risks. In greater detail, we suggest a standard mark-up on some factor, e.g., primary costs incurred when producing and selling goods or services. Regarding the residual profit, apportionment factors that are not associated with vast discretionary powers are chosen. In a basic version of our proposal, a standardized profit mark-up is attributed to production locations, whereas any residual profit is allocated to the points of sales. Most importantly, we build on separate entity accounting and suggest maintaining the assessment of transfer prices for intra-firm transactions.

Our suggestions relate to proposals that address the shortcomings of the prevailing transfer pricing rules. Avi-Yonah, Clausing and Durst (2009) propose a modified formula apportionment of an MNE's combined profit by allocating a fixed return on incurred expenses to each subsidiary and distributing the MNE's residual profit according to a subsidiary's share in the MNE's worldwide sales. Kaminski (2001) suggests a fixed surplus on direct costs if OECD transfer pricing methods fail. Brem (2004) and Russo (2005) also propose some form of residual profit split, whereas Li (2002), Herzig, Teschke and Joisten (2010) and Avi-Yonah (2010) suggest merging aspects of unitary taxation with separate entity accounting. Furthermore, we consider early work by the League of Nations (1933) and a proposal from the US Treasury (1988). We also assess arguments put forward by Musgrave (1972), Higinbotham et al. (1987) and Oestreicher (2000), who suggest a sort of activity-based approach to profit distribution.

The remainder of the paper is organized as follows: Section 2 presents empirical evidence regarding international profit shifting and evaluates the consequences for both MNEs and tax jurisdictions. Section 3 addresses concerns with the OECD rules and Section 4 discusses possible avenues of further developments of the OECD rules. Section 5 concludes.

## **2. Economic Effects of the OECD Approach to Transfer Pricing**

### **2.1 Tax Planning Opportunities**

Firms investing in several countries with different profit tax rates may engage in international tax arbitrage. MNEs might exploit tax rate differences through their choice of investment location and the financial structuring of investments. Given their investment and financing decisions, MNEs can also shift the tax base to low-tax locations through transfer pricing. Several empirical studies have investigated whether MNEs manipulate transfer prices to reallocate taxable profits and reduce tax payments. These studies confirm theoretical expectations that MNEs use trans-

fer prices to shift taxable income. [Table 1](#) in the Appendix provides an overview of the empirical evidence.

### 2.1.1 Profit Shifting

Some studies refer to the reported profits of multinational subsidiaries. These studies use the variation in tax rates across countries and reveal a significant inverse relationship between reported profits and the local tax level. Grubert and Mutti (1991) and Hines and Rice (1994) find a negative association between reported profits and the local tax level of US outbound FDI. A recent study by Huizinga and Laeven (2008) suggests that an European multinational subsidiary discloses earnings before interest and taxes (EBIT) that are one percent smaller if the host-country statutory tax rate is one percentage point higher. Because the analysis relies on the EBIT, financial decisions as the most important alternative profit-shifting channel cannot explain this effect. Therefore, the results suggest the importance of transfer pricing.

Additional evidence supporting this view is provided by studies that focus on transfer pricing as a specific profit-shifting channel of MNEs. Jacob (1996) finds that the amount of intra-firm sales has a negative impact on worldwide tax payments and a positive effect on the response of reported profitability to tax rates. Price data enable a more direct analysis of transfer pricing. An early study by Bernard and Weiner (1990) analyzes the price data of US oil imports but does not find any statistically significant tax effects. The arm's length principle can be easily applied to intra-firm transfers of oil products because prices are available for various qualities and specifications, a fact that may explain these findings. Other studies that consider several products find significant tax effects. Swenson (2001) estimates how prices of US imports would respond to taxes. Clausing (2003) compares the settled prices of US intra-firm trade with those charged to uncontrolled parties and identifies significant tax effects on the product-level price data of intra-firm sales, whereas no tax response is found if sales to unrelated parties are considered. The results reveal that transfer prices decrease by 1.8 to 2.0 percent relative to non-intra-firm transactions if the tax rate in the host country of a delivering subsidiary rises by one percentage point. Bernard, Jensen and Schott (2006) qualitatively confirm the tax elasticity of transfer prices.

Other studies analyze the data for the amount of intra-firm sales. Apart from price effects, these data entirely reflect volume effects. By using aggregated firm data, Clausing (2001, 2006) confirms the significant impact of taxes on intra-firm trade flows between US firms and their subsidiaries. Using a cross-sectional analysis of US firm-level data, Grubert (2003) shows that taxes influence the ratio of intra-firm transactions to total sales of foreign companies. These results suggest that MNEs respond to taxes with transfer prices and the volume of intra-firm transactions.

Finally, empirical evidence indicates that profit-shifting opportunities are closely related to firm-specific transactions. Firm-specific transactions are likely if expenses for R&D or advertising are high. An early investigation by Harris (1993) finds that MNEs with "flexible expenses" (e.g., R&D and advertising) shift more profits than

companies with other expenses. Grubert (2003) finds that the profit-shifting activities of MNEs are driven by their use of intangible assets.

In a recent study, Overesch and Schreiber (2010) analyze the impact of asset specificity on the tax elasticity of intra-firm sales. The study considers R&D expenditures as a proxy for the specificity of a firm's assets. The results suggest that the tax sensitivity of intra-firm transactions increases with rising R&D intensity in the firm's industry. For example, if a firm from the pharmaceutical industry with comparatively high R&D intensity is considered, a local tax rate that is one percentage point higher is associated with a reduction in intra-group transactions of about 3.7 percent. By contrast, the number of intra-group sales at a firm with a very low R&D intensity, such as a company in the petroleum industry, is unaffected by taxes. These findings suggest that profit shifting via transfer prices depends on the volume of firm-specific transactions for which identifying comparable market transactions is particularly difficult.

### **2.1.2 Effects of Profit Shifting on the Decision-Making of MNEs**

The profit-shifting opportunities associated with separate entity accounting stimulate the creation of a taxable nexus in low-tax countries. Firms have a strong incentive to relocate economic functions that, under the OECD approach, trigger the assignment of taxable profits. Relocated economic functions should be mobile if relocation costs are small and productivity is unaffected by location-specific characteristics. In particular, service operations and intangible property are candidates for base-shifting activities. Excepting their mobility, business services and intangible property are firm-specific. Consequently, comparability might fail, and application of the arm's length principle is difficult in these particular cases. Thus, a firm may find two benefits from base shifting. First, exit taxes upon the relocation of service centers or intangible property are difficult to assess (Schreiber, 2009a). In addition, after relocation, transactions associated with the relocated assets or economic functions are similarly difficult to assess.

Some empirical studies have investigated the effects of separate entity accounting on the allocation of specific economic functions within MNEs. Hines and Rice (1994), Grubert and Slemrod (1998) and Desai, Foley and Hines (2006) provide evidence that US MNEs are likely to invest at typical tax havens if the number of firm-specific transactions is supposed to be comparatively high. Dischinger and Riedel (2011) analyze the distribution of intangible assets among European MNE and find that smaller statutory tax rates of a subsidiary relative to all other affiliates of the MNE are related to a larger probability of holding intangible assets and a larger number of intangible assets. Karkinsky and Riedel (2009) focus on the allocation of patents within European MNEs. In agreement with base shifting arguments, they find that the host country's tax rate and the tax rate differential within the group have negative effects on the number of patents filed by a subsidiary. Comparing the tax elasticities of location choices across industries, Overesch and Wamser (2009) show that German subsidiaries performing R&D activities are highly tax-sensitive.

Profit-shifting opportunities associated with transfer pricing not only stimulate base shifting activities but also reduce the relevance of the host country's tax rate for

location choices and investment decisions. If at least some of the expected profits can be shifted, a combination of the host country's tax rate and the tax rates imposed at the MNE's other locations determines investment decisions. Reducing the effective tax level triggers additional investments at high-tax locations. MNEs operating in a high-tax country have lower capital costs in comparison to domestic competitors. Consequently, profit-shifting opportunities stimulate international M&A and encourage domestic firms to go multinational.

Few empirical studies address the real investment effects associated with profit shifting activities in high-tax countries. Grubert (2003) finds that US MNEs, whose profit-shifting opportunities are higher than average, choose locations with either extremely low or extremely high tax levels. The preference for high-tax countries supports the view that, due to profit-shifting opportunities, MNEs can benefit from competitive advantages. Using data on German outbound FDI, Overesch and Wamser (2009) find that host country taxation is less responsible for the location choices of more internationalized companies. Taking into account the enhanced profit-shifting opportunities at more internationalized companies, these results also confirm the adverse effects of profit shifting on the relevance of host-country taxes.

Overesch and Schreiber (2010) analyze how responsive the investment decisions of multinational subsidiaries are to host-country taxes. Although it confirms a general negative impact of host-country taxes, the study shows that the profit-shifting opportunities significantly reduce the negative tax effect. The results suggest that, for some industries with comparatively high amounts of firm-specific transactions, the local statutory tax rate's negative effect on investments is completely eliminated. Additional analyses reveal that an adverse tax effect can only be observed if the subsidiary has the opportunity to save taxes by shifting profits because another MNE location has a lower tax rate.

If part of the local profit is shifted away, this portion is effectively taxed at the tax rate imposed at another MNE location. Thus, the respective tax level should also affect the net present value of investments. Overesch (2009) provides evidence that investments of foreign subsidiaries in high-tax Germany are negatively affected by the tax rates of their parent companies. Becker and Riedel (2008) also show that the tax rate differential between the host country and the parent company's home country impacts investment levels at subsidiaries located in several European countries.

## 2.2 Transfer-Pricing Disputes

In general, empirical studies suggest that MNEs manipulate transfer prices to shift taxable profits across countries. Tax elasticities of transfer prices seem to be particularly strong if transactions are firm-specific. To some extent, however, the striking magnitudes of the estimated tax sensitivities contradict survey evidence from tax practitioners concerning tax compliance costs and tax risks. [Table 2](#) in the Appendix provides an overview of the empirical evidence.

### 2.2.1 Double Taxation Risk

Surveys among tax practitioners suggest that transfer pricing is associated with high risk of supplementary tax payments and tax penalties (cf., e.g., Wunder, 2009; Ernst & Young, 2007, 2009). For instance, about 40 percent out of 850 tax managers surveyed in an international study by Ernst & Young (2007) assert that transfer pricing is the most important tax compliance issue in their company. Tax authorities are also aware that transfer prices for firm-specific transactions are a means to manipulate profits. Tax audits place particular emphasis on service transactions and intangibles (Ernst & Young, 2007, 2009).

Jost, Pfaffermayr and Winner (2010) provide an empirical analysis of the Ernst & Young (2007) survey data. Their findings suggest that the largest tax risk is positively related to transfer pricing-specific determinants, such as the materiality of intangible goods transactions. In a recent study, Beuselinck, Deloof and Vanstraelen (2009) revisit the tax impact on the reported profitability at subsidiaries of European MNEs. While this analysis also confirms a negative effect of the host-country tax rate on the return on sales of a subsidiary, the results also suggest that subsidiary profitability only responds to tax incentives if transfer pricing issues are weakly reinforced.

To summarize, the empirical evidence supports the view that firms use transfer pricing as a means to shift profits across locations and that they are also interested in getting transfer prices reasonable right to protect themselves from penalties. The opportunities of profit shifting and tax compliance risk seem to be maximized if firm-specific transactions are considered.

### 2.2.2 Tax Compliance and Tax Enforcement Costs

Transfer prices simulate market coordination within a decentralized firm. The seminal work of Schmalenbach (1947) and Hirshleifer (1956) established that a transfer price based on marginal cost guarantees that the decentralized firm produces the same quantity of goods that the centralized firm does. Nevertheless, in practice, firms use total cost to determine transfer prices. Conflicting goals are the reason: Marginal costs may be relevant for the sole purpose of internal coordination, but they distort profit allocation within the decentralized firm.<sup>1</sup> Taxes add another goal for transfer pricing: Transfer prices may be the appropriate instrument to shift taxable profits from high-taxed to low-taxed business units. If firms trade off tax effects for non-tax effects, taxes create additional costs for both tax compliance and internal coordination.

If transfer pricing is used for internal coordination and financial accounting purposes, the OECD approach does not require a separate system to determine the taxable income of each affiliate of an MNE. An international survey by Ernst & Young (2003) reveals that approximately 80 percent of the interviewed managers at MNEs use the same transfer price for tax and management purposes, but they give priority

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<sup>1</sup> Ewert and Wagenhofer (2008: p. 579-580) point at conflicting goals and information asymmetries. They conclude that in practice transfer prices are the result of a compromise between different functions of transfer pricing.

to management issues. This survey evidence suggests that managers neglect adverse tax effects, which stands in contrast to empirical findings on profit shifting, suggesting that MNEs do not neglect tax effects.

Whether firms use a single set of transfer prices for tax and non-tax purposes to avoid the additional costs of running the accounting system is unclear. Firms may also use two separate sets of transfer prices because the profit split function for tax purposes conflicts with other functions of transfer pricing. In that case, taxes would not interfere with internal coordination and would solely affect tax revenue distribution in the jurisdictions involved. Nevertheless, if an MNE has the opportunity to shift profits, internal resource allocation in terms of investment decisions may still be tax-driven.

Given two sets of transfer prices, the OECD approach may result in significantly higher costs of internal accounting when compared to other possible apportionment systems. In particular, the focus on single transactions leads to a strong correlation between internal accounting costs and the number of intra-firm transactions. Moreover, parallel tax and non-tax transfer prices could suggest a bookkeeping game, which would be acceptable to neither managers nor tax administrators. Nevertheless, the incentive to implement two sets of transfer prices may increase if transfer pricing rules become more tax-specific.

A particular source of costs arises from documentation obligations. To enforce the arm's length principle, MNEs are obliged to report the methods and data used to value intra-firm transactions. Over the last few decades, formal documentation obligations have significantly increased.<sup>2</sup> We do not have precise information on the amount incurred in compliance costs, but some survey data give an idea of the striking magnitude of compliance costs associated with the OECD approach to transfer pricing.

A survey among US firms documents approximately 140 percent higher tax compliance costs if firms have foreign activities (Slemrod and Venkatesh, 2002: p. 29). Moreover, a survey among European firms suggests that transfer-pricing documentations are associated with a rise in tax compliance costs of about 135 to 178 percent (European Communities, 2004: p. 41). Although compliance costs are generally a function of the number of involved tax authorities, the OECD's focus on transactions means that the number and complexity of intra-firm transactions significantly influence compliance costs. This is particularly disappointing because the number of firm-specific transactions for which transfer prices are difficult to assess increases with a firm's increasing international activities.

### 2.3 Implications of the Empirical Findings

The empirical evidence supports the view that firm-specific transactions are a particular problem with the OECD approach. Basically, the difficulty of applying the

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<sup>2</sup> The increasing relevance of formal documentation obligations is, for example, documented by Bartelsman and Beetsma (2003). They provide a list of OECD countries which have introduced formal transfer-pricing documentation rules.

arm's length principle to firm-specific transactions has two important effects: (i) profit-shifting opportunities and (ii) costs of transfer-pricing disputes.

High-tax countries lose significant amounts of tax revenues due to profit-shifting. Competition for mobile profits requires undercutting of corporate tax rates and, as a consequence, a reduction of overall tax revenues. At first glance, an effective restriction on profit-shifting opportunities seems to be in the interest of high-tax countries. On closer inspection, however, the effect of restricting profit shifting is less clear. The empirical evidence discussed in Section 2.1 points toward the adverse effects of profit-shifting opportunities on the tax elasticity of real investment decisions. From a high-tax country's perspective, the host-country tax rate becomes less important for investment decisions, and tax rate cuts of competing countries can result in a lower cost of capital in high-tax countries. Consequently, profit-shifting opportunities reduce tax competition for real investment projects. Peralta, Whauty and van Ypersele (2006) show that countries can strategically use the strictness of anti-tax avoidance rules in international tax competition to prevent significant tax rate cuts.

The seminal paper by Keen (2001) shows that tax revenues can benefit from discriminatory corporate taxation if the mobility of the tax bases differs across domestic companies and MNEs. If we suppose that domestic firms are less mobile than MNEs, profit-shifting loopholes for MNEs are associated with higher overall tax revenues. Tax competition exerts less pressure on tax rates than the absence of discriminatory taxation. Hong and Smart (2010) also suggest that an increase in income shifting allows a government of a small open economy to increase its tax rate.<sup>3</sup>

Nevertheless, location-specific rents can be taxed without negative consequences for both tax revenue and capital relocations. Baldwin and Krugman (2004) and Borck and Pflueger (2006) argue that the taxation of local rents from agglomerations does not distort investment decisions. Consequently, profit shifting is not in the interest of a country that offers significant agglomeration advantages or other location-specific rents.

Some arguments support profit-shifting opportunities, whereas others oppose them. Having transfer pricing rules that can be applied with some flexibility may be in a country's interest. If this is true, the focus of amendments should not be on abolishing profit-shifting possibilities completely. Instead, the focus should be on compliance and enforcement costs and double taxation risks. Costs have seemingly increased over the last decade due to the increasing complexity of internal transactions. Complexity leads to increased discretion in applying transfer pricing rules, which in turn increases double taxation risks. Tax compliance and enforcement costs for transfer pricing, as well as double taxation risks, are positively correlated with an economy's internationalization process. Therefore, we argue that the reduction of risks and costs is the most important issue.

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<sup>3</sup> The positive effect of discriminatory taxation on tax revenues, however, does not hold if discrimination is very high and mobile tax bases are effectively untaxed (Janeba and Peters, 1999) or if capital investment is endogenous (Janeba and Smart, 2003).

### 3. OECD Transfer Pricing Guidelines Revisited

#### 3.1 General Assessment

The starting point for the OECD approach is the legal fiction that members of an MNE group can be considered as separate entities rather than inseparable parts of a single unified business. Profits for each MNE entity are determined by separate entity accounting. Within this framework, intra-firm transactions are treated in the same way as market transactions. Consequently, intra-firm transactions are supposed to be at arm's length. The OECD Model Tax Convention establishes the arm's length principle as the general rule to assess transfer prices (Art. 9 Para. 1 OECD Model Tax Convention). Dealing at arm's length means that each party is obliged to transact with related parties as if they were unrelated parties. Accordingly, conditions made or imposed between associated parties in their commercial relationships should not differ from those for independent parties (OECD-TPG, 1.3). Although transfer pricing methods differ in scope and detail, the key assumption is the comparability of controlled transactions with uncontrolled transactions.

The idea of comparability neglects the essence of an integrated firm. Acting as an economic entity means the exploitation of competitive advantages. In the case of an internal transaction, the firm has rejected market coordination and has decided to rely on hierarchy as a means to coordinate transactions instead (Coase, 1937; Williamson, 1985). The concept of comparability implies that another firm facing the same economic circumstances would use market coordination. However, given good economic reasons for internal coordination, all firms facing the same circumstances would reject market coordination. From a theoretical point of view, under these circumstances, market prices of comparable uncontrolled transactions do not exist. Against this background, the OECD-TPG takes a misleading position when stating that "(...) the arm's length principle is sound in theory since it provides the closest approximation of the working of open market in cases where property (...) is transferred or services are rendered between associated enterprises" (OECD-TPG, 1.14).

The OECD-TPG refers to five "comparability factors," which are the characteristics of the property or services transferred, the functions performed by the parties, the contractual terms, the economic circumstances of the parties, and the business strategies pursued by the parties (OECD-TPG, 1.36). Of these five comparability factors, "functional analysis" is particularly important because it is based on the idea that transfer prices should reflect the functions performed, the assets used and the risks assumed (OECD-TPG, 1.42 – 1.46). At first glance, the assertion that business units that perform significant functions use certain assets and assume considerable risks should be appropriately awarded seems plausible. However, from an economic perspective, the functional analysis is flawed.

Decentralized and integrated firms realize synergies (e.g., by reducing production costs or by sharing know-how) and usually possess firm-specific assets (e.g., specific knowledge based on R&D as well as production or marketing know-how) that are not traded on markets and earn firm-specific economic rents. In principle, we

lack any economic theory to allocate the total profit of a highly integrated value-generating process to single stages of the value added chain (Ewert and Wagenhofer, 2008: p. 576). A comparison with an uncontrolled transaction fails if a firm-specific combination of input factors determines the profit margin. In addition, the greater efficiency typically realized within integrated firms can, by assumption, not be recognized if transfer prices are derived from a comparison with uncontrolled transactions. To summarize, any assignment of profits to a specific function or a certain stage of an integrated value creation process is conceptually impossible. Thus, the OECD-TPG admits that “(...) transfer pricing is not an exact science but does require the exercise of judgment” (OECD-TPG, 1.13).

In the absence of a clear-cut economic theory, another kind of reasoning must underlie the arm’s length principle. The OECD-TPG explicitly states that the arm’s length principle produces “(...) appropriate levels of income between members of MNE groups, acceptable to tax administrations” (OECD-TPG, 1.14). Accordingly, the OECD-TPG can be best perceived as a set of rules designed to produce a fair allocation of the tax base to the countries involved. Against the background of inter-jurisdictional fairness, the OECD approach is supported by its time-honored international acceptance (Schön, 2010: p. 230 – 231). The arm’s length principle and the OECD-TPG are widely accepted because they generate a profit distribution that is perceived as reasonable and fair. From this perspective, the OECD-TPG translates the idea of inter-jurisdictional fairness into a comparison of intra-firm transactions with uncontrolled market transactions. The arm’s length principle seems to constitute an objective benchmark that is likely to moderate transfer pricing disputes.

Assessment of transfer prices by comparison with data from uncontrolled transactions implies that only two transaction parties are involved, irrespective of the possible complexity of the value added chain. The OECD-TPG prescribes five transfer pricing methods (OECD-TPG, Chapter II): the comparable uncontrolled price method (CUPM), the resale price method (RPM), the cost plus method (CPM), the transactional net margin method (TNMM) and the transaction-based profit split method (TPSM).

The apportionment of an MNE’s profit depends on the transfer-pricing method applied. CUPM, which best represents the arm’s length principle, neglects the competitive advantages of an MNE and thus fails to reflect an economic rent in the transfer price. RPM, CPM and TNMM allocate economic rents on an all-or-nothing basis: Profit margins regarded at arm’s length are attributed to one transaction party, and an additional profit (which reflects the economic rent) is fully attributed to the other transaction partner. TPSM divides economic rents among all transaction partners based on to the distribution of economic functions and according to allocation keys.

Nonetheless, assessment of transfer prices by comparison with data of uncontrolled transactions could be a cost-efficient solution. Because only two transaction parties are involved, tax authorities need only monitor data from these two parties, irrespective of the possible complexity of the value added chain. The set of applicable transfer-pricing methods structures the assessment process. Such a structure might help to cut compliance and enforcement costs and to reduce double taxation

risks. However, the requirement for a detailed comparability analysis may also counteract the OECD-TPG's cost-reducing capability.

### 3.2 The Lack of Comparability

The lack of an economic theory that could guide intra-firm profit allocation is the main reason for the well-known problems with assessing transfer prices in practice. If, for theoretical reasons, the comparability of intra-firm transactions to market transactions fails, data availability is naturally the most challenging problem. Finding adequate and reliable information for a comparable situation is often difficult (e.g., Durst and Culbertson, 2003; Vidal, 2009).<sup>4</sup> Databases may contain huge amounts of data, but this by no means implies that these data are relevant. For instance, financial data often refer to firms rather than to single transactions. Moreover, for some industries, the available data are not representative (Durst and Culbertson, 2003).

According to the OECD-TPG, transactions are deemed comparable if the economically relevant characteristics of an intra-firm transaction are sufficiently comparable to transactions between unrelated parties (OECD-TPG, 1.33). Ideally, none of the differences between the controlled and uncontrolled transactions materially affects the economic outcome of the underlying transaction. All transfer pricing methods, with the exception of CUPM, refer to indirect comparisons. To address comparability, gross and net margins (RPM, CPM and TNMM) and profit distribution (TPSM) have to be assessed.

To control for comparability, the OECD-TPG recommends a comparability analysis. For this purpose, a long list of terms and conditions of the respective transaction is considered. To perform a comparability analysis, the OECD-TPG suggests a typical procedure based on the analysis of functions and risk-taking, which reflects the idea that the functions performed can be traced back to certain locations (OECD-TPG, Chapter III). These functions and the corresponding risk-taking then have to be compensated. The OECD-TPG provides some examples of functions that enterprises can perform, such as design, manufacturing, R&D and distribution (OECD-TPG, 1.43). Although functional analysis takes various details of a transaction into account, the existence and scope of a function may be difficult to assess. In particular, objective measurement of a function's value is a challenging task.

Functions that are carried out by the involved enterprises should be determined by the allocation of the respective risks (OECD-TPG, 1.47). Consequently, a detailed analysis of the risk assumed by the transaction parties is included in the comparability analysis. At first glance, risks in terms of capital losses or forgone profits should be considered because in the case of an uncontrolled transaction, these risks would be reflected in the price. Moreover, given the difficulties of identifying functions, assumed risks may be used as a proxy for functions that are hard to

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<sup>4</sup> Vidal (2009: p. 519) points at the importance of sufficient data and shows for the case *GlaxoSmithKline Inc. vs. The Queen* 2008 that "good comparables are scarce or absent (...)" because "(...) uniqueness and market imperfections are the heart of the economic profit made by multinationals".

observe. Risk-taking can hint at unobservable, hidden intangible assets (Schön, 2009: p. 113).

In some cases, data from the capital market may be used to measure firm-specific risks. However, the identification and measurement of transactional risks reveals a problem: Observed market prices for assumed risks usually reflect the total risk of the firm. The market risk associated with a company's shares reflects all of the investment and financing decisions of the respective company. Although market prices for risk-taking may be observable, the total risk premium can hardly be allocated to single intra-firm transactions. As a result, referring to agreements between related parties to assess risks affords room for discretion.

While the discretion in a comparability analysis may be small in the case of CUPM, the comparability analysis becomes very complex if other methods are applied. Regarding TNMM, for instance, the selection of the net profit indicator should incorporate what the OECD-TPG calls the strengths and weaknesses of the various possible indicators (OECD-TPG, 2.76). If the TPSM is applied, the usual methods of splitting up the profits are contribution analysis or residual analysis (OECD-TPG, 2.118). For these analyses, the OECD-TPG suggests including most of the specific terms and conditions from the involved transaction parties into the comparability analysis.

To summarize, the basic difficulty of the OECD approach to transfer pricing is the lack of data for a direct comparison between controlled and uncontrolled transactions. The OECD-TPG tries to cope with the data problem by accounting for and adjusting to many transaction characteristics related to business functions and risks. However, application of the concept of functions and risk-taking to the profit-sharing process can only be heuristic. This is particularly true if the outcome of bargaining between independent enterprises is modeled by a simulation, as proposed in cases that lack data on comparable transactions (OECD-TPG, 2.122). Because identification of an economically "correct" transfer price is impossible, we draw the conclusion that considering all of the transaction-specific characteristics only results in pseudo-accuracy in transfer-pricing.

Nevertheless, consideration of all of the specific terms and conditions of a certain transaction to safeguard comparability may be necessary to ensure international acceptance. However, inter-jurisdictional fairness obviously comes at a price. Relevant information is rare or asymmetrically distributed across taxpayers and tax authorities. Internal transactions may be very complex, and the measurement problems associated with this complexity are high. The pseudo-accuracy of rules that try to obtain comparability by considering and adjusting to a long list of transaction characteristics entails high compliance and administrative costs. Moreover, pseudo-accuracy can potentially increase the risk of double taxation.

### **3.3 Discretionary Power in Transfer Pricing**

According to the OECD-TPG, transaction-based determination of an appropriate transfer price is the most precise way to determine profits (OECD-TPG, 3.9). The selection of an appropriate method must consider the respective strengths and weak-

nesses of all transfer price methods. Specifically, a method's appropriateness is determined by a functional analysis, the availability of reliable information and the degree of comparability between controlled and uncontrolled transactions (OECD-TPG, 2.2). Because comparability is the overall problem, the choice of methods is guided by the distribution of reliable information across transaction partners. Thus, the lack of explicit priority rules for the five different methods to assess transfer prices seems appropriate. Nevertheless, the absence of an explicit priority rule creates room for discretion. Because differences between controlled and uncontrolled transactions are often difficult to assess, tax administrations may apply different methods to determine the transfer price for the same transaction.

If price data on a comparable transaction between third-parties is available, CUPM is applied (OECD-TPG, 2.13). The OECD-TPG states that CUPM is a particularly reliable method because CUPM offers a direct comparison between the intra-group transfer price and the price charged for the same transaction performed between third parties (OECD-TPG, 2.18). The direct comparison is obviously associated with low costs and small discretionary powers. However, if no direct comparison between a controlled transaction and an uncontrolled transaction is possible, the scope of comparability changes to other criteria, such as gross margins. The differences of the compared transactions are supposed to exert a smaller material effect on margins than on prices (OECD-TPG, 2.23).

Therefore, the OECD-TPG suggests employing the resale price method (RPM) or the cost plus method (CPM) to determine an arm's length price (OECD-TPG, 2.3). The transactional net margin method (TNMM) is closely related to both RPM and CPM (OECD-TPG, 2.58). TNMM focuses on net profit indicators, whereas RPM and CPM consider gross margins. Net profit indicators may be less responsive to functional differences between controlled and uncontrolled transactions (OECD-TPG, 2.62). The three methods share a common feature: margins in a controlled transaction are assessed via comparison with the respective margins for an uncontrolled comparable transaction.

CPM, RPM and TNMM account only for information from one transaction party. Employing a small but reliable set of information seems to be a good strategy to cope with the complexity of internal transactions. For instance, RPM is applied if activities in the sales department are insignificant and easily observed, but the production process is complex. By contrast, if costs can be easily computed and the reseller substantially contributes to the product's value, then CPM is selected. Choosing one of these methods allows abstraction from information that is difficult to find or unavailable. Nevertheless, the assessment of the remunerations and margins of firm-specific transactions can be highly controversial. A simple example might help to clarify the application conditions of these transfer pricing methods.

**Example 1:** Assume three associated enterprises A, B and C located in three different tax jurisdictions. A delivers semi-finished products to B (transaction 1). B delivers finished products to C (transaction 2). Finally, C sells these products to customers.

Transfer prices are separately determined for the two intra-firm transactions. Functions and risk-taking determine the appropriate transfer pricing method. If A and C perform only simple functions and do not take much risks, the transfer price of transaction 1 is assessed by applying CPM and the transfer price of transaction 2 is based on RPM.

If functions of A or C significantly differ from comparable firms, TNMM could be the appropriate method of determining transfer prices in the case of transaction 1 or 2, respectively. Then, for instance, the return to assets of the comparable companies could be employed as allocation key to assess transfer prices. In any case, only information on A and C is considered. Yet, the function and risk analyses might entail considerable discretion.

A one-sided approach to determine transfer prices is inappropriate if each party of a transaction makes valuable and unique contributions and if both parties perform a multitude of functions. When transactions are highly integrated, the OECD-TPG refers to the TPSM (OECD-TPG, 2.109). With intra-firm transactions closely linked, an appropriate transfer price can only be determined if transactions from integrated processes are combined (OECD-TPG, 3.9). Independent parties share the total profit of integrated processes in accordance with their individual contributions. Total profit from a controlled transaction is identified and divided among the parties involved. Profits should be distributed in relation to profits that unrelated enterprises would expect in comparable transactions (OECD-TPG, 2.108).

The usual methods for dividing profits are contribution analysis and residual analysis (OECD-TPG, 2.118). Contribution analysis splits up the combined profits according to a controlled transaction based on the allocation of functions and risks (OECD-TPG, 2.119), whereas residual analysis divides the combined profits into two stages. First, each engaged party receives an arm's length remuneration for its non-unique contributions in relation to the controlled transaction in which it is engaged. This remuneration can be determined by applying CUPM, RPM, CPM or TNMM (OECD-TPG, 2.121). Second, any remaining residual profit is allocated among the engaged parties based on an analysis of the facts and circumstances of the controlled transaction. In practice, the division of combined profits is generally achieved by allocation keys (OECD-TPG, 2.134).

**Example 2:** As in Example 1, assume three associated enterprises A, B and C. Unlike Example 1, suppose that A and B produce goods by using a highly integrated manufacturing process. Moreover, suppose that A and B employ considerable firm-specific know-how.

Transactions between A and B are closely linked. Therefore, the transfer price of transaction 1 cannot be determined applying a one-sided method, and TPSM has to be employed. At first stage, A and B receive remunerations for their non-unique contributions (applying, e.g., CPM or TNMM). At second stage, the residual profit is split up by using one or more allocation keys. Manufacturing expenditures could be employed as an allocation key to assign the profits of the controlled transaction to the enterprises A and B. It could also be argued that the firm-specific know-how has to

be mirrored by the apportionment factors. Accordingly, both the choice and measurement of apportionment keys give rise to vast discretion.

The possibility of choosing one of the five methods allows consideration of the availability of relevant information. This may help firms avoid costs, but a search for the appropriate method entails additional costs. Similarly, when using one-sided methods, determining a transaction's gross or net margins using a comparability analysis may help reduce the details of a transaction that must be considered and thereby reduce assessment costs. Nevertheless, the search for appropriate data may be associated with high assessment costs. In addition, in the case of TPSM, the choice of allocation keys provides considerable room for discretion, which has the potential to increase assessment costs in a transfer pricing dispute.<sup>5</sup> Nonetheless, double taxation risks and compliance and enforcement costs may be particularly high if transactions are highly integrated and firm-specific assets are involved.

To summarize, the assignment of profits to transactions and transaction parties affords considerable discretion. High compliance and enforcement costs, profit-shifting and double taxation risks are the consequences. We conclude that the consideration of too many firm-specific characteristics for a transaction is the main shortcoming of the OECD approach to transfer pricing.

## **4. Amendments of the OECD Approach to Transfer Pricing**

### **4.1 Decreasing Complexity and Discretionary Powers**

Comparability, particularly based on an analysis of functions and risk-taking, is the key to the OECD approach to transfer pricing but is also its Achilles' heel. The approach lacks a standard of comparison for functions and risk-taking as well as a clear measurement concept. When comparable market transactions are difficult to find and assessment of transfer prices is a matter of broad discretion, profit-shifting opportunities increase. Firms have an incentive to structure intra-firm transactions tax-efficiently by contractual arrangement. Moreover, the likelihood of transfer pricing disputes rises with the difficulty of finding appropriate comparable transactions. High double taxation risks and high compliance and enforcement costs then have to be expected. Therefore, our focus is on simplifications that are likely to reduce the complexities in transfer pricing. Any concrete definition of transfer pricing rules must balance the fiscal consequences for the involved countries, compliance and enforcement costs, double taxation risk and behavioral responses of the firms. The OECD approach seems to give priority to inter-jurisdictional fairness

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<sup>5</sup> In general, asset-based allocation keys should be used when a strong correlation between tangible or intangible assets or capital employed and the creation of value of the controlled transaction is given. An allocation based on the expenses is supposed to be appropriate if there is a strong correlation between relative expenses incurred and relative value added. Cost-based allocation keys are suggested because they have the advantage of simplicity, but it is supposed that a strong correlation between relative expenses and relative value does often not exist (OECD-TPG, 2.138 et seq.).

issues. We are aware of the trade-off with inter-jurisdictional fairness. Consideration of a country's negotiations between costs, tax-planning opportunities and the perceived fairness of tax revenue allocation is beyond the scope of this paper.

Some critics feel that the OECD approach fails to account for economic integration, and thus, they propose to substitute the separate entity accounting system for formula apportionment of the firm's consolidated profits (McLure and Weiner, 2000). Our suggestions are not so radical. We argue that compliance and enforcement costs, the risk of double taxation, and tax planning opportunities would be significantly reduced if less controversial and less mobile apportionment criteria were found. Apportionment factors should be easily observable by tax authorities, and the measurement should be as clear as possible. Moreover, tax planning incentives should be low due to significant relocation costs. We build on the overwhelming international acceptance of separate entity accounting but propose to reduce the complexity of current transfer pricing rules. Reduced complexity decreases the likelihood of transfer pricing disputes and double taxation risks but also decreases the likelihood of profit-shifting opportunities. In addition, reduced complexity reduces both compliance and enforcement costs. Therefore, we propose a transaction-based apportionment method that combines a standardized mark-up on some factor with the apportionment of residual profits.

One of the virtues of the OECD approach is the possibility that transfer prices that are used for non-tax purposes may be used for tax purposes as well. A single set of transfer prices reduces assessment costs and probably has positive incentive effects because managers are not confronted with diverging profit figures. Modifying the OECD approach by attaching less importance to comparability may come at the cost of two different sets of transfer prices. Although we do not know definitively whether MNEs use a single set of transfer prices, we also cannot rule out the possibility that some MNEs were forced to introduce a parallel transfer price system for tax purposes. This scenario would, of course, necessitate the additional cost of a standardized apportionment method, which would reduce the overall expected cost savings of the proposed system.

## **4.2 A Concept to Amend the OECD Approach to Transfer Pricing**

The arm's length principle builds on internationally accepted source rules and the fact that a legal entity's taxable income is the result of market transactions, i.e., the accounting balance of supply payments and sales revenues. If an MNE is engaged in transactions that are fully comparable to market transactions, the market price can be used for tax purposes. In such a situation, the MNE does not operate as an integrated firm, and the economic criticism regarding the arm's length principle is nullified. Thus, CUPM can be used for tax purposes without any disadvantage if market prices for a transaction are directly observable. Given our focus on the simplification and reduction of discretionary powers, the CUPM should be maintained for these transactions.

However, if market prices are not directly observable, the OECD-TPG must seek indirectly comparable transactions by attributing the performed functions and

assumed risks to a transaction. To reduce the information requirements in the assessment process, simpler methods to apportion profits of a single transaction or a bundle of transactions must be developed. Our proposal does not seek to allocate economic rents according to plausible economic rationales, such as using the amount of capital invested or public goods utilized at a certain location as an indicator of local rents. On the contrary, our starting point is the fact that, for logical reasons, integrated firms' rents cannot be allocated to certain functions, factors of production or locations. Thus, our proposal focuses on measurement issues and objective data.

We propose not to distinguish between assumed risks and economic rents because both cannot be allocated to single intra-firm transactions; however, our proposal allows for the allocation of a certain amount of profit in terms of a standard mark-up on some easily observable and measurable factor. The residual profit is allocated according to other factors. Basically, in our search for observable and measurable factors, we can look at either the supply side or the demand side. On the supply side, the costs of the firm's input factors could be considered, whereas sales are a natural candidate for an apportionment factor on the demand side.

#### 4.2.1 Attributing Profits to the Point of Sale

One could argue that the profits of the firm are realized at the point of sale. In the case of goods delivered to third parties, the point of sale can be easily identified. Following this line of reasoning, all of an MNE's profits should be attributed to the locations where sales take place. This can be accomplished by assessing transfer prices that reflect production costs but do not include any profit margins. Then profits or losses are entirely assigned to the point of sale. The following example may clarify the resulting profit allocation.

**Example 3:** Let us revisit the case described in Example 1. The associated enterprises A, B and C are located in three different jurisdictions. A delivers semi-finished products to B (transaction 1). B delivers finished products to C (transaction 2). Finally, C sells these products to independent enterprises.

Suppose that the transfer price of transaction 1 reflects A's total costs associated with the production of the respective semi-finished good. The transfer price assessed in the case of transaction 2 reflects primary costs of B and includes the cost of the intra-firm input. Then, the profit or loss generated by the finished product occurs as accounting balance of C whereas A and B do not report any profit or loss. A profit margin has not to be determined.

The striking simplifications associated with the attribution of profits to the point of sale still hold if firms become much more integrated or have considerable intangible assets. If we consider, for example, the case described in Example 2, only cost accounting by each involved transaction party is needed. Still, only costs are compensated while the accounting balance entirely occurs at the sales department.

Although profit margins have not been determined, the apportionment of indirect costs remains.<sup>6</sup> Thus, room for discretion still exists and profit shifting would be possible to a certain extent.<sup>7</sup> Nevertheless, sales-based profit allocation would signifi-

cantly reduce discretionary powers because the comparability analysis is radically limited.

Attribution of profits to the point of sales benefits from reduced tax planning opportunities due to the point of sales is expected to be relatively immobile. This is particularly true if private consumers are involved. In the case of business-to-business trade, however, the location of sales may be mobile because a firm has an incentive to allocate sales to a low-tax country. The firm's business customers could purchase goods in these countries. Joint tax planning may be expected because the seller and purchaser are able to share tax savings. Additional anti-avoidance rules would be necessary to prevent firms from relocating sales departments. Moreover, identifying the point of sale may be difficult if services are rendered to third parties. A possible localization for the point of sale in the cases of business-to-consumer services and business-to-business services could be the customer's tax residence.<sup>8</sup>

A sales-only approach shifts the tax base to the jurisdiction where the customers are located and where consumption takes place. This stands in contrast to the traditional understanding of profit taxation in which profit is basically seen as the result of production activities. Allocating total taxable profit to the point of sale is obviously contrary to the fairness perceptions behind the traditional source rules of international profit taxation. The sales-only approach has the potential to alter the international distribution of profit tax revenues considerably. Given the likely first-round tax revenue effects, the Achilles' heel of the proposal is inter-jurisdictional fairness. Some countries are likely to be winners, whereas other countries will lose significant amounts of tax revenues because sales-based profit allocation entails a profit tax exemption for intra-firm exports. Stated differently, specific characteristics and public good provisions at the locations where production takes place also contribute to the profit. Against this background, taxable profits should be attributed not only to the point of sale but also to other parts of the firm.

#### **4.2.2 Attributing Profits to all Parties Involved**

If taxable profits should be attributed to all locations involved in the value added chain, a more complex profit allocation procedure is needed. We suggest considering apportionment criteria that can be easily observed and measured as objectively as possible. Because the focus is on transactions, apportionment factors must relate to the transaction rather than to the firm as a whole. Although capital is an important input factor, measurement problems associated with capital are well known. In particular, capital as an apportionment factor should be isolated from the financial conditions of a subsidiary because manipulation is easy, e.g., by means of intercompany

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<sup>6</sup> Computing indirect or overhead costs might still be a controversial issue; however, this problem also exists if, for instance, CPM is applied.

<sup>7</sup> Overhead costs could be excluded from transfer prices to reduce cost allocation scope. Then profits of sales departments would increase, whereas production departments would suffer from losses due to indirect costs (Schneider, 2003). However, this seems to be unacceptable from the perspective of inter-jurisdictional fairness.

<sup>8</sup> Rules that identify the point of sales in case of services could build on the rules that are applied under the VAT. See Avi-Yonah et al. (2009) for a thorough discussion.

loans. A feasible solution may be to neglect capital and consider only payroll. Alternatively, apportionment could be based on expenses or primary costs (including capital allowances for fixed assets) associated with the respective transaction.

If profits are distributed across the locations where the MNE has taxable nexus, profit shifting may be achieved by some form of intra-firm arrangement regarding the apportionment factors. However, physical capital, production costs, and payroll are closely linked to a specific location, and relocation is associated with significant changes in the value-generating process. Thus, these apportionment criteria will not tend to respond immediately to tax rate differentials.<sup>9</sup>

Basically, three different types of apportionment schemes can be distinguished. First, a standard profit margin can be attributed with consideration of the apportionment factor. Using a standardized profit mark-up means that no firm-specific characteristics, such as functions and risk taking, are considered. Second, the apportionment of total profits can follow the relative factor share of each subsidiary involved in the respective transaction. If more than one apportionment factor is considered (e.g., sales and primary costs), a weighting scheme is needed. Relative weights of the apportionment factors must be explicitly defined. If two factors are considered, a possible rule could attribute 50 percent of the profit in accordance with primary costs incurred and 50 percent in accordance with sales. Third, the schemes can be combined: A two-tier apportionment scheme allocates a standard mark-up in the first place and residual profit in the second place.

**Example 4:** Let us take our Example 1. A delivers semi-finished products to B (transaction 1), and B delivers finished products to C (transaction 2). Finally, C sells these products to independent enterprises.

Suppose, for instance, primary production cost of A and B, respectively, as apportionment factor. Taking into account a standard profit margin of, e.g. 10 percent of total primary production cost, the transfer prices assessed in transactions 1 and 2 reflect full costs plus the mark-up of 10 percent of total primary costs of the internal suppliers A and B, respectively. Residual profits or losses are implicitly attributed to the sales department C.

By contrast, if total profit is apportioned and primary cost is employed as apportionment factor, the profit margins which are added to primary costs of the involved enterprises A and B are computed by multiplying the total profit or loss of the final product with the relative cost share of A and B. Consequently, the total profit or loss generated by the production and distribution of a product is distributed across the group members involved.

A third solution would be a combination of the two apportionment schemes. Then, profit to the amount of 10 percent of total primary cost plus a cost-based share in the residual profit would be allocated to each group member.

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<sup>9</sup> If primary costs are used as an apportionment factor, firms could try to relocate the respective production factors via internal transactions. Yet, we propose to maintain CUPM if data of comparable transactions are available. Obviously, this is often the case when production factors are relocated by an internal transaction.

One advantage of a fixed mark-up or a standard profit margin is that transfer prices can be assessed on the basis of each separate transaction between two transaction parties irrespective of a complex value added chain. Only information on the apportionment factor of the supplier is needed. Nevertheless, to eliminate the double taxation risk, a bilateral or an international agreement on the standard margins would be necessary.<sup>10</sup> Fixed profit margins may conflict with inter-jurisdictional fairness because the accounting balance still occurs at the point of sale. In contrast, profit sharing on the basis of apportionment factors calls for information on the complete value adding process associated with a product because the total profit is allocated to all parties involved. Although much more complex, the latter concept may well coincide with perceptions of inter-jurisdictional fairness. Finally, in this case, no international agreements on margins are necessary.

#### 4.2.3 Abstracting from Evaluating Single Transactions

In principle, the OECD approach to transfer pricing refers to each separate intra-firm transaction (OECD-TPG, 3.9 – 3.12). Thus, the scope of the OECD-TPG is a single transfer of goods or services. An amendment to the transfer pricing methods could allow pooling of the separate transactions of the production process, for example, with respect to a single product sold to a third party. Thus, abandoning the attempt to assess taxable profits for each single transaction could be a starting point for the reform of the transfer pricing guidelines. Pooling of several separate transactions is likely to reduce compliance and enforcement costs as well as the risk of double taxation. More importantly, this approach has the potential to decouple the correlation between the increasing internationalization process of MNEs and the frequency of transfer pricing disputes.

We suggest taking into account the package of transactions associated with a certain type of sales to third parties. For instance, all transactions contributing to a certain product sold at a certain location to a third party should be combined. Information on sales revenues and total production costs can then be taken together to compute the product's profit. Both sales and production costs can be traced back to third party transactions. Profit apportionment is performed for the entire transaction package.

If more than one transaction is considered in the same assessment procedure, timing issues may become important. A transfer price must be determined when the first transaction in a set of transactions in a value added chain takes place. Frequently, many related transactions will occur later. Therefore, budget figures become increasingly important for assessment. The use of budget figures, however, is not a new issue. The case of the TPSM, if intra-firm transactions are performed prior to sales to uncontrolled parties, offers an example (OECD-TPG, 2.140). The growing importance of budget figures and the bundling of single transactions may

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<sup>10</sup> For instance, the OECD-member countries could agree upon standard profit margins. Standard profit margins could be yearly fixed to take into account business cycle effects. More sophisticated differentiations, for example between industries, could be considered as well. More important, no firm-specific characteristics like functions and risk taking should be taken into account.

increase the need for advanced pricing agreements. Moreover, double taxation risks are likely to increase if more than two tax authorities are involved in a transfer-pricing case. Whether the tax payer's disadvantage arising from an increasing number of tax authorities involved is offset by the advantage of a decreasing number of separate assessment cases is unclear.

### 4.3 The Proposal in More Detail

We propose a standardized transaction-based apportionment method that combines a fixed standard profit margin with the apportionment of residual profits, mainly to points of sales. Our proposal starts with the data on final products sold or services rendered to third parties. Additionally, cost accounting data based on third-party transactions are considered. Then transfer prices are determined depending on the actual profit-sharing concept.

If profit allocation is transaction-based, the allocation of a final product's total budgeted profit or loss  $P_i$  to business units depends on the transfer prices of the intra-firm transactions. The transfer price of a good delivered or service rendered by business unit  $j$  with respect to the final product  $i$  includes intra-firm input to business unit  $j$ , the business unit's primary product cost, and the profit or loss allocated to the business unit according to the apportionment procedure. More formally, the transfer price  $tp_{ij}$  amounts to

$$(1) \quad tp_{ij} = ifi_{ij} + c_{ij} + p_{ij}.$$

The term  $ifi_{ij}$  indicates the intra-firm input to the business unit  $j$  valued at the transfer price of the business unit providing the intra-firm input. The term  $c_{ij}$  indicates the business unit's primary production cost. The term  $p_{ij}$  denotes the profit or loss apportioned to the respective business unit.

If only a standardized fixed mark-up  $m_i$  on the total primary costs  $c_{ij}$  of product  $i$  in business unit  $j$  is considered, the apportioned profit can be described by the following expression:

$$(2) \quad p_{ij} = m_i \times c_{ij}.$$

In addition, if the residual profit allocation to business unit  $j$  with respect to product  $i$  is performed via an apportionment factor, a more complex formula must be considered. Apportionment factors, in principle, could refer to stocks (e.g., capital) or flows (e.g., payroll or primary production cost). For example, suppose that profit is allocated via the ratio of a product's primary costs  $c_{ij}$  incurred in the business unit  $j$  to the product's total primary costs  $C_i$ . The apportioned profit or loss can then be described by the more general expression:

$$(3) \quad p_{ij} = m_i \times c_{ij} + \alpha \times \frac{c_{ij}}{C_i} \times (P_i - m_i \times C_i),$$

where  $\alpha$  denotes the apportionment factor weight ( $0 \leq \alpha \leq 1$ ). The actual allocation of a product's profit depends on the factors chosen. One possible solution could be

$\alpha = 0$  and  $m_i = 0$ . The transfer price thus only reflects incurred costs, and profits actually accrue where sales to third parties take place. Another possible solution could be  $\alpha = 1$  and  $m_i > 0$ . In case  $\alpha > 0$  all group members are involved. The total profit of the production chain must be taken into account. As a result, a share  $\alpha$  of the product's budgeted profit will be allocated according to the primary costs incurred. Likewise, residual profits accrue when sales to third parties take place. *Ex post*, residual profit is implicitly allocated to the point of sale in terms of the accounting balance.

#### 4.4 Comparison of the Proposals with the OECD Approach

At first glance, a group member's product-related primary costs may be perceived as a rather crude and schematic apportionment factor compared to the current OECD-TPG. By considering many of a transaction's terms and conditions, the OECD-TPG intends to identify the contribution of each transaction party in a value generating process. However, this seemingly much more subtle concept is only a different heuristic to apportion profits among transaction parties, given that an economically "correct" assignment of profits generated by a highly integrated process to a single transaction party is impossible. Thus, what is termed comparability or contribution analysis only reflects a certain idea of a fair profit apportionment procedure.

Restriction of the apportionment procedure to only a few factors may come at the cost of dismissing this idea. Conceptually, the number of apportionment criteria could be increased to provide a more sophisticated apportionment mechanism. Then consideration of each function or risk taken, as the OECD recommends, is only a very complex case. Indeed, we suggest reducing the complexity and including only a small number of factors that can be easily measured to eliminate the ongoing controversies associated with the prevailing transfer pricing rules.

We propose an assignment of profits to the point of sales as the starting point for any apportionment method. Current rules try to allocate worldwide profit to jurisdictions where the sold goods and the rendered services originate. Sales-oriented rules, by contrast, allocate worldwide profits to the destination of sold goods and rendered services. Destination-based profit allocation would be a step towards a destination-based business cash flow tax, which was recently recommended by Auerbach, Devereux and Simpson (2010: p. 837). The sales-only approach to international profit allocation effectively exempts production from taxation, thereby eliminating incentives to relocate production to low-tax countries.

Whereas abstracting from comparability as the guiding principle to distribute profits stands in contrast to the OECD guidelines, the valuation of a package of transactions associated with a certain product does not. Interestingly, the OECD-TPG also recommends, under some circumstances, an extension to more than two transaction parties. The OECD refers to situations in which separate transactions are closely linked and hence cannot be evaluated on a separate basis.<sup>11</sup> We propose the

<sup>11</sup> For example, an enterprise licenses manufacturing know-how and supplies vital components to another associated manufacturing enterprise. In this case, it is supposed to be more reasonable to evaluate the two items together to determine whether the conditions are at arm's length rather than evaluating the items separately (OECD-TPG, 3.9).

pooling of transactions that contribute to a certain product. This approach is related to an activity-based scope of profit distribution as proposed by Musgrave (1972), Higinbotham et al. (1987) and Oestreicher (2000).

The second key element in our proposal is standardization. In particular, we propose the use of a standardized profit mark-up for some production-related factor. Attributing a standard profit margin to each production location is very similar to the residual profit split under the TPSM.<sup>12</sup> Recent reform proposals also entail remunerations for routine functions (Brem, 2004; Russo, 2005). Similar to proposals by the US Treasury Department (1988), by Kaminski (2001) and by Avi-Yonah et al. (2009), we consider a fixed standardized mark-up on primary costs. A standardized mark-up avoids the problem of identifying routine functions and also avoids difficulties in finding information on the profit margins of functions. A standardized mark-up displays similarities to so-called safe harbor rules. For certain transactions, some countries already use safe harbor rules referring to fixed standardized mark-ups, for example, Brazil (cf. International Fiscal Association, 2009). The OECD also discusses safe harbor rules but refuses application (OECD-TPG, 4.123).

Finally, let us briefly discuss our proposal's consequences for asset relocations within MNEs. A transfer price must be assessed if assets are transferred when a business restructures (exit taxation). The OECD-TPG refers to arm's length prices, which are often difficult to assess if, for instance, intangible assets are shifted. According to our proposal, the transfer price could reflect production costs plus a profit margin (e.g., a standardized profit margin on the production costs).<sup>13</sup> Another possibility would be to allocate a part of the budgeted profit to the transferred asset using, for example, primary costs as an apportionment factor. Regardless, abstracting from business functions and risk-taking as assessment criteria of transfer-prices will significantly reduce the incentives for asset relocations because changes in functions or risk characteristics will not affect transfer prices.

#### **4.5 Comparison of the Proposed Amendments with Formula Apportionment**

The European Commission proposes to substitute separate entity accounting for a common consolidated tax base (CCCTB) and formula apportionment (European Commission, 2011). The CCCTB proposal includes two key elements: (i) elimination of intra-firm profits via the consolidation of harmonized tax bases and (ii) distribution of the consolidated profit via apportionment factors among the group members. Taxable profit attributed to a subsidiary or a permanent establishment is computed by multiplying the MNE's total profit by the product of the apportionment factor weights and apportionment factors of the respective subsidiary. In contrast to formula apportionment, our proposal adheres to separate entity account-

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<sup>12</sup> According to a recent report by the US International Revenue Service (2008), profit-based transfer-pricing methods are the dominant method in determining transfer prices in advance pricing agreements.

<sup>13</sup> In order to prevent firms from tax planning, anti-tax avoidance rules have to define some minimum holding period after asset reallocation.

ing.<sup>14</sup> Apportionment factors are embedded in a transaction-based framework, and they refer to budgeted product-profits. Furthermore, harmonization of tax bases is not a necessary element of our proposal.

Consolidation and formula apportionment may conflict with the idea of a fair distribution of taxable profits among the jurisdictions involved. This is especially true if MNEs are not highly integrated and the rates of return differ between an MNE's locations.<sup>15</sup> By redistributing the total consolidated profit of an MNE, formula apportionment generates a factor profitability that is equalized for tax purposes. Following this line of reasoning, Hines (2010) analyzes data of European firms and finds that the factors usually proposed as formula weights poorly explain differences in profitability across firms. From the country's perspective, misattribution caused by the CCCTB may emerge from location-specific advantages because formula apportionment will redistribute location specific agglomeration rents. However, taxation of location-specific rents does not distort an MNE's investment decision. Therefore, the redistribution of profits with respect to, for example, agglomeration advantages cannot be in the interest of a respective country.

Because we propose the allocation of profits based on transactions, we avoid a systematic redistribution of local rents. Therefore, transaction-based profit apportionment may correspond much better to inter-jurisdictional fairness perceptions than a company-wide formula apportionment that redistributes an MNE's profit in a comparatively simplistic manner. Nevertheless, with standardized apportionment factors, our proposal significantly reduces profit-shifting opportunities. Although we intend to reduce tax base shifting within the MNE, we argue that, given the ambiguity of fiscal and welfare effects, profit-shifting opportunities should not be eliminated completely. In contrast to full-blown formula apportionment, our proposal still allows different operating margins due to different market conditions and differences in the profitability of products.<sup>16</sup>

Finally, unlike the European Commission's proposal of a CCCTB, we do not suggest the establishment of a profit allocation system that operates in parallel to the current OECD rules. The introduction of an additional apportionment method that is not in accordance with the OECD rules would probably entail high compliance and enforcement costs and cause double taxation problems. Therefore, the striking argument in favor of amending instead of abolishing the OECD approach arises from the

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<sup>14</sup> Thus, we avoid profit-shifting strategies with respect to the relocation of assets within the MNE that arises under the CCCTB (Schreiber, 2009b).

<sup>15</sup> Consider, for example, a simple MNE consisting of a parent company and a subsidiary located in two different countries and assume that there are no intra-firm transactions. Due to different local market conditions or management performance, only the parent makes a profit whereas the subsidiary has zero profit. Then, under separate accounting, the MNE pays taxes only in the home country of the parent. Under formula apportionment, the total profit of the MNE is allocated to both countries according to some formula. Thus, the MNE pays taxes at all locations where it has taxable nexus.

<sup>16</sup> The definition of a valuation package determines the potential variation in profit rates across locations. Generally, a broader definition of valuation units is likely to reduce enforcement costs but will come at the costs of leveling profit rates across the group members.

simple fact that almost all countries apply transfer pricing rules in accordance with the OECD-TPG.

## 5. Conclusions

The OECD approach to international profit allocation is not unchallenged. A recent proposal for a common consolidated tax base and formula apportionment by the European Commission (2011) is widely discussed. Nevertheless, separate entity accounting and the arm's length principle are time-honored and internationally accepted. The limitation of the OECD approach is that it is economically flawed because the profit of an integrated firm cannot be divided with market prices. This shortcoming makes it difficult to find sufficient data on uncontrolled transactions to assess transfer prices.

The OECD-TPG makes a remarkable effort to overcome the data problem by identifying performed economic functions and assumed risks for which market prices can be found. However, given the specificity of most internal transactions, considerable room remains for discretion in the identification and valuation of functions and risks. Tax authorities react by requiring more detailed documentation, which increases compliance and enforcement costs. Coincidentally, the risk of conflicting assessments and double taxation rises.

This paper suggests relying on less sophisticated methods to allocate a MNE's tax base to countries involved. Instead of identifying functions and risks for single transactions, we recommend pooling transactions and allocating the profit of such a bundle of transactions along the value added chain according to easily observable apportionment factors. Such factors could be transaction-related costs, wages, capital or a combination of some or all of these factors. Our proposal has the potential to reduce tax compliance and enforcement costs. If the transaction-related apportionment factors are largely immobile, tax planning opportunities are restricted. However, in contrast to formula apportionment, separate entity accounting and the assessment of transfer prices are preserved.

The simplest procedure would be to allocate a product's profit to the location of sale, whereas no profit would be assigned to production locations. As a result, assessment costs and double taxation risks would be low; however, the international distribution of profit tax revenues would be changed to a great extent. Given the likely first-round tax revenue effects, the Achilles' heel of this proposal may be inter-jurisdictional fairness. To bring about a profit allocation that better conforms to established fairness perceptions, taxable profits could be attributed to all locations involved in the value added chain. Unlike the OECD approach, we suggest considering only a small number of standardized apportionment criteria that can be easily observed and measured as objectively as possible. A standard profit margin could be attributed considering an apportionment factor. The residual profit could be assigned to the point of sale. Alternatively, total profits could be distributed to all group members according to one or more apportionment factors.

A fixed standard profit margin has the advantage that transfer prices can be assessed on the basis of each separate transaction between two transaction parties.

Nonetheless, a bilateral or an international agreement on the standard margins would be necessary. Fixed profit margins might conflict with inter-jurisdictional fairness, but the proportional profit split probably has no such conflict. However, this concept calls for information on the complete value adding process associated with a sales item because a final product's total profit is allocated to all parties involved. Nonetheless, the proposal is likely to significantly reduce tax-planning opportunities, double taxation risks, and enforcement and compliance costs.

## Appendix: Empirical Evidence on Effects of the OECD Approach

**Table 1: Tax Planning Opportunities**

	Studies	Main Results
<b>Profit Shifting</b>		
Tax Response of Profitability	Grubert and Mutti (1991); Hines and Rice (1994); Huizinga and Laeven (2008); Weichenrieder (2009); Beuselinck, Deloof and Vanstraelen (2009); Blouin, Robinson, and Seidman (2010)	The local tax rate exerts a significantly negative impact on reported profits of MNEs' subsidiaries.
Tax Response of Prices and Transactions	Bernard and Weiner (1990); Swenson (2001); Clausing (2001, 2003, 2006); Bernard, Jensen and Schott (2006)	Transfer prices and the amount of intra-firm transactions are responsive to tax rate differentials, whereas no tax response is found if price data of sales to unrelated parties are considered.
Importance of Firm-Specific Transactions	Harris (1993); Grubert (2003); Overesch and Schreiber (2010)	Profit-shifting opportunities are closely related to transactions which are of a firm-specific nature.
<b>Profit Shifting and Decision-Making</b>		
Location of Specific Functions	Hines and Rice (1994), Grubert and Slemrod (1998); Desai, Foley, and Hines (2006); Dischinger and Riedel (2011); Karkinsky and Riedel (2009); Overesch and Wamser (2009)	MNEs invest more at typical tax havens if they have particular high amounts of firm-specific transactions. Moreover, MNEs allocate R&D and intangible assets at low-tax locations.
Investment Effects in High Tax Countries	Grubert (2003); Becker and Riedel (2008); Overesch (2009); Overesch and Schreiber (2010), Overesch and Wamser (2009)	Host-country taxation is less accountable for the location choices of more internationalized companies. With a rising amount of firm-specific transactions, investment decisions are less responsive to the local statutory tax rate while the tax-level at other locations of the MNE becomes decisive.

**Table 2:** Transfer Pricing Disputes

	Studies	Main Results
<b>Double Taxation Risk</b>		
Penalty Risk and Supplementary Payments	Ernst & Young, (2007, 2009); Jost, Winner and Pfaffermayr (2010); Wunder (2009)	Largest tax risk is related to transfer pricing specific determinants, such as the materiality of intangible goods transactions and service transactions.
Effects on Tax Planning	Beuselincx, Deloof and Vanstraelen (2009)	Subsidiary profitability only responds to tax incentives if the enforcement of transfer pricing issues is rather weak.
<b>Tax Enforcement Costs</b>		
Accounting Costs	Ernst & Young (2003)	About 80 percent of the interviewed managers of MNEs use the same transfer price for tax and management purposes.
Compliance Costs	Slemrod and Venkatesh (2002); European Communities, (2004)	Transfer-pricing documentations are associated with a rise in tax compliance costs of about 135 to 178% for European firms and 140% for US MNEs.

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# OECD Guidelines: Causes and Consequences

Michael C. Durst

## Abstract

*This article provides an historical and evaluative perspective on the OECD Transfer Pricing Guidelines. The article argues generally that the “uncontrolled comparables” on which the Guidelines seek to rely cannot in fact be found with the degree of precision needed for effective tax administration. The result has been a failure of international tax administration with harmful effects on many national economies. The article argues for a re-thinking of the Guidelines that does not rely on searches for comparables, and which closes off opportunities for tax avoidance by the shifting of income through contracts between commonly controlled parties. The article also urges that the OECD adopt a more rigorous set of rules governing profit splits than currently contained in the Guidelines, as current approaches have proven unenforceable.*

## 1. Introduction

Despite having little aptitude for the physical sciences, I have long been fascinated by the story of the development of quantum mechanics – the study of the strange world that exists inside the atom. When I learned I was to have the opportunity to speak at the institute that is named for Max Planck, the central figure in the development of quantum mechanics, I thought I should take a refresher course. I therefore bought and read a wonderful biography of Max Planck, by J.L. Heilbron, entitled *The Dilemmas of an Upright Man*.<sup>1</sup> I recommend this book to anyone with an interest not only in physics, but also in Twentieth Century European history.

For our purposes today, the most important lesson from the book is that Planck’s greatness arose from an ability to apply empirical observation – real-life experiment, real-life observation – to the solution of the most difficult problems of theory. He held himself to a rigorous standard with respect to consistency between empirical observation and theory. As a result, he allowed his worldview to develop over time, and he produced works of genius.

The book becomes most interesting, and indeed tragic, toward the end, as Professor Planck was compelled late in life to deal with the rise of National Socialism. This tragic part of the book is especially important, although it would divert us from our current topic. So let’s now leave Max Planck, at least for now, with the observation that we meet today in an institute named for a bastion of scientific integrity, and move to the topic of the OECD Transfer Pricing Guidelines.

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<sup>1</sup> Heilbron, *The Dilemmas of an Upright Man*, Cambridge (Mass.), 2000.

## 2. Theoretical and Empirical Claims Made by the Guidelines

In particular, let's look at the theoretical and empirical claims that stand at the heart of the Guidelines. The Guidelines are based on the principle that the best reference points for determining the appropriate prices, for tax purposes, in transactions between members of commonly controlled groups are the results of functionally similar transactions – “comparable” transactions – between unrelated parties. This principle pervades the entire Guidelines: On the basis of a so-called “functional analysis,” the person determining a company's pricing methodology is supposed to gain a detailed understanding of the related-party transactions that are at issue; and then, usually from computerized databases compiled from publicly available securities-law filings, that person is supposed to find similar transactions between unrelated parties. The company is, finally, to use these ostensibly comparable transactions to benchmark pricing in its transactions involving related parties.

It is here, at its most fundamental core, that the OECD approach to transfer pricing, both theoretically and empirically, falls apart. I know that this subject matter makes some uncomfortable – there has long been an “emperor's new clothes” quality to many discussions of this topic – but I think the problem needs to be faced squarely. Economic theory has long recognized that integrated corporate groups, including the large multinational companies, form because the costs of doing business other than in an integrated, commonly controlled form are too large for non-integrated businesses to be competitive. Imagine, for example, the US subsidiary of a global, non-US automobile company attempting to bargain, on a shipment by shipment basis, over the price of cars that the subsidiary purchases from its parent. Such a process would be enormously expensive. Similarly, it would be impossibly inefficient for global oil companies to negotiate on a batch-by-batch basis for the refining and shipment of most of their products.

For this reason, we have seen relationships between independent manufacturers and sellers in a great many industries, especially in the larger markets, give way to integrated structures in which manufacturers and sellers are commonly owned. For example, I personally have witnessed the elimination in the US market of independent distributors of non-US automobiles, and I also have seen the elimination, in large markets, of independent distributors in the medical device industry. There are hundreds if not thousands of other examples. The fact is that in many industries in many markets, *only* integrated, multi-national, commonly controlled businesses are active in the market, because a non-integrated structure would be too costly to survive.

This means that as a general rule, for transactions entered into among members of commonly controlled groups – that is, the very transactions for which transfer pricing rules are needed – “uncontrolled comparables,” as we transfer pricing practitioners call them, simply do not exist. Even when, say, a company sells to an affiliate a commodity – say, a bushel of wheat of a specified grade and at a specific location – the economically correct price is different from that in an identical sale between unrelated parties, because the sale exposes the unrelated parties to costs

and risks that the commonly controlled parties do not bear. And, of course, once the product is more differentiated than a barrel of oil or a bushel of wheat, the notion of comparability is even more implausible.

It is interesting to see the manner in which the OECD Guidelines attempt to deal with what on its face seems to be the small likelihood that the Guidelines ever can be made to work. Let me quote from paragraph 1.9, which the OECD re-issued only this past July. Paragraph 1.9 starts with the following undocumented assumption: “The arm’s length principle has ... been found to work effectively in the vast majority of cases.” As someone who has worked hands-on with the arm’s length principle for about twenty years, I am left breathless by this assertion. In my experience, the arm’s length standard *rarely if ever* works effectively. And even if my experience is not entirely representative, it seems very unlikely that the arm’s length standard works well in the vast majority of cases; if it did, it seems unlikely that the question of the efficacy of the arm’s length standard would remain subject to such pervasive contrary, fifteen years after the Guidelines were released. The OECD either should provide empirical support for its improbable assertion or should, in the interest of its own credibility, delete it from the Guidelines.

Let’s read on in paragraph 1.9. The paragraph says, “For example, there are many cases involving the purchase and sale of commodities and the lending of money where an arm’s length price may readily be found in a comparable transaction undertaken by comparable independent enterprises under similar circumstances.” We have just seen, though, that even in the “commodity” case to which the authors of paragraph 1.9 seem to be referring, comparable prices will not be found; and in any event, such “commodity” situations represent only a small fraction of the transactions engaged in by multinational businesses. So the second sentence of paragraph 1.9, while perhaps not as startling as the first, also does not seem to support the OECD approach.

The next sentence of paragraph 1.9 suggests that even when comparable prices don’t exist, comparability analysis might be effective based on such indicators as gross and net margins and markups; we’ll see in a few minutes why this assertion is mistaken. Paragraph 1.9 then continues with what on its face is a concession that all might not be well in the land of arm’s length, but which in fact may be the most misleading statement in the entire Guidelines: “[T]here are some significant cases in which the arm’s length principle is difficult and complicated to apply, for example, in MNE groups dealing in the integrated production of highly specialized goods, in unique intangibles, and/or in the provision of specialized services”; and the Guidelines acknowledge that perhaps, some special measures might be needed to deal with them. But see what the authors of the Guidelines have done here: they have taken the usual, and I believe universal case, in which uncontrolled comparables cannot be found, and pretended that it is the exception, not the rule. This switch is essentially a verbal sleight of hand, and the entire OECD system of transfer pricing rests on it.

The Guidelines make many other claims which, like those of Paragraph 1.9, could benefit from close scrutiny; but the Guidelines are far too lengthy to permit their examination in detail here today. (Indeed, I believe that the sheer length of the

Guidelines, like an elephant's bulk, has helped to shield them from attack). Rather than continuing to parse language, let's move to a practical examination of a by-product of the Guidelines – the now global institution of “contemporaneous documentation”.

Contemporaneous documentation originated in the United States during the early 1990s, and was soon adopted as well by the OECD Guidelines. In a process that still continues, rules prescribing contemporaneous documentation already have been adopted by dozens of tax administrations around the world. The basic idea is that by requiring taxpayers to maintain detailed “functional analyses,” and quantitative presentations in support of their transfer pricing, taxpayers would enable tax inspectors to bring order to the difficult process of transfer pricing examinations.

In practice, however, this has not happened. In almost every package of contemporaneous documentation I have seen – and I have seen a great many over the years, designed for use in a number of countries– the “functional analysis” consists primarily or exclusively of material copied from annual reports or other publicly available information; this material gives the tax inspector nothing that the inspector could not easily have downloaded from the Internet in a few minutes. Another element of most contemporaneous documentation is the inclusion of lengthy appendices which do nothing but either reproduce or summarize the transfer pricing regulations of the jurisdiction for which the documentation is written. These appendices seem to reflect either (i) that the preparers of the documentation are concerned that tax inspectors will not have access to copies of their own regulations; or (ii) that the preparers are adding bulk to the documentation, perhaps from a desire to add an appearance of substance.

The most revealing part of the typical package of contemporaneous documentation, however, is neither the functional analysis that provides no new information nor the pointless regulatory appendix, but is instead the purported statistical analysis of comparables that almost every package of contemporaneous documentation contains. The great majority of transfer pricing documentation uses one of the methods of the Guidelines that I briefly mentioned a few moments ago, which involve benchmarking a so-called “test party's” results against the gross or net margins or markups of purportedly “comparable” companies that the preparer of the documentation has selected. These comparables generally are selected from commercially maintained databases of public company data culled from government sources around the world, such as the SEC in the United States.

When the selection of companies is completed, however, the group of ostensible comparables that survives the screening process almost always is very small. The OECD Guidelines and similar provisions of national law permit the selection only of comparables that are functionally similar to the tested part and, for the reasons as we have seen, such close comparables rarely if ever exist. As a result, in my experience, the typical package of contemporaneous documentation relies on a sample size of, say, between four and nine ostensibly comparable companies, and even within this small sample, the degree of apparent comparability with the tested party is highly attenuated.

The small sample sizes mean that the search for an “arm’s length range” becomes meaningless. Under the US regulations, and under prevailing practice in other countries, the arm’s length range of acceptable results is supposed to consist of the interquartile range determined from the sample: the range extending from the 25<sup>th</sup> to the 75<sup>th</sup> percentiles of results. Any competent beginning student of statistics and economics, however, can tell you what is likely to happen when you try to derive a range, from data drawn from an actual market economy in which companies experience a wide range of degrees of success and failure, using sample sizes of four to nine. One is almost always going to get ranges that are so wide as to be useless for a practical task such as tax administration.

In almost all of the documentation that I have seen around the world, the top of the interquartile range exceeds the bottom by about 300 or 400 percent, and often the range is even wider. That is, a range of net operating margins for a distribution company might typically extend from, say, 2 percent to 8 percent. This means, for example, that for an inbound distribution operation in, say, a developing country, with the distributor having total in-country sales volume equivalent to \$USD1 billion, the tax administration is told that the taxpayer’s income should fall somewhere in the range from US\$20 million to US\$80 million. This information is essentially useless.

Referring back to a comment I made a few moments ago, it is the inevitably broad width of so-called “arm’s length ranges” that explains why income-based methods, which the OECD now sets forth as a means of salvaging comparables-based transfer pricing, can never be effective in doing so. Income-based methods assume a convergence of rates of return, among businesses in particular industries, which empirically does not exist – and which economic theory shows, in a dynamic economy in which the fortunes of companies are constantly changing, cannot exist. Income-based methods are, in short, based on a fallacy, or at best on a fundamental misunderstanding of economics.<sup>2</sup> A small amount of empirical research, making reference to contemporaneous documentation submitted to tax inspectors in actual practice, would quickly confirm that.

### **3. Particular Needs of Developing Countries**

The defects in the institution of contemporaneous documentation have special implications for developing countries, some of which are currently developing their

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<sup>2</sup> The dependence of both the OECD Guidelines and US regulations on income-based methods may reflect a misunderstanding of the concept of a “market rate of return” as the concept appears in the well-known capital asset pricing model (CAPM). CAPM does, indeed, reflect the view that an average rate of return on capital can be identified within the economy, but CAPM in no way suggests, as the drafters of the Guidelines and US regulations appear to have believed, that the financial results of a small sample of competitors within a particular industry will cluster closely around a central average. Actual practice with income-based method shows just the contrary: in reality, the financial results of functionally similar companies vary far too widely for useful ranges to be computed. For useful background on this point, see Wills, *Risk Measurement: Applying Financial Theory to Transfer Pricing*, 52 *Tax Notes* (1991), 1311.

systems of transfer pricing enforcement. Despite its uselessness, the institution of contemporaneous documentation continues to spread throughout the world. It is spreading with the encouragement of the OECD Guidelines which, despite the apparent absence of any systematic empirical review, endorse the institution of contemporaneous documentation as it is understood today. The result is that with the apparent blessing of the OECD, tax practitioners in developing countries are allowed to impose a toll charge, probably in the neighborhood of several hundred thousand dollars per taxpayer, on investment in even the poorest of countries.

Much if not all of the waste of contemporaneous documentation for developing countries could be alleviated by safe harbors – for example, by the local government specifying for, say, inbound distribution operations, a required net operating margin of 3.5%, instead of inviting taxpayers to submit “arm’s length ranges” extending from, say, 1% to 9%. Earlier this week, I published in Tax Notes recommendations designed for use by tax administrations in developing countries, and these recommendations are centered on the concept of safe harbors. As the article indicates, there are surely technical issues that need to be addressed in designing safe harbors, but these technical issues can be resolved tolerably well, and safe harbors are in fact used around the world, such as in the US transfer pricing regulations governing services. A system of safe harbors surely is preferable to what amounts to the skimming off of resources from the economies of developing countries to support the production of useless documentation.

The potential advantages of transfer pricing safe harbors, for developing and other countries, have been known for many years. As seen, however, in chapter 4 of the Guidelines, the OECD does not approve of them. The OECD’s main point seems to be that prescribed safe harbor rates of profit or markup will never be quite “correct,” and that this inevitable imprecision makes their use unacceptable. Apparently, in the view of the OECD, a system of ranges that produces bands of imprecision of 400 or 500 percent or even more, does a better job at approximating the “right” answer than would a safe harbor.

Why would the OECD Guidelines take a position with respect to safe harbors that seems so divorced from reality? The reason, I believe, lies in politics. For reasons to be discussed a bit more in a moment, the working party that wrote the Guidelines appears to have been frightened of saying anything that might challenge the fantasy that transfer pricing rules can be administered on the basis of “comparables searches.” Safe harbors expose that fantasy, and hence their specter had to be exorcised from the Guidelines. Today, the economies of many countries continue to suffer the resulting costs.

#### **4. Why Have OECD Transfer Pricing Rules Persisted?**

Let’s move now to some wider “why” questions – namely, (i) why would the United States develop such a demonstrably unenforceable regime as that set forth in the US regulations under Section 482; (2) why would the OECD adopt the system and enshrine it in Guidelines that one cannot even begin to read without encountering palpably implausible statements; (3) why would multinational businesses toler-

ate being required to spend billions of dollars over the years on contemporaneous documentation that appears useless; and (4) why would so many of us, in government and in the private sector, go through the motions of preparing reports based on database searches that have no apparent statistical validity?

I think that at least part of the answer is to be found in history.<sup>3</sup> Although the arm's length standard, and especially the idea of relying on comparables, was first articulated as an international consensus by the League of Nations in the first part of the 1930s, there seems to have been little if any international enforcement of arm's-length pricing, and little if any public interest in the topic, until after the Second World War. After the War, companies, mainly in the pharmaceutical industry and mainly based in the United States, had invented powerful antibiotics and other valuable medications. Tax advisers to these companies developed the technique of using contracts – license agreements – to assign rights in valuable patents to subsidiaries that were organized in low-tax countries such as, in those days, Switzerland and Puerto Rico. Through a combination of two phenomena: (i) the tendency of the corporate tax laws, at least in the United States, to respect the terms of contracts even between commonly owned parties with no adverse interests; and (ii) the ability, based on the few uncontrolled comparables that were available, to justify just about any royalty rate as sufficient to compensate the US parents for the rights transferred under the licenses – the companies were able to assign huge amounts of income to the low-tax base companies. These amounts were much greater than could plausibly be seen as proportionate to any observable indicator of business activity actually conducted in the low-tax countries concerned, such as employment of personnel, investment in plant and equipment, or the value of product sold in the countries.

By the early 1960s, the US Congress, and the administration of President John Kennedy, began to perceive federal revenue losses from foreign base companies as problematic, and Congress addressed the topic in what became the Revenue Act of 1962. The lower house of the US Congress, the House of Representatives, is responsible for initiating tax legislation; and in its version of what became the Revenue Act of 1962, the House passed a bill that would have directed the Treasury to implement a formulary system for transfer pricing.

In taking this step, the House was not departing from the pre-War “international consensus” as dramatically as might be supposed. The League of Nations seems to have envisioned that comparables-based methods would be used when apparently useful comparables were available, but that where available comparables did not yield a facially sensible apportionment of income, formulary methods would remain available. This can be seen in a 1934 Columbia Law Review article written by Mitchell Carroll, a US-based lawyer who led the team that conducted the

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<sup>3</sup> The historical discussion in these remarks depends on Langbein, *The Unitary Method and the Myth of Arm's Length*, 30 *Tax Notes* (1986), 625, which I believe to be the most important source available on the history of transfer pricing; Avi-Yonah, *The Rise and Fall of Arm's-Length: A Study in the Evolution of US International Taxation*, 15 *Va. Tax Rev.* (1995), 89; Durst/Culbertson, *Clearing Away the Sand: Retrospective Methods and Prospective Documentation in Transfer Pricing Today*, 57 *Tax L. Rev.* (2003), 37.

League of Nations study.<sup>4</sup> The League of Nations study does not seem to have resulted in as categorical a rejection of formulary approaches as seems to be assumed today.<sup>5</sup>

The House's adoption of formulary apportionment did not, however, make it into the Revenue Act of 1962 as finally passed. Business groups vigorously opposed the measure, and the US Senate dropped it from the legislation. As ultimately passed, the 1962 Revenue Act made no decision on how the transfer pricing laws might be shaped, but instead left to the US Treasury the task of making policy in the area. Congress instead attempted to deal with income shifting through intangibles licenses by enacting the first version of the US controlled foreign corporation, or CFC, legislation in subpart F of the Internal Revenue Code, and subpart F has remained the primary means of addressing such shifts ever since. In fact, subpart F seems to have done little to affect the amount of intangibles-based income that is shifted, although the strengths and weaknesses of subpart F need, in the interest of time, to stay outside the scope of our discussion today.

For today's purposes, the important point is that after the dust had settled on the Revenue Act of 1962, intangibles-intensive multinationals based in the United States – and this originally meant mainly pharmaceutical and specialty chemical industries, joined a couple of decades later by computer and software companies – found themselves benefiting from large assignments of intangibles-based income to zero- or low-tax countries. The preservation of that regime depended on the maintenance of arm's length transfer pricing laws that tolerated the use of licenses (and later, as we will see, other kinds of intragroup contracts) to direct income to low-tax jurisdictions, without regard to the level of observable business activity conducted in the jurisdictions.

Politically, survival of this system depended in part on taxpayers being able to maintain the image of an international consensus in favor of comparables-based transfer pricing that went well beyond the model that the League of Nations initiated in the 1930s. This was the beginning of a tradition of insistence, on the part of many business representatives, that *any* income apportionment that seeks to rely not on searches for comparables, but instead depends on measures of observable business activity, violates international norms.

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<sup>4</sup> Carroll wrote, for example:

If the factory in a given state sells its products to independent purchasers, the income may readily be ascribed to it. If an office in one state purchases from outsiders and sells the same goods, with or without transformation, to outsiders, such income is properly attributable to it. In other words, if the various items of income of an enterprise are analysed and separately allocated either to the obvious source or to the fiscal domicile of the corporation, there remains perhaps a relatively small balance of income that is derived from the joint activities of establishments in two or more states. If there are no criteria for apportioning this income, e.g., independent factory price or dealer price, or if sales establishments may not be regarded as receiving the goods on consignment and therefore remunerated on a commission basis, there may be occasion to resort to an apportionment formula; Carroll, Allocation of Business Income: The Draft Convention of the League of Nations, 34 Colum. L. Rev. (1934), 473, at 490 – 91.

<sup>5</sup> Langbein, *supra* (note 3), contains an especially exhaustive analysis of the League of Nations' involvement with transfer pricing.

Consistently since 1962, US-based multinationals have devoted large sums to lobbying and other public relations efforts aimed at reinforcing the idea that international norms prohibit reference to measures of physical business activity in apportioning income, especially income from intangibles. This persuasive effort, backed up in some instances by hard-ball politics (including a threat in the 1990s, through members of the US Congress, to cut funding for the OECD over its approach to “tax competition”) has been directed at the OECD as well as legislators in the United States.

Within the past fifteen years or so, not only intangibles-intensive companies but even “brick and mortar” businesses have gained a strong financial interest in perpetuating transfer pricing rules that permit the shifting of income through intragroup contracts. Through what have come to be referred to as “restructurings,” companies based in many countries have used intragroup contracts to shift business risks of many different kinds to so-called “entrepreneur” or “hub” affiliates located low-tax countries, and thus shift to those affiliates much of the income from the companies’ operations. Through restructurings, many corporate voices, and not only American ones, have been added to the ranks of lobbyists for rules that allow the shifting of income by contract, without the need for the shift to be proportional to physically observable business activities.

In addition, a discussion of sources of political pressure to retain current transfer pricing rules cannot be complete without addressing the role of us tax practitioners. Large amounts of money are earned every day, not only in preparing contemporaneous documentation of the kind we discussed a little earlier, but also in planning and papering the many transactions that are used to shift income through the use of intragroup contracts. Clearly, hundreds of millions of dollars every year are earned by performing these tasks. Those of us who earn our incomes in these ways have strong interests in seeing current transfer pricing rules perpetuated around the world, and for purposes of policy-making, the presence of those interests needs to be soberly acknowledged.

Those who mount political efforts in support of OECD-style transfer pricing rules have concentrated financial incentives to make those efforts. The damages arising from current transfer pricing rules, however, as we will see in a moment, are spread through entire economies and among millions of taxpayers, so that few if any individuals or defined groups have significant financial incentive to initiate political efforts in support of reform. The result is that lobbying and other advocacy efforts, at least to the extent they have been conducted by persons with detailed knowledge of transfer pricing and other components of international taxation, have been greatly imbalanced in favor of transfer pricing rules in their current form. I am not at all certain how this phenomenon can practically be remedied, but I think the phenomenon must be recognized. In any event, I do not think there can be serious question that the presence of large financial incentives for lobbying in support of OECD-style transfer pricing, coupled with only diffuse incentive to initiate political advocacy of reform, has had a large influence on the shape of current transfer pricing rules, both within and outside the walls of the OECD.

Another rather special historical reason why OECD Guidelines sometimes, at least in my view, seem intemperate in their insistence on comparables-based pricing relates to the effects of the world currency conditions that prevailed in the period leading up to debate over the Guidelines.<sup>6</sup> Following the Plaza Accords in 1985, the value of the US dollar declined dramatically against the Japanese yen and some other currencies, and it became difficult in many instances to manufacture products, such as automobiles and heavy machinery, in some countries, paying compensation and other expenses in local currencies, and then to sell those products profitably in the United States.

The result was that many US distribution subsidiaries of non-US manufacturers saw an extended period of poor financial results. The US Internal Revenue Service believed that despite these difficulties, the US distribution subsidiaries should be guaranteed certain minimum profit levels, on the ground that the subsidiaries were in effect performing services for the benefit of their parents. The US Treasury proposed an early version of what is now the comparable profit method, which many foreign governments thought amounted to an inappropriate minimum tax, determined in a formulistic manner, on US distributors.

Historically, it had primarily been the United States, and particularly business interests in the United States that were intent on preserving the use of 1962-style base companies, that provided political support for comparables-based pricing. The currency shifts following the Plaza Accords, however, and the US reaction, gave other governments a strong interest in resisting any movement away from comparables-based transfer pricing. The result was a great outcry against the proposed US approach, and much of that outcry took the form of expressions of hostility toward any kind of transfer pricing method that did not continue to depend on comparables, but instead bore even a slight resemblance to formulary approaches.

In addition to the currency-exchange situation, efforts by the State of California to implement worldwide unitary apportionment in the 1980s had raised concern among governments around the world, and these concerns placed any departures from the arm's length paradigm in an unfavorable political light. This controversy has faded over time, but there can be no question that during the first half of the 1990s it influenced the course of discussions at the OECD.

Today, many non-US governments are facing new transfer pricing challenges, particularly from the shifting of income through restructurings, and I suspect that in the privacy of their conference rooms, tax officials around the world are giving more open consideration to new approaches to transfer pricing. However, the hostility of earlier years toward any questioning of the supposed "international consensus" remains deeply embedded in the language and tone of the OECD Guidelines and continues to inhibit reforms today.

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<sup>6</sup> Background on the events described in the following paragraphs can be found in Durst/Culbertson, *supra* (note 3), at 77 – 81.

## 5. The Harm Arising from Current Transfer Pricing Rules

I have now completed a rather long criticism of current transfer pricing institutions and practices. The questions next to be addressed are (i) how damaging are these institutions and practices; and (ii) what if anything should be done to change them?

I believe that the damages caused by today's transfer pricing rules can be identified fairly specifically, that these damages are significant, and that they can and should be addressed. The damages include:

- (i) The economic waste represented by the cost of contemporaneous documentation as it is currently prepared, and also of government enforcement practices which, because they are based on attempted reference to comparables, amount merely to expensive wheel-spinning;
- (ii) The waste of even larger resources as a result of the needless legal and accounting work, and the dislocation of corporate investment and personnel, caused by "intangibles migrations," "restructurings," and other transactions incentivized by the ability, under current transfer pricing rules, to shift income through the use of contracts; and
- (iii) A systematic constraint, arising from the impossibility of effective enforcement, on the ability of governments to raise the revenues suggested by the statutory tax rates that legislative authorities have established, or even to control the extent to which revenues fall short of those suggested by the statutory rates.

In mentioning the tendency of current transfer pricing rules to reduce companies' effective tax rates below prescribed statutory rates, I do not want to ignore the possibility that if current transfer pricing rules were replaced by more effective ones, the result might be to increase business tax burdens to levels higher than would be economically desirable. Alternative means, such as explicit reductions in corporate tax rates, might well be called for to reduce those burdens. If, however, limited taxation of multinational companies is the desirable result, political systems in the United States and elsewhere should reach that decision through explicit and reasoned political debate. To date the disinformation and specious analysis that has prevailed concerning transfer pricing rules has inhibited the development of such rational debate.

## 6. Possible Remedies

What, then, should be done about current transfer pricing institutions? It is tempting to suggest wholesale and prompt replacement of the arm's length system as it is described in the OECD Guidelines. I am one who believes that a new system, based closely on the residual profit split method, and avoiding the need for searches for comparables, can function fairly well – far better, in any event, than the OECD's system; and I have published statutory language that might implement such a system.<sup>7</sup> Others, of course, might not share my optimism concerning such an approach

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<sup>7</sup> The language was published in Durst, *A Statutory Proposal for US Transfer Pricing Reform*, 115 *Tax Notes* (2007), 1047; and then in revised form as Appendix B to Avi-Yonah/Clausing/

based on profit split and might have other models for reform, which should be given careful attention. I suspect that many people could contribute to the design of a viable replacement system, and that we have not yet heard all potentially useful ideas.

The OECD has been especially deficient, I believe, in its lack of willingness to give serious and open-minded attention to the possibility of alternatives to comparables-based transfer pricing rules. The OECD Guidelines claim summarily that “no legitimate or realistic alternative to the arm’s length principle has emerged.”<sup>8</sup> The OECD has never, however, attempted a systematic and quantitative comparison between their approach and alternatives, such as the formulary system that has been in place among the US states for about one hundred years – a longevity that suggests such a system is at least to some extent “realistic” – or alternatives based on the OECD’s own profit split method, such as the one I mentioned a moment ago.<sup>9</sup> It should be possible to compare alternative systems, by use of realistic and quantitative case studies, with respect to such criteria as avoidance of both double taxation and double under-taxation, and feasibility and cost of compliance and enforcement. I believe the world’s governments deserve – and need – a much more thorough, systematic, and open-minded comparison of possible alternatives, insulated from the participation of financially interested parties, than the OECD has offered to date.

But even to the extent that reasoned analysis might demonstrate both the feasibility and desirability of reform, I fear that comprehensive replacement of current transfer pricing rules will remain, for the foreseeable future, politically infeasible. The political support for the ability to shift income by means of intragroup contracts remains enormously important to many companies in the United States and, through the spread of “restructuring,” to many companies elsewhere. At least in the United States, half a century of lobbying has succeeded in masking political debate over the real issues involved – namely, the global effective tax rates that should be faced by multinationals in a competitive world – under a smokescreen of defense of the purported international consensus that is represented by “arm’s length.” The success of this kind of political advocacy does not seem likely to evaporate soon, and I think, therefore, that comprehensive replacement of the OECD approach is not likely in the near term.

Even in the absence of opportunity for comprehensive reform, however, I believe that practical measures to mitigate some of the most damaging consequences of the OECD approach are likely to be available, in at least some countries.

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Durst, *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split*, 9 Fla. Tax Rev. (2009) 497, at 540 – 53.

<sup>8</sup> OECD-TPG, 1.15.

<sup>9</sup> OECD-TPG, 1.16 – 1.31 are devoted to an identification of perceived defects of global formulary apportionment, but the discussion in the Guidelines is devoid of any systematic comparison of the extent of difficulties under a formulary system with the extent experienced under the OECD’s current approach. For example, Paragraph 1.26 identifies possibility difficulties posed by fluctuating exchange rates under a formulary system, but says nothing about the vexing difficulties posed by exchange rate fluctuations under the OECD’s current approach.

First, I think, governments around the world should conduct fair, methodologically sound reviews of contemporaneous documentation that is available in government files, in order to expose plainly wasteful practices and to change administrative rules so as to eliminate those practices. Similarly, governments, especially outside the United States and other countries where the OECD model has achieved the status of a politically powerful ideology, should design and adopt safe harbors and perhaps other administrative measures that will reduce or even eliminate the need for contemporaneous documentation as we know it, especially the most costly component of such documentation, computerized database searches and analyses. Governments of developing countries, in particular, should adopt such cost-saving measures.

In addition, legislatures in those countries where the political situation permits should consider clarifying existing rules to make clear that contracts among commonly controlled entities will not be respected to the extent they have the effect of shifting income. (This approach bears some similarity to legislative initiatives undertaken in recent years here in Germany, in response to the recent wave of “restructurings.”) Such legislation might affect a wide range of intragroup contracts, including licenses of rights to intangibles, or may be limited more narrowly to contracts that seek to assign the risks of different business functions, a kind of contract that is associated in particular with restructurings. Countries can adopt legislation of this kind while leaving the system of arm’s length transfer pricing otherwise largely intact.

Although I realize that opinions might differ, I do not believe that legislation effecting disregard of certain intragroup contracts would violate existing income tax treaties. There is, I believe, nothing in the notion of “arm’s length,” as incorporated into today’s income tax treaties, which requires respect for the shifting of income through contracts between entities that share common economic interests. Indeed, income shifting through such contracts would seem to be precisely the opposite of anything that might in real life occur between unrelated parties transacting at arm’s length. Overall, although there is likely to be controversy, I believe that a government that wishes to do so can protect its revenue by disregarding income-shifting through intragroup contracts without fairly being said to have violated existing income tax treaties.

By combining such measures as reform of contemporaneous documentation, safe harbors, and limitations on the use of intragroup contracts to shift income, I believe that governments can ameliorate much of the harm that today is caused by OECD-style transfer pricing rules, while staying largely within the framework of those rules. Given the political pressures, especially in the United States, that seem for now to stand in the way of more comprehensive reform, I think that these kinds of incremental measures can be of significant value.

## **7. Conclusion**

Concluding this discussion, let us pause for a moment and ask how the web of deception – largely, really, self-deception – that underlies the OECD approach to

transfer pricing could have persisted for so many years, in the face of hundreds billions of dollars shifted to jurisdictions in which little business is conducted; hundreds of tax examinations that last for years but reach no firm conclusions; and thousands of packages of contemporaneous documentation that extract valuable resources from the productive economy and provide little if any useful service in return. I do not have a full answer to this question, but in search of perhaps a partial answer I read, in anticipation of this conference, another book with an historical connection not specifically with Max Planck, but with the economic history of Central Europe generally, and even Munch in particular: *The Business of Alchemy*, written by Pamela H. Smith.<sup>10</sup>

This book describes how, for many years (Smith's book focuses primarily on the late 17<sup>th</sup> Century), highly respectable scientists made large amounts of money transmuting various metals into gold. Now, it has been reasonably well established that no alchemist actually succeeded in converting other metals into gold, but nonetheless these alchemists were widely acclaimed by the royal houses of Europe that paid for their services, and they often enjoyed repeat business.

The reason for their extended success seems to have been a mixture of greed, embarrassment among those who were deceived, and a large dose of pure humbug. The crowned heads of Europe were desperate for revenues, largely for military purposes; they desperately wanted to believe that they had obtained a rich source of revenues, and they also wanted their competitors to believe this. Also, once a customer had paid the alchemist for work performed, the customer, even if it became clear that the alchemical services were fraudulent, generally did not want to admit that he or she had been deceived. Further, the more successful among the alchemists were adept at using the appearance of scientific terminology to promote themselves; at times, they published lengthy guidelines for how to conduct their work, which looked wonderful on the printed page but, to the apparently few who attempted really to read them, proved to contain nothing but speculation and empty, flowery prose. And the institution of alchemy survived in Europe for hundreds of years.

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<sup>10</sup> Smith, *The Business of Alchemy*, Princeton (1994).

# Reflecting on the “Arm’s Length Principle”: What is the “Principle”? Where Next?

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## Abstract

*The “arm’s length principle,” is fundamentally antithetical to the economic, commercial and business characteristics of the taxpayers whose relations with each other within commonly controlled groups it is meant to evaluate and discipline. This collision has always been embedded in the “principle” but is becoming more prominent and disruptive in transfer pricing as manifestations of “intangible” value are recognized as being responsible for entrepreneurial returns perceived to be highly mobile. Where and how international business income is earned is accordingly becoming increasingly difficult to discern according to conventional physical, separate entity and transaction precepts underlying international tax and treaty rules, principles and practices. The “arm’s length principle” is facing many challenges. Effects of “globalization,” and more precisely the increasingly evident importance of “intangible” manifestations of value within corporate groups to account for where income ought to be considered to be earned, disturb and amplify long standing tensions underlying the application of the arm’s length principle to enterprises that essentially are single economic “firms”. This paper reconsiders the sustainability of the “arm’s length principle” as a “principle” with reference to distortionary effects that arise from subdividing an “economic firm” into constituent legal “fictions” spread across a number of tax jurisdictions. It advocates consideration of a recalibration of the “principle” by adopting objective reference factors short of “formulating apportionment” as commonly discussed to determine where income-earning activity is considered to take place and resulting income earned.*

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\* These comments are mine and are not those of and should not be attributed to any organization with which I am associated. They were inspired by the multi-disciplinary Conference on Fundamentals of International Transfer Pricing in Law and Economics. The varied backgrounds of the conferees served to generate novel, probing and even provocative perspectives on transfer pricing, particularly as it confronts “intangibles” as a manifestation of economic value transmissible within corporate families in ways that tax and legal systems might not readily recognize or be able to value. It is in particular the intangibles aspect of transfer pricing, explored at the Conference philosophically, mathematically, with reference to judicial decisions, and according to inferences drawn about differences between management and financial (and also tax) accounting, that is the particular focus of these comments. I am grateful for comments on earlier drafts of this paper by co-conferees Professor Jinyan Li and Mr. Michael Durst as well as by my colleagues Ms Alexandra Brown and Ms Pooja Samtani.

## 1. Introduction

“The Little Engine That Could”<sup>1</sup> is a well-known children’s story about an unassuming little blue steam engine called upon to pull a heavily loaded train over a mountain – a task well beyond its normal capacity and usual work as a modest yard engine – after other stronger and possibly more capable engines demurred confessing, each for its own reasons, an unwillingness or inability to help. Undaunted, through sheer resolve, the little engine succeeded in the face of no practical alternatives by chanting over and over “I think I can, I think I can,” delivering the train’s cargo, in one version of the story toys and food for children, to the expectant recipients on the other side of the mountain relying on it as their last hope.

The arm’s length principle – as commonly perceived, the notion that transfers within a commonly controlled group should adhere to the dictates of seemingly equivalent transactions between parties connected only by those transactions – is the contemporary tax world’s “Little Engine That Could.” It is a resilient mainstay of the framework within which perceived distortions of the allocation of multinational or global corporate group income are addressed. That said, it is being asked to contend with broadly based international tax challenges for which it was never intended and may not be well equipped. These comments concede its frailties,<sup>2</sup> but invert them as possible positive indicators of how its residual directional guidance – the essence of any principle – could be enhanced, taking account of more general pressures on international tax jurisdiction assumptions and conventions.<sup>3</sup>

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<sup>1</sup> Piper, *The Little Engine That Could*, New York (1930); a revised version was published in 1954; A brief history of how this story evolved can be found at: [http://en.wikipedia.org/wiki/The\\_Little\\_Engine\\_That\\_Could](http://en.wikipedia.org/wiki/The_Little_Engine_That_Could).

<sup>2</sup> See, for example, among many commentaries these that stimulate thinking in this area: Langbein, *The Unitary Method and the Myth of Arm’s Length*, *Tax Notes Special Report* (February 17, 1986), 625; Langbein, *Cognitive Capture, Parliamentary Parentheses, and the Rise of Fractional Apportionment*, 39 *Tax Management International Journal* 10 (2010), 567; Durst, *A Statutory Proposal for U.S. Transfer Pricing Reform*, *Tax Notes International* (January 4, 2007), 1041; Durst, *It’s Not Just Academic: The OECD Should Reevaluate Transfer Pricing Laws*, *Tax Notes International* (January 18, 2010), 247; Durst, *The President’s International Tax Proposals In Historical and Economic Perspective*, *Tax Notes International* (June 1, 2009), 747; Durst, *Fix Transfer Pricing and Protect U.S. Competitiveness*, *Tax Notes Special Report* (July 26, 2010), 401; Vann, *Reflections on Business Profits and the Arm’s Length Principle*, in Arnold, Sasseville and Zolt (eds.), *The Taxation of Business Profits Under Tax Treaties*, Toronto (2003), 133; Avi-Yonah, Clausen and Durst, *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split*, 9 *Fla. Tax Rev.* (2009), 497; Avi-Yonah, *The Rise and Fall of Arm’s Length: A Study in the Evolution of U.S. International Taxation*, 15 *Virginia Law Review* 89 (1995); Durst and Culbertson, *Clearing Away the Sand: Retrospective Methods and Prospective Documentation in Transfer Pricing Today*, 57 *N.Y.U Law Review* 37 (2003).

<sup>3</sup> See for a flavour of pertinent international tax considerations affecting tax jurisdiction and the debates about them, for example, Vann, *Taxing International Business Income: hard-Boiled Wonderland and the End of the World*, *World Tax Journal* (2010), 291; Vann, *Tax Treaties: The Secret Agent’s Secrets*, BTR No. 3 345 (2006); Vann, *Do We Need 7(3)? History and Purpose of the Business Profits Deduction Rule In Tax Treaties*, Sydney Law School, University of Sydney, Legal Studies Research paper No. 10/18, (2011), <http://ssrn.com/abstract=1787805>; Kleinbard, *Stateless Income*, USC Center in Law, Economics and Organization Research paper

## 2. Concerns About the “Arm’s Length Principle”

The arm’s length principle has enjoyed a long and essentially continuous life, reaching back to the early part of the twentieth century.<sup>4</sup> What has changed to raise concerns about how well we understand it or how useful it is? The short answer is: “intangibles.” Are we, or should we be, concerned about whether countries’ control over their jurisdiction to tax international business income according to transfer pricing rules and practices grounded in the supranational guidance of the Organisation for Economic Co-operation and Development (“OECD”) in its Transfer Pricing Guidelines (“TPG”) is being eclipsed by the circumstances to which they are directed? The equally short answer is: yes.

For the arm’s length principle to continue to serve its purpose – to surmount the mountain of challenges it faces – there are three requirements. First, it is necessary to recalibrate the “principle” by recalling its origins, and inherent limitations – its essence as a kind of “international code” instructing that income should not be misdirected through nothing more than an opportunistic exercise of organizational (i.e.,

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No. C11-1 USC Legal Studies Research Paper No. 11-6, <http://ssrn.com/abstract=1791769>; Kleinbard, *The Lessons of Stateless Income*, USC Center in Law, Economics and Organization Research Paper No. C11-2 USC Legal Studies Research Paper No. 11-7; Rosenbloom, *From the Bottom Up: Taxing the Income of Foreign Controlled Corporations*, 26 *Brooklyn Journal of International Law* 4 (2001), 1525; Taylor, *What’s ‘Neutral’ About This?*, *Tax Analysts Worldwide Tax Daily* (May 30, 2011), 715.

<sup>4</sup> See, for example, early work of and arising from the study of international tax issues by the League of Nations and Mitchell B. Carroll and other, notably though certainly not exclusively, League of Nations, *Economic and Financial Commission, Report on Double Taxation Submitted to the Financial Committee by Professors Bruins, Einaudi, Seligman and Sir Josiah Stamp*, Geneva (1923); Carroll, *Taxation of Foreign and National Enterprises (Volume IV), Methods of Allocating Taxable Income*, Geneva (1933); Jones, *Taxation of Foreign and National Enterprises (Volume V), Allocation Accounting for the Taxable Income of Industrial Enterprises*, Geneva (1933); See also Carroll, *Allocation of Business Income: The Draft Convention of the League of Nations (1934)* 34 *Colum. L. Rev.* (1934), 473, a commentary that in an international context foreshadows much of the discussion and debate about the “source” of income, income allocation issues and conventions, “empirical methods and method of fractional apportionment” for allocating international business income and related jurisdictional considerations. Not only are the concepts addressed by Carroll not new, but allowing for the passage of time the manner in which he discusses them in light of the then perceived jurisdictional issues could seem to be today’s discussion and debate for someone transported through the intervening seventy-five years or so. It is true that his discussion is focused on the allocation of income to “permanent establishments,” or more generally among multiple business presences of an enterprise. However, as the conclusion of the OECD’s recent inquiry into the attribution of profits to “permanent establishments” according to the “authorized OECD approach” reflects the inter-jurisdictional considerations affecting the identity of the source of income and the measurement of income amounts proximate to a source are thought to be informed by many of the same considerations and analysis that are taken for granted in applying Article 9 of the OECD Model Tax Convention to income allocation between legally distinct members of a larger common “enterprise.” Indeed, given the necessary concern of both “permanent establishment” income attribution and transfer pricing as usually understood with jurisdictional proximity to income from what amounts to a unitary, or at least presumptively and organizationally integrated, commercial operation, it is hard to see how this could be other than the case. Going back in time with Carroll’s comments seems like encountering a discussion in the present.

corporate) power. Second, the ongoing inquiry into its and the TPG's effectiveness must move away from a label – laden debate (i.e., arm's length versus "formulary" or something else) that distracts from the objective of aligning economic and tax income according to how it is actually earned, recognizing that there are only a few core inputs and equally few or fewer measures of their commercial mobilization to produce a return. Third, it is necessary to appreciate and build on the burgeoning respectability of profit-oriented transfer pricing approaches as reflected in the most recent restatement of the OECD's TPG; in other words the TPG also need to be recalibrated. It is also necessary to acknowledge when, possibly despite appearances to the contrary, international income allocation questions faced by the arm's length principle fundamentally may not be, or at least may be considerably more than, transfer pricing as such, requiring broader though possibly co-ordinated jurisdictional responses.<sup>5</sup>

A possible way ahead may lie in a generally accepted factor – based adaptation of a "profit split" approach. It would be oriented to the actual, rather than rigidly methodological expectations about, contributions made by members of a commonly controlled multinational or global corporate group to their collective enterprise, with reference to objective categories of contribution. This describes a "contribution profit split" of sorts with categorical rather than formulary reference points that would reflect where and how, necessarily, income is actually earned and value created. This approach possibly might incorporate limited "safe harbours"<sup>6</sup> or other features that define its predictable application according to some agreed objective parameters. Interestingly, it would be consistent with a more holistic examination of what too often seem to be treated as separate international tax subjects – transfer

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<sup>5</sup> See, for example, the commentaries mentioned in note 3. A critical issue in this context that cannot ultimately be avoided, and should not suffer from serious want of study and revision for much longer, is the meaning of "permanent establishment." The significance of this issue has been acknowledged in the OECD's review of how to attribute business profits to permanent establishments. The application of transfer pricing – based measurement tools, as extensions of the arm's length principle, can be expected to generate uncertain and even questionable results using the arcane and possibly antiquated notions of mostly overtly physical business presence reflected in Article 5 of the OECD Model Tax Convention particularly in so far as they increasingly acute questions about "constructive permanent establishments," and what "fixed place of business" and "place of management" mean or could mean and whether these notions need to advance or are being dragged forward beyond their generally accepted connotations. In fact, formulating an elaborate framework for measuring and allocating international business profits, within the relatively narrow ambit of Article 7 for "branches" or more generally taking account of how international business income is actually earned, without reconsidering the utility and scope of the "permanent establishment" notion as historically and still commonly understood, is limiting; See the OECD's Report – The Attribution of Profits to Permanent Establishments, Paris (2008); See also, as an interesting foil for this most recent international treatment of the issue, which bears strongly on the thesis and commentary of this paper, Carroll, Allocation of Business Income: The Draft Convention of the League of Nations, (note 4).

<sup>6</sup> For a very thoughtful recent discussion see Lewis, Short Cuts for Small Fry: Why the IRS Should Reconsider Transfer Pricing Safe Harbors for Small Taxpayers and Transactions, 19 Tax Management Transfer Pricing Report 24 (April 21, 2011), S-1; It might be suggested that restricting this idea to so-called "small" taxpayers and their transactions is out of politeness, in the nature of "walk before you run"; the idea could have broader appeal as a practical matter.

pricing, controlled foreign corporation rules, foreign tax credit regimes and attribution of income to permanent establishments – even though they are all aspects of the same practical reality that global business is managed globally with the objective of fashioning a bespoke competitive effective global tax rate for a global business. Proceeding this way may also alleviate pressure on very difficult questions about what “intangibles” are, how as such they should be valued and whether countries’ tax laws adequately foresee them as “taxable objects” transmitted or otherwise deployed by “taxable realizations”.

### 3. The “Arm’s Length Principle,” “Intangibles,” and the TPG

The “authoritative statement”<sup>7</sup> of the arm’s length principle is found in Article 9 of the OECD Model Tax Convention. It is simple enough to say as paraphrased in paragraph 1.6 of the TPG.

*[Where] conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations which 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.*

Conceptually, the arm’s length principle manifests a common expectation of rules, practices and conventions outlining the parameters of jurisdiction to tax in an international setting. Countries’ competing business income tax claims should be reconciled with reference to the source of that income, identified in some manner with where taxpayers conduct business, undistorted in the cases of dealings within commonly controlled business groups by exogenous non-“commercial” influences.

The TPG and countries’ adaptations of them in their tax laws are the indisputable clockwork of the arm’s length principle. They focus on the *conditions [that] are made or imposed between the two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises* as transactional terms of dealing. The ideal comparator, on this premise, is generally thought to be what “unassociated” enterprises would have done in an equivalent setting. That, however, begs many questions. The actual comparator is not some “other” transaction, however “other” is defined. In fact, this “authoritative statement of the arm’s length principle” by the OECD sets up a much more subtle comparator: *[the] profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions have not so accrued*. What are those normative profits, after correcting for terms and conditions *made or imposed* by acts presented by the opportunity of association? What about profits that are more insidiously unavoidable because they inhere in “association,” and are not a result of the opportunistic exercise of corporate power defined by the organizational and transactional fictions that are the medium by which a group, as a group, functions? Should it be expected that they would be explained or defined, or more

<sup>7</sup> OECD, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Paris (2010), para.1.6.

precisely benchmarked, by the outcome of dealings between disinterested parties? Doesn't the "principle" ask a much more difficult question, and posit a much less methodologically controlled or prescriptive inquiry, than the TPG as usually understood foreshadow?

As long as transfers involve or take the form of familiar property and services well defined legally, the TPG may permit potential distortions arising from more insidious dimensions of corporate group existence and internal "dealings" to be identified and evaluated well enough to sustain a measure of practical confidence about a taxpayer's resulting reported income. Things change, however, when manifestations of "intangible" value become more pronounced, by essentially becoming in themselves the valuable "products" and "services," transmissible silently and invisibly behind the mask of apparently typical transfers.

"Intangibles" – pointedly so-called "soft intangibles"<sup>8</sup> – pose enormous challenges for transfer pricing and raise larger issues of international tax jurisdiction. The incumbent weaknesses of the arm's length principle are even more exposed when "intangibles" are not "transactional" in ways typically understood by tax legislation and related law. The situation becomes decidedly more acute when the "intangibles" we are concerned about are the essence of a taxpayer whose transfers nevertheless are being tested for their "arm's lengthedness" according to the TPG's methodological propositions. Now that "intangibles" are the object of specific transfer pricing study by the OECD – "out of the bottle" so to speak – a more thorough rethinking of the arm's length principle and how countries adopt it in their tax laws cannot be avoided.

#### 4. A "Principle" In Spite of Its Fictions

Much of the criticism directed at the arm's length principle, and the substantive risks to which it is exposed as it confronts "intangibles," are in one way or another attributable to the disputability of its supporting fictions<sup>9</sup>, fictions of two kinds:

<sup>8</sup> "Intangibles" that are not well defined legally and not specifically defined as objects of taxation in a tax code. See comments of Wilkie made to the OECD as part of the OECD's public consultation in connection with its project on the "Transfer Pricing Aspects of Intangibles," (September 15, 2010), [http://www.oecd.org/documents/5/0,3343,en\\_2649\\_34897\\_46030661\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/documents/5/0,3343,en_2649_34897_46030661_1_1_1_1,00.html) as well as the presentations most recently made in late March, 2011 reported by the OECD in "OECD meets with business commentators on the valuation of intangibles for transfer pricing purposes," [http://www.oecd.org/documentprint/0,3455,en\\_2649\\_33753\\_47445940\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/documentprint/0,3455,en_2649_33753_47445940_1_1_1_1,00.html), documenting "Working Party No. 6's Special Session On The Transfer Pricing Aspects of Intangibles: Meeting With Private Sector Representatives On the Valuation of Intangibles for Transfer Pricing Purposes," OECD, Paris, in the context of the OECD's "scoping paper" on this project available at [www.oecd.org/ctp/tp/ilintangibles](http://www.oecd.org/ctp/tp/ilintangibles). See also Sheppard, Intangibles Revisited In OECD Intangibles Project, *Tax Analysts Worldwide Tax Daily* (June 8, 2011), Doc 2011-12407.

<sup>9</sup> A thought provoking discussion of the reliance by tax systems on "functions" is Rosenbloom, Address: Banes of an Income Tax: Legal Fictions, Elections, Hypothetical Determinations, Related Party Debt, delivered as the 2003 Ross Parsons Lecture at the Supreme Court of New South Wales, Sydney, Australia, on 28 August 2003 and published as modified in *32 Tax Notes International* (15 December 2003), 989.

(i) general legal fictions that, for example, give life to corporations distinct from their economic owners and establish the respectability of contracts, including debt and equity forms of financing, within a corporate group; and (ii) the fiction that a unitary “economic” firm can and should be judged as if it were something other than the singular economic actor it is simply because its commercial and organizational existence is defined by the other fictions. The current focus by the international tax community on “intangibles,” including so-called “soft intangibles” and “synergies” that define a “firm”, draws attention to the limitations of these fictions and accordingly of the arm’s length principle.

Economic income is neither contained or defined by, nor dependent on, these fictions. Financial accounting conventions accommodate them, but measure “income” only to fit assumptions based on the fictions. They “account” for income whose limits, within the accounting rules, and origin are set by these organizational and transactional fictions. Multinational and global businesses labour under these fictions. In fact, however, these businesses operate functionally almost in spite of them as global enterprises, according to business imperatives that are not intuitive to the expectations and requirements of these fictions. In addition to transfer pricing rules, normative international tax rules and principles directed to where business is considered to be carried on and business presences (“permanent establishments”) found consequently are engaged.<sup>10</sup>

The arm’s length principle, built as it is on legal and accounting of fictions, is itself a fiction. Captured in the “arm’s length” premise of the “principle” is an acknowledgment, however, that the relationship between parties who are commonly controlled accounts primarily if not exclusively for the difference between their economic and financial outcomes – income, or profits – and those of parties not similarly engaged. The expectation of transfer pricing is that through a variety of methodological simulations, the relative equivalence of these two situations, devoid of the taint of “association,” can reliably be discerned. However, a “firm” is an economic unity despite its operating manifestation as various legal “bits.” It is the direct antithesis of the taxpayers to which “the arm’s length principle” is meant to apply. Its internal organs and appendages have no more intrinsic significance than the organs and limbs of the human body each on its own apart from the human “being” of which it is a component. A “firm” is an economic “being.” Its existence, and the inherent value it captures by its existence is uniquely self-interested; it is not merely the sum of the values ascribed to its “bits” as if they had the same functionality and significance apart from that economic “being.”

“Firms” exist to avoid costs and other limitations associated with not being “firms.” This is how internal “rents” or synergistic returns are generated. Encasing these sorts of dealings in a “firm” is the valuable benefit from not dealing at arm’s length. It is the source of a unique “return” that decidedly is not “transactional”. Even in the most “routine” cases, the unavoidable realization is that the TPG as a statement of the arm’s length principle necessarily misses the mark, though by how much is hard to tell. The increasingly restive need is to be able to capture and allo-

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<sup>10</sup> See commentaries and comment at (notes 2, 3, 4 and note 5).

cate among its organs the “value delta” that defines a particular “firm” as such without being distracted or misled by inherently unreliable “comparisons” to others seemingly engaged in similar activities in an equivalent commercial and industrial environment.

The arm’s length principle and transfer pricing more generally, are stacked on – indeed depend on – a variety of legal, tax, accounting and practical fictions and assumptions. However, the OECD’s latest revision of the TPG suggests a not-so-subtle change in course toward the arm’s length principle’s essence, presenting an opportunity via profit-oriented methodologies to reinforce the “principle” and constructively reorient the TPG.

## 5. The “Principle” Should Not Be Confused With the “Tools”

The TPG are not the arm’s length principle. But sometimes, this is hard to tell.

The arm’s length principle is concerned with the correspondence between profits of a “firm” and a taxpayer’s share of those profits as its return on contributions it has made (including risks undertaken) in relation to or at least with an awareness of the “firm’s” and other relevant taxpayers’ circumstances.

The TPG, on the other hand, have a much narrower derivative role and a more mechanical focus. They are concerned with whether the return on a particular event – a “transaction” or other specific transfer – is the same or close enough to what outsiders would realize on the assumption that the artificial subdivision of a “firm” into legally distinct pieces actually has economic significance. Together with countries’ transfer pricing rules and practices, the TPG are directed to and indeed have become consumed by methodological, rules-based and often mechanical “analyses” directed to somehow divining the “right” price for discrete transfers apparently similar to those involving outsiders. It is then assumed that the aggregation of these outcomes should necessarily yield income satisfying the arm’s length “principle.”

The arm’s length principle seems to have been overtaken by the “tools” whose judicious and artful application was originally meant only to animate the “principle. Yet, the TPG originated only as “tools” to test and illuminate the application of arm’s length principle first by understanding the “facts and circumstances” of complex taxpayer groups and then guiding the elimination of profit distortions attributable to terms of dealing imposed through actions made possible by association – the assertion of organizational power.<sup>11</sup> The TPG’s economic prescriptions

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<sup>11</sup> This sense of the role of the TPG pervades the recent decision of the Federal Court of Australia in *Commissioner of Taxation v SNF (Australia) Pty Ltd* (2011) FCAFC 74 (Federal Court of Australia) where the Court said at paragraph 109 of their reasons: Article 9(1) attempts to address at a high level of generality the problems thrown up by transfer pricing by providing for pricing as if the transactions had been between independent parties. The precise words of Article 9(2) are not directly relevant to this appeal but, we note, they ensure that a determination by one jurisdiction that profits should be included in a taxpayer’s income in that jurisdiction pursuant to Article 9(1) results in a corresponding omission of income in the other jurisdiction, thereby avoiding double taxation.

and transactional formulations are only guidelines<sup>12</sup> even though they seem to have been imbued with an almost quasi-legislative, prescriptive status. They are, however, no more the “principle” than construction tools are a building plan.

Is the entrepreneurial return realized by what the OECD Model Tax Convention calls “associated enterprises” not intrinsically a shared return? How can it be anything but this? The subdivision of a “firm” according to various legal fictions is convenient in many ways but, regardless of any attempts to exploit these fictions to manage its global effective tax rate, reflect only limitations that the “firm” imposes on itself, offering little guidance about what “profit” is or necessarily to whom, particularly, it belongs.

There is, we remind ourselves, a “principle” of sorts, though it may be a buried in the “toolbox.” The “principle” is that profits, whatever they are and however they are measured, should come to rest where the productive activities giving rise to them are located or take place, recognizing that because of the artifice inherent in the forms of a commonly controlled business they could be directed elsewhere through the simple expedient of “association,” relying on or justified by the forms of business – the fictions. It recognizes, though its original expression may not have spoken this way, that what is in issue is the ability of an economic “firm” to control its *effective global tax rate* because of the subdivision of the “firm” into legal organizational fictions – separate legal entities comprising the group but accounted for separately – that engaged with each other using transactional fictions – contracts – akin formally to those employed in their commercial relations by “real” third parties in order to abridge genuinely adverse economic and commercial interests that do not exist when a “firm” – in more than one jurisdiction.

Article 9 of the OECD’s Model Tax Convention addresses “profit” distortions. While it would be naive to suggest that profits are not the result of underlying transactions that entail costs and produce revenue, the focus, or balance, is important. It is not on any particular transaction formulation or any rigid expectation about how a global business should have been configured or operated. Further, it is on profit distortions attributable to the *imposition* of terms and conditions because of “association.” It asks that those terms and conditions be ignored for measuring profit. It does not say, what most take for granted and the TPG assume, that profit therefore is what another would have earned in the absence of terms and conditions so imposed. The comparator is the profit of the enterprise itself without the offending

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<sup>12</sup> See, for example, the recent Australian tax decision in *Commissioner of Taxation v SNF (Australia) Pty Ltd* (note 11), at paragraph 116 and surrounding paragraphs of the Court’s reasons, as well as and the decisions of the Tax Court of Canada and the Canadian Federal Court of Appeal in *General Electric Canada Capital Inc. v. R*, 2009 TCC 563, 2010 DTC 1007 (TCC), 2010 FCA 344, 2011 DTC 5011 (FCA), as well as the application of the TPG in the recent Tax Court of Canada Decision in *Alberta Printed Circuits Ltd. v. The Queen*, 2011 TCC 232 (TCC) in which the Court approached the application of the TPG as “guidelines” but otherwise, as was the Australian Court primarily influenced by the dictates of the relevant legislation regardless of what the TPG, on their own might recommend. In other words, as useful and commonly applied as the TPG are, the point of departure for their application is the relevant transfer pricing law of the country concerned.

terms and conditions – the profit that otherwise would have been earned.<sup>13</sup> That is not necessarily what somebody else earned in seemingly equivalent circumstances. The inquiry is about whether the opportunity and power to dictate terms and conditions of dealing, itself, is accountable for profit distortions. Transactional analysis, as an element of what amounts to a valuation inquiry, may be useful for this “forensic” exercise; but the controlling objective of the exercise must be kept in view. The “arm’s length” aspect of the test is a kind of instruction to ignore terms of dealing that would not have been possible in the absence of “association”; it is not, necessarily, a proposition that transactions of seemingly like kind between disinterested

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<sup>13</sup> Despite the deference paid to “arm’s lengthness” as a controlling limit on profit distortions, the application of the arm’s length principle does not require that the “family pedigree” of a tested party be ignored in establishing the basis on which its profitability would be evaluated according to the arm’s length principle and the TPG or that the so-called comparable circumstances be precisely the same. This is evident in how the Canadian Tax Court and Federal Court of Appeal, and the Australian Federal Court conceived the applicable standard captured by the arm’s length principle and the as well as the application of transfer pricing methodologies at the heart of the TPG, in adjudicating General Electric Capital Canada Inc. and SNF (Australia) Pty Ltd cases, respectively. The Canadian Courts have also endorsed what amounts to a reasonableness standard with reference to what reasonable business persons would do as a determining factor in evaluating the acceptability of transfer prices and resulting income, with reference to a legislative precursor of the present Canadian transfer pricing rule in section 247(2) of the Income Tax Act (Canada) which these Courts see as still present. See (note 12). There is also a sense of this kind of outlook in paragraphs 9.173 and 9.174 of Chapter IX of the TPG dealing with “business restructurings.” The OECD, reflecting a general sensitivity to business reasons in this context, remarks: Business restructurings often lead MNE groups to implement global business models that are hardly if ever found between independent enterprises, taking advantage of the very fact that they are MNE groups and that they can work in an integrated fashion. ... [A] lack of comparables does not mean of course that the implementation of such global business models should automatically be regarded as not commercially rational. What is being tested is whether the **outcome (the arrangement adopted)** accords with what would result from **normal commercial behaviour** of independent enterprises; it is not a behaviour test in the sense of requiring the associated enterprises to actually behave as would independent enterprises in negotiating and agreeing to the terms of the arrangement. Thus, whether the associated enterprises actually engaged in real bargaining or simply acted in the best interests of the MNE group as a whole in agreeing to a restructuring does not determine whether the arrangement would have been adopted by independent enterprises behaving in a commercially rational manner or whether arm’s length pricing has been reached. The focus, here, on the “outcome,” commerciality and behaviour, recognizing that the interests of the group, i.e., the “firm,” as a whole may be the object, is interesting in light of the thesis of observations and thesis, generally, in this paper. The As to the significance of a tested taxpayer being a member of a “firm” – a composite multinational or global group – see also Horst, How to Determine Tax-Deductible, Debt-Related Costs For a Subsidiary, 62 Tax Notes Int’l (May 16, 2011), p. 589; an earlier version of this paper was presented at the Munich Conference and contends with the approach to “implicit” support, the characteristic of a taxpayer that is attributable to and derives from its status as a piece of a “firm” – its organizational genes in other words, taken by the Canadian Courts in the General Electric Canada Capital case analyzed by Horst. Those Courts did not think that taking account of what amounted to the corporate pedigree fell afoul of the obligation imposed by the Canadian transfer pricing rule and foreshadowed by thy the arm’s length principle and the TPG to have regard to what “arm’s length” parties would have done, which in their view involved looking at the value of the “incremental” benefit of a particular commercial transaction, in that case an inter-corporate guarantee.

parties establish enterprise profit within the boundaries of an “association.” So, the “authoritative statement,” as the OECD puts it, of the arm’s length principle actually invites – even requires and expects – a profit-focused inquiry and is refreshingly free of presumption about how this necessarily would take place.

It may be, nevertheless, that countries will be unsatisfied with this more principled approach to the application of the “principle” even as framed by their legislation. Or, it may be that this perception of the “principle” reveals why countries’ transfer pricing rules are less mechanistic than commonly perceived but also may short-change it. “Intangibles” are the case in point, both in the “business restructuring” context and more generally. A country may have particular expectations about how “value” generated in or with the support of its national economy should be captured as taxable income, not merely as a by product of a narrow transaction – based determination but more broadly as a division of profits corresponding to the relative “economic” contributions of its members of a corporate group and more generally of its national economy or market. Concerns of this nature no doubt are reflected in the pervasive international attention directed to how countries’ tax regimes and the arm’s length principle apply to “business restructurings.” In such cases, however, the economic propositions that animate the arm’s length principle may be insufficient themselves, even with the benefit of a strong directional statement of the “principle”, to capture certain perceived transmissions of value, without corresponding law changes. The arm’s length principle, and the TPG, have practical limits; as sound as they may be, they have to find life in countries’ tax and supporting general laws.

## 6. “Intangibles” and International Tax Jurisdiction

The basic parameters of international tax jurisdiction are fundamentally unchanged from those originally developed in the early part of the twentieth century to ameliorate trading relations among countries in a more “physical” commercial world.<sup>14</sup> Then, the possibility of material incremental value being associated with other than primarily physical “products” or value generating activities being transmitted or performed in other than observable physical ways, was much less pronounced or even likely let alone possible. Nor were the objects of trade likely to be manifestations of knowledge and experience as such, in the form “services” or “products” capable of being delivered and produced, as the case may be, without an affected taxpayer actually “touching” any particular location or destination. Generally, eco-

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<sup>14</sup> They are framed by various model tax conventions, notably the OECD and UN Model Tax Conventions, with which countries’ own “models” are closely aligned, and reflect the early twentieth century work commissioned or inspired by the League of Nations’ work on reconciling countries’ competing tax claims so as to preserve the essential entitlement of each to tax according to certain jurisdictional norms ensuring that tax, notably duplicative tax would not get in the way of their trading relations. See for example, as a point of departure for considering these issues note 4 as well as precursors of present model tax conventions: Fiscal Committee of the League of Nations, *London and Mexico Model Tax Conventions Commentary and Text*, Geneva (1946) and *The Elimination of Double Taxation, Report of the Fiscal Committee of the O.E.E.C. (The Organisation for European Economic Co-operation)*, Paris (1958).

conomic activities had to be in the places where goods were produced and sold and services provided, and the goods and services – the “products” – were observable in conventional ways. Certainly valuable intellectual property, for example in the form of transactional intangibles, existed. But these “rights” was readily noticeable and well defined legally, and their use and payment for them followed certain legal conventions that were also well known to tax and legal regimes. Modes of transport and communication, too, were observable in relation to jurisdictions, being more cumbersome compared with electronic communication that may be either a medium of trade or a “product” or “service” itself.

Acknowledging the role played by “intangibles” – particularly “soft intangibles” – as a defining characteristic of a “firm” despite its subdivision into organizational and transactional units – feeds an underlying realization that accepted notions of international tax jurisdiction, including those on which transfer pricing depends, are outmoded in relation to what accounts for “value” within a global business. This puts at risk countries’ tax bases and engenders insecurity about their fiscal constructs. This seems to be the case even for developed countries with robust tax regimes and sophisticated tax relations between them. Transfer pricing is just part of this larger phenomenon, which however, transfer pricing notions cannot address themselves.

The world has shrunk in ways that one economic and social geographer describes as “space-time compression”<sup>15</sup> – a smaller functional world ostensibly without economic borders. Tax regimes, on the other hand, need and rely on borders. Aside from the fictions considered earlier that create organizational and commercial borders, political borders sustain tax borders. It is fundamental according to international tax jurisdiction norms to be able to readily capture manifestations of business behaviour “inside” or “outside” those borders using more or less objective measures. Now, however, returns on the deployment of productive resources are much less clearly associated with, and through an extension of the legal fictions that are the skeleton of a global corporation, are more easily disconnected from the physical circumstances that influence how those returns are generated. “Income” and the organizational imperatives defining its location, are becoming what has

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<sup>15</sup> Harvey, *The Enigma of Capital and the Crises of Capitalism*, New York (2010), at 155 – 159, in particular at 157 and 158: What we now call ‘globalisation’ has been in the sights of the capitalist class all along. Whether the desire to conquer space and nature is a manifestation of some universal human longing or a product of specifically capitalist class passions we will never know. What can be said with certainty is that the conquest of space and time, along with the caselaw quest to dominate nature, have long taken centre stage in the collective psyche of capitalist societies. In spite of all manner of critiques, objections, revulsions and political movements of opposition, and in spite of the massive unintended consequences in the relation to nature that are increasingly felt, the belief still prevails that the conquest of space and time, as well as of nature including even human nature, is somehow within our reach. The result has been an inexorable trend for the world of capital to produce what I call ‘time-space compression’ – a world in which capital moves faster and faster and where distances of interaction are compressed. There is a more prosaic way to look at this. The coercive laws of competition (often resisted) impel both corporations and states to seek out advantages conferred by superior command over space and time, as well as technological advances.

been described as “stateless.”<sup>16</sup> Although these effects may seem be the stuff of “transfer pricing”, as far as the norms and practices of international tax jurisdiction are concerned, in fact they may reflect other dynamics beyond the capacity of transfer pricing rules to address.

What are the implications of these developments for transfer pricing? Simultaneously, circumstances that seemingly should be within its grasp are beyond its competence, at least according to prevailing perceptions and applications of the TPG. Transfer pricing is primarily concerned with identifying where business capital in a broad sense is deployed – where and how, and to what end the factors of production are actually used – and with testing the measurement of an appropriate return on this basis in ways that are suggested and framed by the TPG. Increasingly, however, it may be that regardless of where the productive factors are located, the location of profit could be somewhere else according to practices that the TPG seem to be inclined to validate or at least accommodate. For example, Part IX of the TPG dealing with business restructuring down plays the shifting of “profit potential” within a multinational or global group as a trigger for tax rebalancing, and attaches considerable significance to contracts which shift “risk” (and corresponding entrepreneurial reward) but possibly not much else as seen through the lens of normative business activity. Allowing these features of contemporary business organization to have primarily a transfer pricing animus may, at the same time, mask more urgent questions about the reliability of international and corporate tax norms embedded not only in treaty notions of “permanent establishment” and attributed “business profit” but also the design and reach of “controlled foreign corporation” rules which in turn focus on how to define and purify “domestic” and “foreign” territorial income ensuring a theoretically sound alignment of revenue expenses such as inter-

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<sup>16</sup> The transfer pricing rules invoke, indeed in a real way are at one with, very difficult, much larger and much more insidious questions about the “source” of “income.” See the very insightful commentaries of Kleinbard (note 3); Kleinbard draws attention effectively to the distinction between the concerns of transfer pricing – analyzing mobile capital according to where it has been mobilized and how it got there essentially according to the characteristics of the capital – and other larger international tax considerations of the sort alluded to in this paper relating to where “profit” ends up almost regardless of where normative productive activities take place and productive resources are deployed. Kleinbard’s comments are particularly penetrating in this regard in the paper entitled “Stateless Income” notably at pages 6 – 10. He says: Stateless income also flourishes because of nations’ failure to agree on other critical international tax norms that would determine “source” of income – that is, the mechanical rules by which income is attributed to one jurisdiction or another, based on the perceived economic contribution in that jurisdiction to the generation of that income. This failure reflects the fundamental commercial and economic ambiguity surrounding the locus of the value added through the exploitation of tangible assets. The consequences of this failure in turn are exacerbated by aggressive transfer pricing strategies. As the earlier examples of income stripping demonstrate, however, stateless income tax planning encompasses more than the exploitation of collective failure to develop binding normative source rules for income derived from intangible assets. And as this Article demonstrates, whatever first-order coherence in the definition of the source of income might exist in turn is vitiated when stateless income tax planning is layered on top, because that planning can take income originally “booked” in an economically-rational jurisdiction and in a second, separate, step move that income to another, lower-taxed one.

est. In a manner of speaking, all of this is “transfer pricing”. As conventionally understood, however, transfer pricing is too narrow and limited to be the exclusive source of larger international tax policy solutions. That is the innocent observation. More darkly, perhaps treating these sorts of concerns as primarily invoking transfer pricing conceivably may exacerbate them by validating outcomes that satisfy the “rules” but collide not only with the arm’s length principle but other equally important tenets of international taxation.<sup>17</sup>

## 7. Global Effective Tax Rates and International Corporate Taxation

International corporate tax involves a multinational or global “firm” fashioning a “competitive” international effective tax rate on its own terms based on its “facts and circumstances” understood with reference to those of its competitors who are assumed to be engaged in the same exercise, avoiding “duplicative” tax costs induced by the very legal (and accounting) fictions that subdivide the “firm” into a constellation of separate “contributing” members.<sup>18</sup> Transfer pricing is an element of the global effective tax rate planning by the “firm” with reference to its global profits. The “pieces” of the “firm” ostensibly engaged in conducting business and the “places” in which they do it, are not that important in themselves. Just as the arm’s length principle, at its core, concerns global “profits”, so more generally in fact does the actual application of international tax rules, including the TPG and the arm’s length principle, by those affected by them.

In effect the uncoordinated collection of national tax laws and practices intrinsic to the TPG and other international tax jurisdiction parameters is seen as a single international tax code.<sup>19</sup> Neither in a transfer pricing context nor with reference to other notions of tax jurisdiction do global “firms” conduct business as a collection of autonomous actors. They see themselves as single economic enterprises, or “firms”, with equally singular or unitary global profits. It is global profits, not per

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<sup>17</sup> In effect, the regime by which “firms” as global groups are regulated becomes so closely associated with and defined by their own expressions of form and interest that the regulatory guidelines, when they emerge, not only explain but sustain the activities and how they occur that inspired the regulation in the first place. Langbein has drawn attention to this phenomenon, called “cognitive” capture (note 3) and a recent reported exchange of views by officials of the OECD and knowledgeable commentators draws attention to this possibility at a more practical level; see Wright, Practitioners Assess Need for UN to Share OECD’s Role As Standard Setter In Developing International Tax Regimes, 20 Tax Management Transfer Pricing Report (June 4, 2011); See Langbein (note 2), Cognitive Capture, Parliamentary Parentheses, and the Rise of Fractional Apportionment; Buiters, Central Banks and Financial Crisis, to which he refers at note 79 in his paper.

<sup>18</sup> In effect, “firms” operating as multinational or global corporate groups have and have taken advantage of opportunities presented to them by the same tax and legal systems that define their financial and organizational existences to elect the amount of tax they pay and where they pay it. This is a practical response by them to the mix of tax systems they, and their competitors, face in the course of their global profits being subject to tax on what amounts to be a global basis. See the comments of David Rosenbloom (note 9).

<sup>19</sup> See Kleinbard’s comments on this (note 3).

country profits, that are the tax focus; per country taxes not rationalized elsewhere, even more than taxes generally, are a business cost. Overtly transactional transfer pricing practices of the sort framed by the TPG and countries’ tax rules – the innocence of which is magnified by dealing inadequately with “intangibles” – may not only contribute to but actually justify results that originally transfer pricing and like international tax jurisdiction prescriptions set out to deter: absolute reductions in global effective tax rates through absolute, not shared, reductions of “national entity” and correspondingly national tax bases.

This recurs as a dominant theme for various inquiries about the continuing utility of various international tax rules. The prevailing debate about territorial tax regimes as an alternative to world-wide taxation with foreign tax credit and more generally the continuing integrity and reliability of corporate tax regimes are manifestations of this theme.<sup>20</sup> The same can be said of initiatives from time to time to limit expense recognition according to versions of thin capitalization rules or in other ways, to better self-contain “foreign” and “domestic” income sources. It is also the catalyst for more blunt questions about international tax avoidance traceable to recharacterization, residence, agency and other avenues of reconstruction that in one way or another reflect the inherent artifice of multinational or global group organization. But artifice is at the heart of tax regimes and the legal systems on which they float and indeed depend.

In our spatially “compressed”<sup>21</sup> business world, what especially fuels doubt about the adequacy of international tax rules and corporate taxation? What draws attention to the frailties of relying on legal fictions to define national corporate tax system’s absolute and relative limits? Again, it is “intangibles,” the source of a unique often invisible implied return from being an economic “firm.” Having released “intangibles” into the agora of serious contemplation, it is not possible to resile from addressing their broad implications – much broader than devising valuation protocols on the basis of assumptions made in the TPG. They need to be addressed much more fully for what they are, namely the essence of the contradic-

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<sup>20</sup> See Kleinbard (note 3) and Taylor (note 3); One of the curiosities of “profits” possibly migrating according to places other than where, necessarily, productive activities that must somehow generate them are located is a “lock-in” effect. This means, essentially, that those profits cannot be redeployed in productive activity at or from where, denuded or supplemented – as it may be chosen to say – of their incumbent inherent tax liabilities, they have come to rest without unlocking tax deferral so profound as it otherwise would be considered not to exist. In relation to the field occupied by transfer pricing, this it is a revelation of sorts; the profits are where they cannot be well used and to get them where they need to go, the tax savings realized by transfer pricing practices in accord with the TPG and, purportedly the arm’s length principle, may to some extent have to be “returned.” See Shreve, Territorial System Sidesteps ‘Lockout Effect,’ Panelists Say, (2011 TNT 101-2) Tax Analysts Tax Notes Today (May 25, 2011); See also Fleming, Peroni, and Shay, Perspectives on the Worldwide vs. Territorial Taxation Debate, Tax Notes International Special Report (January 4, 2010), 75; Mustard, Pantaleo and Wilkie, Why Not Kenora? Reflections On What Canada’s Approach To Taxing Foreign Business Income Is and Could Be, Proceedings of the 2009 Annual Conference of the Canadian Tax Foundation, Toronto (2010), 6:1.

<sup>21</sup> See Harvey (note 15).

tion embedded in the arm's length principle – the manifestation of “income” that some are worrying may be beyond the reach of tax systems even with robust transfer pricing regimes.<sup>22</sup>

## 8. Recalibrating the “Arm’s Length Principle”

The arm's length principle reflects an expectation that the income reported by members of a commonly controlled, and operationally and economically integrated, corporate group should correspond in some observable or objectively noticeable way to their contributions to earning the shared entrepreneurial “firm” return. In other words, transfer pricing is meant to and should measure the correspondence between “value added” contributions, which subsume risks of various kinds, and a share of resulting “firm” or enterprise income.

Analytical approaches considered at the Munich Conference to rationalize management and financial accounts, to understand the notion of “implicit support” as articulated by some courts<sup>23</sup>, and even to apply calculus to discern and quantify that “value delta” attributable to being an economic “firm”, all illuminated a path pointing in this direction. Whether in any case a particular transaction price is “right” according to some exogenous and often questionable standard almost is beside the point – and also not what Article 9 of the OECD Model Tax Convention actually says is the overarching objective. Pursuing a “price is right” approach is so antithetical to the business and economic characteristics of the affected taxpayers – for which additionally “intangibles” are a lightning rod – that it feels like undertaking a journey without a beginning or end and with no compass to make course corrections along the way.

“Intangibles” – as “products” and “services” themselves and, possibly much more important, as the defining characteristics of taxpayers as “firms” and not merely or at all the outcome of “conditions made of imposed” by taxpayers as such – are the catalyst for reconsidering what the arm's length principle means and whether its directional guidance has been unduly limited by traditional perceptions framed in the TPG.

Accepting that legal entities “do things” in “particular places”, that there are only so many inputs to productive activity and representations of commercial reward<sup>24</sup>, that contracts by themselves do not constitute productive activity, that “firms” operate and are governed as “firms,” and that a premise of international tax jurisdiction is to rationalize competing but unharmonized tax claims of national tax jurisdictions, does a salutary and possibly more “politically correct” response lie

<sup>22</sup> See Kleinbard (note 3); See also Durst, *The Two Worlds of Transfer Pricing Policymaking*, Tax Notes Viewpoints (January 24, 2011), 443.

<sup>23</sup> See comments relating to recent judicial decisions (notes 12 and 13).

<sup>24</sup> Engaging in putatively productive activity is like “one hand clapping” unless and until that activity is transformed into market-generated revenue and income. This suggests strongly the location of and activity in or in relation to “the market,” regardless of arcane jurisdictional notions associated for example with “permanent establishment” as not only a relevant but a compelling indicator of where “firms” and their organs carry on business and are “present.”

directionally in objectively predictable standards – a uniform, though not necessarily algorithmic<sup>25</sup>, factor-based adaptation of a “contribution profit split?” Are there indications that the application of the TPG could and in fact may be less preoccupied with elusive transactional comparability?

The seeds of such an approach actually can be found in the revision of Chapters I to III of the TPG. There, the utility and possibly enhanced respectability of profit oriented approaches are acknowledged as step along the way to being less confined by transactional comparability. Chapter IX also evinces a focus on “profits” as the transfer pricing focus through an underlying thematic concern about profit migration, even though declining to concede migration of “profit potential” in itself to be a sufficient trigger for transfer pricing induced income adjustment. However, the OECD does seem to be pointing in the direction of recognizing profit-oriented measures as a more “principled” way to give effect to the arm’s length principle, in relation to taxpayers’ actual transactions rather than economic reconstructions of them. That, in a manner of speaking, recalibrates the “principle” in relation to profit-oriented roots of Article 9 of the Model Tax Convention.

A recalibration of the arm’s length principle would, however, require an extension of the TPG, if the TPG are to continue as the “tools” for the “principle.” This is not surprising given their historic organic development to address changes to the circumstances to which they are meant to be applied. The TPG’s principal persistently controversial alternative is “formulary apportionment.” Without advocating “formulary” in deference to international fiscal and political reality, it is nevertheless useful, heuristically, to speculate about whether the application of the TPG would be improved by relying more on “contribution” profit splits based on objective contribution factors.

The most trenchant criticisms by the OECD of formulary apportionment are traceable, in its view, to the “...use [of] a formula that is predetermined for all taxpayers to allocate profits...”<sup>26</sup> However, the OECD also acknowledges the possible utility of bespoke, less rigid, formulations: “Global formulary apportionment also should not be confused with the selected application of a formula developed by both tax administrations in cooperation with a specific taxpayer or MNE group after careful analysis of the particular facts and circumstances, such as might be used in

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<sup>25</sup> This is not to concede that an algorithmic and indeed a uniformly algorithmic approach is neither desirable nor possible, but simply to recognize the international fiscal reality that opening a discussion on this point will be difficult at best and will no doubt detract and distract from other useful study that appeals to the same objectives of a formulary method but is not formulary as commonly understood. The OECD goes to great lengths to dismiss “formulary” methods as useful at all or as an alternative to the arm’s length principle as articulated in the TPG. However, there is no compelling reason why a formulary method that reflected broad international agreement, as the TPG are expected to do, would be worse than the results of coping with the fictions and uncertainties that the TPG necessarily manifest and engender, or that the instances of double taxation that would ensue would be any more likely or complex to resolve than is the actual experience of the TPG through the well intentioned efforts of tax authorities acting as Competent Authorities in Mutual Agreement Proceedings.

<sup>26</sup> TPG, para.1.17.

a mutual agreement procedure, advance pricing agreement, or other bilateral or multilateral determination. Such a formula is derived from the particular facts and circumstances of the taxpayer and thus avoids the globally pre-determined and mechanistic nature of global formulary apportionment.”<sup>27</sup>

What does this say about the OECD’s outlook? Rigid, mechanistic formulations are not acceptable. However, absent rigidity and pre-determination, formulations that reflect the “facts and circumstances” of a taxpayer may be fine within the precepts of the TPG. This, coupled with the acceptability in principle of profit-based methods (which are in any event not easily accommodated by the basic notion of “arm’s length” dealing), supplies a helpful platform from which to extend profit splits beyond their present transactional limitations, in the direction of evaluating, as the OECD’s comments effectively acknowledge could be acceptable, profit contributions to explain a taxpayer’s reported income.<sup>28</sup> Presumably, an acceptable formula would have to include components of some kind; it is unlikely that they would stray from basic but objective manifestations of capital and its business uses, human intervention, and expenses and revenue, without however being algorithmic in their combination but recognizing the business and economic reality that they have meaning only in combination.

Some direction might also be inferred from conceptually formulary tax jurisdiction notions we take for granted, whose tendencies in this regard are not well noted. Conceived in a simpler and more physical world, the “permanent establishment” and “business profits” articles of tax treaties adopt a conceptually “formulary” approach to apportion a shared tax base. The “permanent establishment article” incorporates manifestations of business “capital”, as well as direct or implied contributions by people even though in limiting cases a permanent establishment can be wholly inanimate. The “business” profits article implicitly allocates revenue and expenses. These are elements, effectively, of a three factor formulation (not “formula”), oriented to give objective but exclusive significance to capital, people and “income” (revenue and expenses) as determinants of how much income is earned where (and why). This is not of course an algorithm in the nature of a typical formula. But its direction is notable. It is hard to ignore the likely combined effect that a more or less intensive relative deployment of physical, financial and human capital (i.e., a permanent establishment) and income earning activity associated with it captured by revenue and expenses (“attribution”) would have on the relative allocation of overall income among business centres within a “firm” regardless of how they may be manifest organizationally. These three factors, in the main, capture by category the main factors of production and measures of reward that determine where and to what

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<sup>27</sup> TPG, para.1.18. The OECD also specifically anticipates, in paragraph 1.22 of the TPG, that a formulary method would lead to more and presumably in its view more intractable double taxation, although why this is necessarily so and what the supporting evidence for this would be is unclear, particular since a number of OECD member countries have experience with formulary methods to apportion income among sub-national tax jurisdictions using conventions notably similar to those found in the “permanent establishment” and “business profits” articles of the OECD Model Tax Convention.

<sup>28</sup> Criticisms about duplication however are difficult to concede. See (note 27).

outcome business activity necessarily is conducted.<sup>29</sup> It may even have been the case that when these treaty notions of jurisdiction were developed, they had a constructively algorithmic effect by force of circumstance in that more “physical” world.<sup>30</sup>

A possible failing of a solely bilateral approach, and a reason why an enhanced profit-oriented approach would need to benefit from an equivalent uniformity of application as the TPG enjoy, is that elements of international profit may be “lost.” One way of looking generally at a country’s international tax rules is imagining there to be only two jurisdictions, “home” and “away”. “Away” subsumes all other political jurisdictions and geographic regions, without regard for the forms (i.e., subsidiaries, branches etc.) or actual locations of business activities. Business income that is not justifiably “home’s” is “away’s”; apart from “controlled foreign corporation” and like rules, this income is not “home’s” concern. Absent an overarching conceptual discipline on the measurement of intra-group contributions, however, it is not hard to imagine how the “Venn diagram” of “income” allocated by many jurisdictions simultaneously to “away” – which is not necessarily any place in particular – becomes quite large but also not visible in its entirety or even at all to any particular jurisdiction interested to know whether and to what extent its “give” is some other jurisdiction’s “get.”<sup>31</sup>

A “contribution” profit split that is factor based, even though not algorithmically formulary<sup>32</sup>, would seem to serve a number of purposes and address many concerns about the TPG as a faithful exposition of the arm’s length principle. First, it would conform to the expectation that productive factors are – have to be – deployed somewhere to earn income and that earning income depends on them. Second, it would be consistent with evident tendencies in the evolution of the TPG to accord more significance to profit-based approaches – this would not involve “cutting from whole cloth” and would therefore reflect a measure of existing international agreement. Third, it would impose a measure of discipline, transparency and predictability by offering an objective framework for evaluating “contributions” with reference to a number of agreed and more or less defined factors, limiting the circumstances in which income might be allocated where no observable or

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<sup>29</sup> In this context, a useful reference is, possibly, the OECD’s “authorized OECD approach”, or “AOA,” as illustrating the holistic approach to apportioning or allocating enterprise profits among the contributors to them; See (note 5).

<sup>30</sup> In a manner of speaking, the AOA, incorporating by reference the TPG, is an extension of this way of approaching the allocation of profits among countries – itself is kind of “contribution profit split”.

<sup>31</sup> In fact, it becomes “stateless.”; See Kleinbard (notes 3 and 16); Using transfer pricing lexicon, this is one of the risks of “one-sided” analysis.

<sup>32</sup> Again, this is not meant to concede the utility of an algorithmic approach but simply to recognize the political reality that what the OECD considers to be “formulary” – which is algorithmic – is unlikely to be the subject of serious discussion. That said, there could be a “middle ground” that imports some of the objectivity and commercial reality associated with formulary’s identification of factors of production and measures of return, to establish uniform expectations about the elements of business meant to be measured by the a profit-oriented method within the parameters of the TPG and more generally according to the “principle” part of the “arm’s length principle.”

conceivably necessary business activity actually takes place. This is not a suggestion, though, that another controversial jurisdictional notion – “key entrepreneurial risk taker” or “kert” – be adopted. Rather this approach would simply recognize that in performing a “contribution profit split”, there are certain indisputable factors of production the deployment of any one of which in an integrated business setting necessarily generates a share of the a “firm’s” entrepreneurial income, and that contracts, by themselves in this context, orchestrate how income earning activities take place but are not themselves self-limiting or self-defining determinants of profit, its “location” or its ownership. Fourth, it would reflect similar, though not the same, imperatives directing reconsideration of other international tax conventions and indeed corporate taxation. Fifth, it would be consistent with how multinational and global businesses actually operate and organize how they are taxed.

In “principle” then, it seems that the arm’s length principle’s utility as a “principle” could be enhanced by refining its *application* via an adaptation and extension of the TPG to rely on a factor-based profit – oriented approach, without necessarily abandoning familiar reference points for transfer pricing or international tax jurisdiction more generally. This would adhere even more closely to the essence of the arm’s length “principle”. While it might be difficult ever to know in any absolute sense whether an outcome is “right” – in fact, this is impossible – there is something to be said for defining the limits determining how “wrong” it could be. This may also assist with addressing the “(soft) intangibles” question by muting the need to find relevant but for various reasons elusive or illusionary transaction analogues and would side-step, perhaps the fact that countries’ tax rules may be found wanting. It seems that this approach is at least worth considering as an extension of the TPG and contemporary application of the arm’s length principle, in territory in which it is being taken anyway. There are signs, in the transfer pricing area and more generally with respect to traditional markers of international tax jurisdiction, that if the TPG do not evolve this way, sooner than possibly later what the arm’s length principle is and what its effects are may no longer matter very much.

## 9. Over the Mountain

“The Little Engine That Could” persevered, despite limitations, obstacles and doubts, to carry its load over the mountain. Not as smoothly perhaps as had there been another way. But none was available. On the down grade, so the story goes, it could be heard to say “I thought I could, I thought I could.” Despite justifiable reservations about the arm’s length principle’s ability to handle its load, there are signs that an enlightened approach to its application could address a number of its perceived limitations on the tide of international tax developments more generally. That said, there is a limit to what it, alone, can do. “Larger” jurisdictional questions seeming to converge on transfer pricing may be different in kind than those transfer pricing alone can, or can be expected to address. It is necessary to see inquiries into the contemporary application of the arm’s length principle – focused by the “intangibles issue” – as part of a more thorough re-examination of corporate taxation and international tax norms.

## **Part 3:**

### **Transfer Pricing in Practice**

# Credit Ratings and the Debt-related Costs for a Subsidiary of a Multinational Firm

Thomas Horst

## Abstract

*This paper evaluates debt guarantee fees paid by a subsidiary to a foreign parent company. Part 2 explains in very general terms how a company's consolidated financial results can be used to predict with surprising accuracy the credit rating that the rating agencies have assigned to the company.*

*Part 3 of reviews the Canadian Tax Court opinion *General Electric Capital Canada, Inc.*, which concluded that (1) the benefit to GECCAN of GECUS's written guarantee was equal to the 1.83 percentage point differential between the average interest rates on BB+/BBB- rated debt and AAA rated debt, respectively, and (2) the incremental benefit to General Electric Capital Canada, Inc. ("GECCAN") of a written guarantee set an upper limit on the arm's length price.*

*Part 4 compares the rules for calculating guarantee fees paid by a subsidiary to the OECD's current guidelines for determining the comparable rates for a domestic branch of a foreign corporation. Also, the tax treatment of a consolidated company's credit rating is compared to the treatment of patents, trademarks and most other intangibles.*

## 1. Introduction

The subject of this paper is how tax-deductible, debt-related costs are determined for a subsidiary corporation ("subsidiary"<sup>1</sup>) of a multinational firm. In very general terms, a subsidiary's tax-deductible debt-related costs depend on two broad factors: the amount of debt the subsidiary incurs in financing its business and the rates of its interest expense, guarantee fees and other debt-related costs (e.g., the cost of standby letters of credit required to support the issuance of commercial paper) that are recognized for tax purposes. The second of these two factors – specifically, the guarantee fee paid by a subsidiary to its parent company – was the subject of the Canadian Tax Court's opinion in *General Electric Capital Canada, Inc.* and the subsequent opinion by the Canadian Federal Court of Appeal sustaining the Canadian Tax Court's opinion.<sup>2</sup> Because both Canadian courts interpreted specific language in

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<sup>1</sup> Broadly speaking, a "subsidiary" is incorporated separately from its "parent" company, which owns a controlling interest in the shares of its subsidiary. By contrast, a "branch" is not separately incorporated and thus is part of the same legal entity as its "head office." A subsidiary can enter into contracts (e.g., to borrow money) in its own name, but a branch cannot.

<sup>2</sup> See *General Electric Capital Canada, Inc. v. The Queen* (2009) TCC 563 (Tax Court of Canada), and *The Queen v. General Electric Capital Canada Inc.* (2010) F.C.A. 344 (Federal Court of Appeal).

the OECD Guidelines pertaining to arm's length fees for related-party loan guarantees and, by implication, interest rates on related-party loans, the opinion should be of broad interest.

Broadly speaking, a company's interest rate on amounts borrowed from *unrelated* creditors depends on the company's creditworthiness. Standard & Poor's, Moody's and/or other rating agencies typically rate debt that is held by the general public in the United States. All other things (e.g., seniority, maturity, currency of denomination of the debt) being equal, companies with any given credit rating (e.g., BBB) will typically incur similar interest rates. Similarly, companies with higher credit ratings will generally incur lower interest rates than companies with lower ratings.

Part 2 of this paper describes in very general terms how a company's consolidated financial results can be used to predict with surprising accuracy the credit rating that the rating agencies have assigned to the company. The analysis in Part 2 is pertinent not only to understanding why some public companies have higher credit ratings and thus pay lower interest rates than other public companies, but also how transfer-pricing experts estimate the credit rating for a subsidiary and thus the interest rates and/or the guarantee fees it would pay if it were dealing with its parent company at arm's length. As I will explain, the Canadian Tax Court relied on this analysis to assess the incremental benefit to General Electric Capital Canada, Inc. ("GEC-CAN") of a written guarantee, which set an upper limit on the arm's length price. The findings of the credit rating analysis are also critical to my ultimate conclusion that as a matter of tax policy (but not current tax law), a company's credit rating should be viewed as an intangible asset jointly owned by all affiliates of a multinational group, not as the property of the parent company.

Part 3 of this paper reviews the Canadian Tax Court opinion *General Electric Capital Canada, Inc.* and the subsequent opinion by the Canadian Federal Court of Appeals. Broadly speaking, I will explain why Justice Hogan of the Canadian Tax Court ultimately concluded that:

- 1) GECCAN would have had a B+/BB- credit rating on a "stand alone" basis – that is, if GECCAN were not a subsidiary of its U.S. parent company, GE Capital Corporation ("GECUS");
- 2) Absent any written guarantees of its debt, but taking account of its ownership by GECUS, GECCAN's credit rating would have been "notched up" from B+/BB- to BB+/BBB- to reflect creditors' expectation that GECUS would take steps to prevent GECCAN from defaulting on its debt (sometimes referred to as the "implicit guarantee");
- 3) Because GECUS provided explicit written guarantees to GECCAN's creditors, GECCAN's debt enjoyed the AAA credit rating that the rating agencies assigned to GECUS's own debt;
- 4) The benefit to GECCAN of GECUS's explicit guarantee was equal to the 1.83 percentage point differential between the average interest rates on BB+/BBB-rated debt and AAA rated debt, respectively; and
- 5) The arm's-length guarantee fee was less than GECCAN's 1.83 percent point interest rate saving because in arm's length dealings, GECCAN would have

expected to keep some of the 1.83 percentage point benefit for itself. Because the guarantee fee actually charged by GECUS, 1.00 percent per annum, was notably less than GECCAN's 1.83 percentage point benefit, the Canadian Tax Court accepted that the arm's length charge was no less than the 1.00 percentage point guarantee fee actually charged.

The major issue in the Crown's appeal of the Tax Court's opinion was its claim that even if GECUS had provided no written guarantee, GECCAN would have been considered a "core" subsidiary that GECUS would not allow to default, so GECCAN's debt would have had an AAA rating. The incremental benefit to GECCAN of GECUS's explicit guarantee was zero, not 1.83 percentage points, so no payment would have been made at arm's length for the explicit guarantee. In replying to the Crown's claim, GECCAN counter-claimed that the Tax Court should not have given any weight to the implicit guarantee resulting from GECCAN's affiliation with GECUS. That is, the economic benefit of GECUS's written guarantee to GECCAN should have been based on its "stand alone" credit rating of B+/BB-, not on the notched-up credit rating of BB+/BBB- based on GECCAN's affiliation with GECUS. The Federal Court of Appeals rejected both the Crown's claim and GECCAN's counter-claim and affirmed the Tax Court opinion.

In my view, the Canadian Courts' opinions seem to be carefully considered and well reasoned. Their acceptance of the incremental benefit analysis urged by the Crown and opposed by the taxpayer will likely be widely cited in future transfer pricing cases in Canada and other countries. The incremental benefit analysis may ultimately be relevant not just to intercompany loan guarantees and interest rates, but other transfer pricing issues. The economic sophistication of the Canadian Courts' opinions clearly differs from the simpler understanding of the arm's length method in some other transfer pricing cases, such as the U.S. Second Circuit opinion in *U.S. Steel*.<sup>3</sup> While that greater sophistication is in my view a virtue, others may be troubled by the greater complexity and uncertainty that are the byproducts of the increased complexity.

The focus of Part 4 of this paper is the broader tax policy implications of using the arm's length standard to determine guarantee fees and interest rates payable to related parties.<sup>4</sup> Two comparisons are instructive. First, under the OECD's current guidelines for bilateral tax treaties, the arm's length method of determining intercompany interest rates and guarantee fees for the domestic *subsidiary* of a foreign corporation stand in sharp contrast to the method of determining the comparable rates for the domestic *branch* of a foreign corporation. Under the approach recommended by the OECD, the interest expense of a branch that is considered to be a "permanent establishment" would reflect the underlying interest rate paid by the company of which the branch is part, and the profit attributable to a permanent estab-

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<sup>3</sup> *United States Steel Corp v. Commissioner*, 617 F. 2nd 942 (2d Cir. 1980), rev'g 36 T.C.M. 1152 (1977).

<sup>4</sup> In making this assessment, I assume that the Canadian Tax Court opinion in *General Electric Capital Canada, Inc.* was correct in concluding that the 1.00 percent guarantee fee charged by GECUS was an arm's length price.

ishment would not be reduced by any guarantee fee. While the legal basis for treating a domestic branch of a foreign company differently from a domestic subsidiary is obvious, the economic basis for the different rates of interest expense and guarantee fees is not apparent to me.

Second, a company's credit rating can be viewed as a valuable intangible asset, and the tax treatment of a credit rating can be compared to the tax treatment of patents, trademarks and most other intangibles. This comparison leads me to question the economic basis (but not the legal basis) for attributing income to the parent company because of its superior credit rating. From a broader tax policy perspective, it makes more sense to me to treat the parent company's credit rating as a collective asset that should be available at no charge to the affiliates of a multinational group, rather than as intangible property that is owned by just the parent company. That is, since the credit rating reflects the consolidated financial results of the entire multinational group, not the separate financial results of the parent company, its subsidiaries should not have to pay the parent company to enjoy the benefit of the collectively created asset. Consequently, the interest rate on intercompany loans should reflect the parent company's credit rating, and there should be no charge to the subsidiaries for intercompany guarantees. That is, the OECD's treatment of permanent establishments should be extended to subsidiaries. This result appears to require changes in countries' tax laws and their bilateral tax treaties and, as demonstrated by the result in *GE Capital Canada*, cannot be achieved by tax authorities under existing tax law.

## 2. Analysis of Companies' Credit Ratings

Part 2 provides a general explanation of how a company's credit rating can be predicted with surprising accuracy by applying a formula based on results reported in its consolidated financial statements. An understanding of the determinants of a company's credit rating is helpful in understanding not only the results in *GE Capital Canada*, but also why from a tax policy perspective a credit rating should be viewed as jointly owned by all affiliates in a multinational group, not just the parent company.

In the United States, the two largest rating agencies are Standard & Poor's and Moody's. While those agencies have different labels for their rating categories, they employ similar alphanumeric schemes. [Table 1](#) shows the rating categories from highest to lowest (i.e., most creditworthy to least creditworthy) for Standard & Poor's and for Moody's, respectively.

**Table 1:** Credit-Rating Categories for Standard & Poor's and Moody's

Standard & Poor's		Moody's
Compustat Number Code	S&P Rating	Rating
2	AAA	Aaa
4	AA+	Aa1
5	AA	Aa2
6	AA-	Aa3
7	A+	A1
8	A	A2
9	A-	A3
10	BBB+	Baa1
11	BBB	Baa2
12	BBB-	Baa3
13	BB+	Ba1
14	BB	Ba2
15	BB-	Ba3
16	B+	B1
17	B	B2
18	B-	B3
19	CCC+	Caa1
20	CCC	Caa2
21	CCC-	Caa3
23	CC	Ca-C
27	D	Default

The basic purpose of a credit rating is to indicate the risk that a borrower will default on its contractual obligation to pay interest and repay principal. A creditor's expected default loss depends on two elements: the probability that a default will occur, and the magnitude of the creditor's loss if a default occurs. One method of estimating the probability that a default will occur is the average frequency with which debt with the same credit rating has defaulted in previous years. [Table 2](#) shows Moody's estimates of the average frequency of default over the period 1920 – 2009 for debt with various *initial* ratings<sup>5</sup> and holding periods.<sup>6</sup> Clearly, the lower the borrower's initial credit rating and the longer the investor's holding period, the greater was the average frequency of default.

<sup>5</sup> That is, while no one can predict with any certainty the specific companies that will eventually default and those that will not, actual defaults are typically preceded by successive downgrades in a company's credit rating. Standard & Poor's and Moody's both publish data showing the frequency of upgrades and downgrades in companies' ratings, not just the frequency of defaults.

<sup>6</sup> For example, for debtors with an initial Moody's credit rating of B, 4.0% defaulted within the first year, 9.0% defaulted within the first two years, and so forth.

**Table 2:** Average cumulative default rates, 1920-2009

Initial Credit Rating	Time in Years Since Initial Rating																			
	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
AAA	0,0%	0,0%	0,0%	0,1%	0,2%	0,2%	0,4%	0,5%	0,7%	0,9%	1,0%	1,1%	1,3%	1,3%	1,4%	1,4%	1,5%	1,6%	1,7%	1,7%
AA	0,1%	0,2%	0,3%	0,5%	0,7%	1,0%	1,3%	1,6%	1,9%	2,2%	2,6%	3,0%	3,4%	3,8%	4,1%	4,4%	4,6%	4,8%	5,1%	5,4%
A	0,1%	0,3%	0,6%	0,9%	1,3%	1,6%	2,0%	2,4%	2,9%	3,3%	3,8%	4,2%	4,7%	5,1%	5,5%	5,9%	6,3%	6,6%	7,0%	7,3%
BBB	0,3%	0,8%	1,5%	2,3%	3,1%	4,0%	4,7%	5,5%	6,4%	7,2%	8,0%	8,8%	9,6%	10,3%	10,9%	11,6%	12,2%	12,7%	13,2%	13,7%
BB	1,4%	3,3%	5,5%	7,7%	9,9%	11,9%	13,8%	15,7%	17,4%	19,2%	20,8%	22,4%	24,0%	25,4%	26,6%	27,8%	29,0%	30,1%	31,1%	32,1%
B	4,0%	9,0%	14,0%	18,5%	22,4%	25,9%	29,1%	31,9%	34,3%	36,4%	38,3%	40,2%	41,8%	43,4%	44,7%	46,1%	47,3%	48,3%	49,0%	49,5%
CCC-C	14,3%	24,0%	31,4%	36,9%	41,2%	44,3%	46,7%	48,8%	50,9%	52,8%	54,7%	56,7%	58,5%	60,4%	62,4%	64,2%	65,8%	67,3%	68,7%	70,0%

When a borrower defaults on its debt obligations, a creditor will typically lose a substantial portion, but not all, of the principal and interest amounts due from the creditor. According to Moody's, creditors' ultimate recovery rates<sup>7</sup> for senior unsecured debt for bonds that defaulted between 1987 and 2009 was 44.6% on average, so the average default loss rate was 55.4%.

To compensate for the higher risk of default losses, bond prices adjust so that bonds with lower credit ratings and thus higher projected default losses have lower market prices and thus higher stated yields to maturity.<sup>8</sup> Table 3 shows the stated yields to maturity as of December 31, 2009 for fixed rate debt with various credit ratings and maturities. Stated yields make no adjustment for possible default losses. They are, rather, the internal rate of return on the investor's cash flow assuming the bond does not default. One can also calculate an "expected" rate of return by reducing the stated yield by the expected default loss, which is the expected loss in the event of default multiplied by the probability of default. When a default could occur in any year the bond remains outstanding, the projected cash flow for each year can be reduced to reflect (1) the diminishing probability that the bond will not have defaulted in any prior year, and (2) the expected loss of a default in the year at issue. To illustrate, Appendix A to this paper shows how I calculated the adjustment for default losses to the stated yield to maturity as of December 31, 2009 for a 10-year, B-rated bond.

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<sup>7</sup> The ultimate recovery rate reflects the value creditors realize at the resolution of a default event. For example, when a borrower files for bankruptcy, its creditors' ultimate recovery is the present value of the cash and/or securities that the creditors actually receive when the borrower exits from bankruptcy, typically 1-2 years following the initial default date.

<sup>8</sup> I use the term "stated yield" to mean a creditor's internal rate of return on cash flow assuming the borrower makes full and timely payments of interest and principal.

**Table 3:** Annual yields for fixed rate debt by credit rating and maturity, Dec. 31, 2009

	Maturity														
	3 Month	6 Month	1 Year	2 Year	3 Year	4 Year	5 Year	7 Year	8 Year	9 Year	10 Year	15 Year	20 Year	25 Year	30 Year
AAA	0,13%	0,26%	0,56%	1,29%	2,01%	2,49%	3,00%	3,75%	4,03%	4,27%	4,51%	4,90%	5,25%	5,33%	5,59%
AA	0,69%	0,79%	0,97%	1,63%	2,39%	3,08%	3,47%	4,26%	4,45%	4,62%	4,83%	5,20%	5,60%	5,56%	5,65%
A	0,77%	0,88%	1,05%	1,71%	2,49%	3,25%	3,61%	4,46%	4,56%	4,71%	4,97%	5,38%	5,71%	5,69%	5,80%
BBB	1,80%	1,84%	2,07%	2,68%	3,46%	4,18%	4,49%	5,22%	5,33%	5,50%	5,59%	6,04%	6,27%	6,27%	6,34%
BB	3,71%	3,72%	4,06%	4,88%	5,41%	5,94%	6,46%	7,10%	7,23%	7,41%	7,54%	7,86%	8,09%	8,18%	8,27%
B	5,00%	5,05%	5,40%	6,31%	7,07%	7,69%	8,11%	8,74%	9,00%	9,08%	9,21%	9,51%	9,74%	9,80%	9,92%

To demonstrate the impact of default losses on projected yields to maturity, I calculated in [Table 4](#) the expected yield for bonds with 10 years to maturity as of December 31, 2009 assuming that (1) the projected default rate would vary with the bond's initial rating based on the historical default frequencies shown in [Table 2](#), and (2) that if a bond defaulted, the creditor recovered 44.6% of the principal and interest amounts due. For example, for 10-year fixed-rate bonds with an initial rating of AAA, the (small) projected default losses would reduce the yield to maturity from the stated yield of 4.51% (which assumes no default losses) to an adjusted yield of 4.47%. By contrast, for 10-year fixed-rate bonds with an initial rating of B, the (larger) expected default losses would reduce the yield from the stated yield of 9.21% to an adjusted rate of 6.45%. Note that the default-adjusted yield also varies inversely with a bond's initial credit rating, which implies that stated yields to maturity provide not only for expected default losses, but also a premium to compensate investors who are willing to hold bonds with lower credit ratings for default risk.

**Table 4:** Stated vs. Adjusted Yields for Fixed-Rate 10-Year Senior Unsecured Debt as of 12/31/2009

<u>Initial Credit Rating</u>	<u>Stated Yield</u>	<u>Maturity</u>	<u>Default Recovery Rate</u>	<u>Default- Adjusted Yield</u>	<u>Impact of Default Loss</u>
AAA	4.51%	10	44.6%	4.47%	0.04%
AA	4.83%	10	44.6%	4.70%	0.12%
A	4.97%	10	44.6%	4.79%	0.19%
BBB	5.59%	10	44.6%	5.17%	0.42%
BB	7.54%	10	44.6%	6.30%	1.24%
B	9.21%	10	44.6%	6.45%	2.76%

Standard & Poor's and Moody's respective websites describe in general terms the procedures and criteria those agencies apply in determining a company's credit rating. Notwithstanding what is obviously a very time consuming and carefully considered rating process, the credit rating for a company ultimately published by Standard & Poor's is often not only the same as the comparable rating of Moody's, but also the same as the credit rating predicted by a mathematical formula based on statistical analyses of public companies' credit ratings and their consolidated financial results. Indeed, both Standard & Poor's and Moody's offer internet-based models that estimate (for a fee) a company's credit rating based on its latest financial data. For example, Standard & Poor's web-based service, CreditModel, appears to rely on the following data derived from a company's consolidated financial statements:

- Total assets (Million \$),
- Total equity (Million \$),
- Total sales (Million \$),
- Total debt/capital (%),
- Funds from operations/total debt (%),
- Free operating cash flow/total debt (%),
- Operating income/sales (%),
- Return on capital (%),
- EBITDA interest coverage (times), and
- EBIT interest coverage (times).

Standard & Poor's website describes its credit-rating model as follows:

*CreditModel employs advanced proximal support vector modeling, guided by expert judgment. Models are rigorously validated and reviewed by Standard & Poor's senior credit analysts. A very high correlation between CreditModel scores and Standard & Poor's credit rating has been demonstrated.*

Although the mathematical formulas and statistical methods embedded in S&P's Credit Model or other credit-rating models may be very sophisticated, a high correlation between companies' actual credit ratings and predictions of those ratings based on the companies' recent financial data can also be obtained using a linear formula derived using a very simple statistical method. To demonstrate that credit ratings can be predicted using very simple methods, I downloaded from Standard & Poor's Compustat database (1) the S&P credit ratings for 317 manufacturing companies as of December 31, 2009 and (2) financial data for those companies' 2009 fiscal years.<sup>9</sup> The simple correlation between (1) the numerical code that the Compustat database assigns to a company's S&P credit rating, which is shown in the first column of [Table 1](#) above, and (2) the logarithm to the base 10 of the company's total assets<sup>10</sup> was minus 67%<sup>11</sup> – see the scatter diagram that is [Chart 1](#). Using linear regression analysis, which is a widely used method explained in most introductory statistics textbooks, the correlation between a company's actual S&P credit rating and the credit rating predicted by the linear regression equation based on just three factors – (1) the logarithm to the base 10 of the company's consolidated total assets, (2) the company's consolidated operating income expressed as a percentage of its consolidated total assets, and (3) the company's consolidated debt-capital ratio – increases to 81%.<sup>12</sup> See the scatter diagram that is [Chart 2](#). That is to say, the con-

<sup>9</sup> By the "2009" fiscal year, I mean the company's fiscal year ending closest to December 31, 2009.

<sup>10</sup> Because a company's total assets are stated in millions of dollars, the logarithm (to the base 10) of \$100 million in total assets is 2.0, \$1 billion in total assets is 3.0, \$10 billion in total assets is 4.0, and so forth.

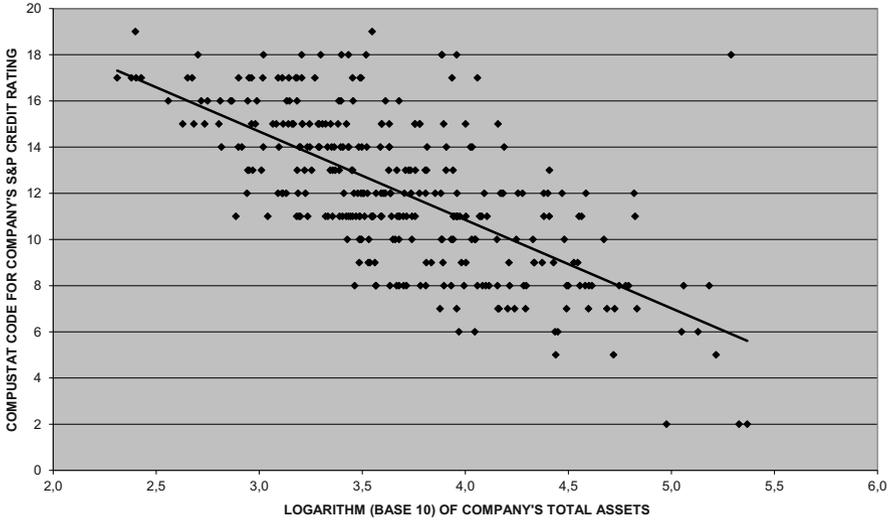
<sup>11</sup> The correlation is negative because a low numerical value in the first column of [Table 1](#) indicates a high credit rating (e.g., AAA=2, AA+=4, AA=5, etc.).

<sup>12</sup> The linear regression equation that I estimated based on data for 317 manufacturing companies as of 2009 was:

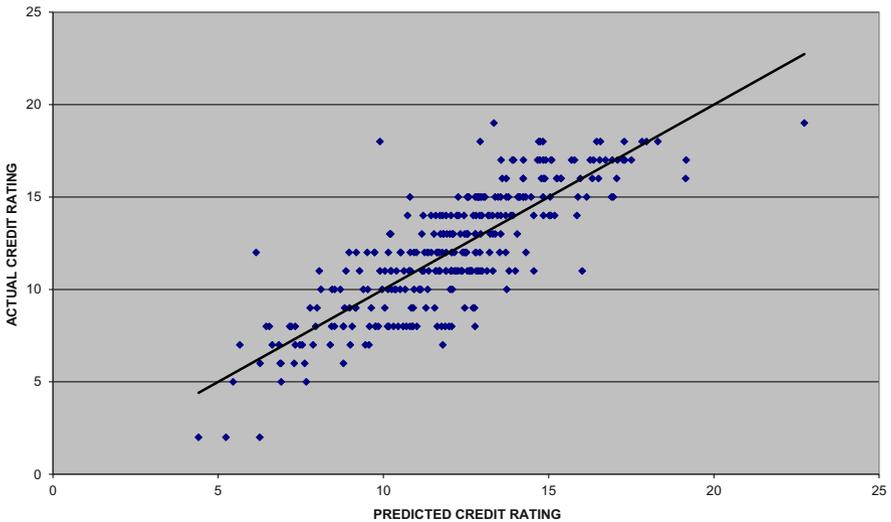
$$\text{S\&P} = 24.4 - 3.4 \log(A) - 16.9 \text{ROA} + 4.0 \text{D}/(\text{D}+\text{E}) \quad R = 67.5\% \quad (-18.3) \quad (-11.7) \quad (8.5)$$

where the number in parenthesis is the t-statistic of the regression coefficient.

siderable complexity of the statistical models used by Standard & Poor's, Moody's and other sophisticated experts may obscure the key point that a company's credit rating is determined mainly by its size and secondarily by its profitability and its capital structure.



**Chart 1:** S & P Credit Rating vs. Logarithm of Total Assets for U.S. Manufacturing Companies, 2009



**Chart 2:** Actual vs. Three-Factor Predicted Credit Rating for U.S. Manufacturing Companies, 2009

The paramount importance of a company's size in determining its credit rating may be surprising to some, but is familiar to anyone who has undertaken a statistical analysis of companies' actual credit ratings. The reason why large companies have lower default risks and higher credit ratings, all other things being equal, is due mainly, I would assume, to the ability of diversification to reduce risk. Larger companies tend to have greater diversity not only in the number of products and services they sell, but also in the number of geographic markets in which they operate. Because a large company's cash flow is more stable than the cash flow of a small company, a large company is less likely to default on its debt. Since large companies are less likely to default, they have higher credit ratings.

### **3. Canadian Court Opinions in General Electric Capital Canada, Inc.**

#### **3.1 Canadian Tax Court Opinion**

The General Electric Company ("GE") was and is a very large, publicly owned U.S. company operating diversified industrial and financial service businesses in many countries. According to the statement of agreed facts in the Canadian Tax Court opinion,<sup>13</sup> GE's financial services group was organized under a wholly owned GE subsidiary, General Electric Capital Services, Inc. ("GE Capital"), of which GECUS was the principal U.S. operating subsidiary. While GECUS' financial business originally related to financing customers' purchases of capital equipment manufactured by GE, by the mid-1990s, GECUS' financial businesses were more diversified and generally unrelated to GE products.

To fund its financial investments, GECUS issued its own debt and had its own credit rating, AAA from Standard & Poor's and Aaa from Moody's, which are the highest ratings possible.<sup>14</sup> GECUS' AAA rating, which was based on its consolidated financial results,<sup>15</sup> was a key element of GE Capital's overall competitive strategy for leasing and other forms of equipment financing.<sup>16</sup> Unlike the large banks with which GE Capital competed, GECUS issued commercial paper and long-term debt, but was not regulated as a bank and so did not have a bank's access to retail deposits or to wholesale inter-bank deposits. Because GECUS was not eligible to receive deposits guaranteed by a government, the AAA credit rating of its commercial paper and longer-term debt was critical to its competitive strategy.

GECCAN, GECUS' wholly owned subsidiary, carried on in Canada several of the financial businesses that GECUS conducted in the United States. During the five

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<sup>13</sup> Canadian Tax Court opinion (note 2), para. 2.

<sup>14</sup> The credit ratings referred to in this study are those of the borrower, which generally correspond to the rating assigned to its senior unsecured debt. To qualify for the AAA rating, S&P required GE to execute a keep-well agreement under which GE committed to maintain GECUS' consolidated debt-to-equity rate at no more than 8 to 1; Canadian Tax Court opinion (note 2), para. 266.

<sup>15</sup> Canadian Tax Court opinion (note 2), para. 255.

<sup>16</sup> Id at para. 290.

years, 1996-2000, at issue in the Canadian Tax Court proceeding, GECCAN's total assets represented 2 – 2.3% of GECUS' consolidated assets and 3 – 4.4% of GECUS' consolidated revenues.

To fund its Canadian investments, GECCAN issued both commercial paper and longer term unsecured debentures. GECUS' own treasury department managed the issuances of debt by all its subsidiaries, including GECCAN. GECUS' treasury department's objective was to fund GECUS' consolidated business activities at the lowest possible cost while adhering to the risk management guidelines established by its senior management.<sup>17</sup>

GECCAN itself did not have a credit rating from any U.S. or Canadian rating agency. Rather, all of GECCAN's outstanding debt was guaranteed by GECUS, so GECCAN's debt had the same AAA credit rating as GECUS' own debt. In the absence of GECUS' guarantee, GECCAN would have been unable to execute its business plan because the Canadian commercial paper market was geared to the highest investment-grade borrowers.<sup>18</sup>

Under a corporate reorganization in 1988, GECUS succeeded GE Canada as GECCAN's parent company. GECUS guaranteed GECCAN's debt, but did not charge a fee for doing so until 1995, when a guarantee fee equal to 1% per annum of the average principal amount of GECCAN's guaranteed debt was instituted. Over the next five years, 1996 – 2000, the guarantee fees based on a 1% annual rate represented 33 to 40 percent of GECCAN's pre-tax and pre-guarantee-fee profits.<sup>19</sup>

In its examination of GECCAN's tax returns for 1996 – 2000, Revenue Canada disallowed GECCAN's deduction for guarantee fees paid to GECUS. Under the OECD Guidelines, a guarantee fee is treated as a service. Paragraph 7.13 of the OECD Guidelines stated:

*... an associated enterprise (e.g., GECCAN) should not be considered to receive an intra-group service when it obtains incidental benefits attributable solely to being a part of a larger concern, and not to any specific activity being performed. For example, no service would be received where an associated enterprise by reason of affiliation alone has a credit rating higher than it would if it were unaffiliated, but an intra-group service would usually exist where the higher credit rating was due to a guarantee by another group member, or where the enterprise benefited from the group's reputation deriving from global marketing and public relations campaigns. In this respect, passive association should be distinguished from active promotion of the MNE group's attributes that positively enhances the profit-making potential of particular members of each group. Each case must be determined according to its own facts and circumstances.*

In a nutshell, Revenue Canada disallowed GECCAN's deduction of the guarantee fee on the argument that, absent an explicit guarantee, GECUS would never allow GECCAN to default on its debt because a default would cause creditors to lose

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<sup>17</sup> Id at para. 86.

<sup>18</sup> Id at para. 305.

<sup>19</sup> Id at para. 79.

confidence in GECUS' own creditworthiness. Given this implicit guarantee, the incremental benefit to GECCAN of an explicit guarantee was *de minimis*.

By contrast, GECCAN's primary position was that under the arm's-length standard, GECUS' implicit guarantee should be disregarded. Alternatively, if the benefit of GECCAN's affiliation with GECUS should be taken into account, GECCAN would still not have qualified for the AAA credit rating unless GECUS provided an explicit guarantee of its debt. The incremental benefit to GECCAN of GECUS' explicit guarantee was greater than the 1% fee that was charged, so no transfer pricing adjustment should be made. The Canadian Tax Court opinion of Justice Hogan ultimately rejected GECCAN's primary position, but accepted GECCAN's alternative position.

In reaching the ultimate conclusion that GECUS' 1% guarantee fee did indeed represent arm's length consideration:

- Justice Hogan accepted that GECUS as a separate legal entity was not required to give its subsidiary, GECCAN, access to GECUS' credit facility.<sup>20</sup>
- GE Financial Corp., which was a second wholly owned subsidiary of GECUS, was a regulated insurance company. GE Financial Corp's debt was *not* guaranteed by GECUS and was rated A+ (as compared to the AAA rating of GECCAN's guaranteed debt). Since GE Financial Corp's assets were 10 times greater than GECCAN's assets and represented 21% of GECUS' consolidated assets, Justice Hogan concluded that GECUS would be even less inclined to allow GE Financial Corp to default than to allow GECCAN to default.<sup>21</sup> The fact that GE Financial Corp's unguaranteed debt was rated A+, not AAA, undermined Revenue Canada's claim that GECUS' explicit guarantee conveyed no incremental benefit over an implicit guarantee.
- Justice Hogan considered and ultimately *rejected* GECCAN's expert testimony that an arm's length charge would be based on the premiums that insurance companies charge to municipalities and other bond issuers to guarantee their payment of interest and principal to the bondholders. According to GECCAN's insurance-method expert (Mark Fidelman):
  - An insurer would not take into account the benefit of an implicit guarantee from a subsidiary's parent company.
  - From the insurance company's perspective, the total guarantee fee would have two components: (1) the cost of the expected loss, and (2) the return on the insurer's risk capital (i.e., a risk premium).
  - A 1% guarantee fee would *not* have provided an insurance company with an adequate risk-adjusted rate of return and was thus less than an arm's length amount.<sup>22</sup>

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<sup>20</sup> Id at para. 297.

<sup>21</sup> Id at para. 277.

<sup>22</sup> Id at paras 29 – 35.

- In explaining why he did not rely on the insurance-based evidence:
  - Justice Hogan noted that guarantee insurance has been used as a credit enhancement arrangement only for municipal bonds and asset-backed securities, but not for corporate bonds or commercial paper. Justice Hogan speculated that this was because insurers price the risk higher than the benefit received by corporate issuers that have parent corporations able to provide credit enhancements.
  - According to Justice Hogan, a third-party insurer would be unable to control the timing, terms and payment of GECCAN's debt offering. Consequently, a third-party insurer, unlike GECUS, would have no direct control over GECCAN's default risk.<sup>23</sup>
  - Justice Hogan also noted that the insurance analysis made no adjustment for the possibility that to protect its own credit rating, GECUS might provide financial assistance to GECCAN even though GECUS was not legally obligated to do so. Justice Hogan agreed that a third-party insurer would not place any weight on an implicit guarantee, but concluded that the insurance analysis was less reliable because it made no adjustment for this difference.
- Rather than relying on the insurance-based analysis, Justice Hogan focused on the interest cost savings that GECCAN achieved as a result of the higher credit rating, AAA, given to debt that was explicitly guaranteed by GECUS. In summary:
  - Justice Hogan accepted expert testimony that on a "stand-alone" basis – that is to say, taking no account of the affiliation of GECCAN with GECUS – GECCAN would have had an S&P credit rating between B+ and BB-.<sup>24</sup>
  - Justice Hogan further concluded that an unrelated lender to GECCAN would assume that GECUS might come to GECCAN's rescue if GECCAN would otherwise default on its debt. That is, in the hypothetical arm's length negotiation, the debtor is not GECCAN as a stand-alone company, but GECCAN as a subsidiary of a AAA-rated parent company dealing with an unrelated creditor.<sup>25</sup>
  - Based on the expert testimony, Justice Hogan concluded that GECCAN's affiliation with GECUS would have had the effect of increasing GECCAN's credit rating by three notches<sup>26</sup> from B+/BB- to BB+/BBB-.
  - Justice Hogan concluded that the benefit to GECCAN of having GECUS' explicit guarantee was equal to the average interest cost savings, 1.83 percentage points, resulting from the difference between GECCAN's BB+/BBB-rat-

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<sup>23</sup> Id at para. 254.

<sup>24</sup> That GECCAN's stand-alone credit rating was substantially lower than GECUS' rating is not surprising given that (1) GECCAN's total assets were 2 – 2.3% of GECUS' consolidated assets, and (2) its debt-equity ratio was 12 to 1 vs. the consolidated company ratio of 8 to 1.

<sup>25</sup> Canadian Tax Court opinion (note 2), para. 255

<sup>26</sup> That is, the difference between a B+ rating and a BB- rating is one notch, between a B+ rating and a BB rating is two notches, etc.

ing with only the implicit guarantee and its AAA rating with an explicit guarantee.

- Finally, Justice Hogan concluded that in arm’s-length negotiations, GECCAN would have been able to retain for itself some portion of the 1.83 percentage point benefit, so the arm’s length charge would be something less than the full interest cost differential. Because GECUS’ 1.00 percentage point guarantee fee was well below the 1.83 percentage point benefit, Justice Hogan accepted the 1.00 percentage point fee actually charged as an arm’s length result.

### 3.2 Canadian Federal Court of Appeals Opinion

In December 2010, the Canadian Federal Court of Appeals rejected the Crown’s appeal and sustained the Tax Court opinion. Accordingly, the main points that interest me are the ways in which the Court of Appeals either modified or reinforced the reasons given in the Tax Court’s opinion. In particular:

- The Court of Appeals fully considered and ultimately confirmed the Tax Court’s conclusion that the arm’s length price should reflect the incremental benefit to GECCAN of GECUS’ explicit guarantee over the implicit guarantee. That is:
  - The objective is to ascertain the price that would have been paid in the same circumstances if the parties had been dealing at arm’s-length.<sup>27</sup>
  - The implicit support of a parent company is a factor that an unrelated creditor would have taken into account in pricing the guarantee:

“The suggestion that implicit support should be ignored would require the Court to turn a blind eye on a relevant fact and deprive the transfer pricing provisions of their intended effect.”<sup>28</sup>
- The Court of Appeals found that this conclusion was supported by Paragraph 1.6 of the OECD’s Transfer Pricing Guidelines, which provides that the concept of independent parties is used to adjust profits “by reference to the conditions that would have been obtained between independent enterprises in comparable transactions in comparable circumstances.”<sup>29</sup>
- The Court of Appeals agreed with the Crown that the Tax Court erred in focusing on the effect of removing the written guarantee, but concluded that the Tax Court had other compelling reasons for reaching its conclusion.<sup>30</sup>
- The Crown also faulted the Tax Court opinion for its failure to perform a reasonableness test. The test proposed by the Crown sought to demonstrate that a 2% guarantee fee would be unreasonable because it represented an excessive portion (i.e., 60%) of GECCAN’s profit before deducting the guarantee fee. The Court of Appeals could not see how this claim assisted the Crown given that the guarantee fee actually charged was 1%.

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<sup>27</sup> Canadian Tax Court opinion (note 2), para. 54.

<sup>28</sup> Id at para. 56.

<sup>29</sup> Id at para. 57.

<sup>30</sup> Id at paras 67 – 74.

### 3.3 My Commentary

Both the Tax Court and the Court of Appeals opinions seem to be carefully considered and well reasoned. Based on my own experience as a transfer-pricing expert, it appears to me that the Crown's basic claim – that GECCAN did not require an explicit, written guarantee to achieve an AAA rating – was inherently unsustainable. As I will explain more fully below, because an incorporated subsidiary is a separate legal entity, written contracts with its parent generally provide the starting point for applying the arm's length standard to allocate income between those two related parties. The argument that a written contract has no material economic consequences is difficult to sustain in general and was not sustained in this particular case.

The Canadian Courts nonetheless accepted of the Crown's argument that GECUS' affiliation with GECCAN and the implicit support for its debt was a circumstance to be taken into account in assessing the amount of an arm's-length guarantee fee. The Tax Court stated:

*This brings us to the next step, which concerns the proper description of the analysis of the parties to the hypothetical transaction. Dr. Becker (the Crown's economic expert) suggests the hypothetical guarantor should have characteristics similar to GECUS, namely, it should be a AAA-rated multinational (parent) of a AAA-rated multinational (subsidiary). Similarly, the hypothetical debtor should be a subsidiary of a AAA-rated multinational corporation. The hypothetical parent of the debtor should be a corporation conducting an international unregulated financial services business that borrows large amounts of money in the international commercial paper markets.<sup>31</sup>*

By contrast, the taxpayer's position, which the Canadian Courts rejected, was that GECCAN should be viewed as a separate, stand-alone company, not as a subsidiary of a parent company that might rescue it from insolvency. The general principle of setting a transfer price based on the *incremental* benefit, rather than the total benefit, to the subsidiary – which principle led the Tax Court's rejection of the insurance-premium analysis – was strongly contested by GECCAN. The Canadian Courts' endorsement of an incremental benefit analysis will likely be cited in many future cases, both in Canada and around the world. The incremental benefit analysis may be relevant not just to guarantee fees and interest rates, but to other transfer pricing issues as well.

One other aspect of the Canadian Courts' opinions should be noted. In other decided transfer pricing cases, judges have often relied on simpler understandings of what the arm's length standard requires. For example, in *U.S. Steel*, the U.S. Tax Court concluded that the ocean transportation rates charged by U.S. Steel's Bahamian shipping subsidiary to unrelated customers for transporting Venezuelan iron ore could *not* be applied to determine the rate for comparable transportation provided to the U.S. parent company because of very substantial differences in the

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<sup>31</sup> I have corrected the text of the Tax Court opinion by transposing the bracketed terms ("parent" and "subsidiary") in the second sentence of the quotation; Canadian Tax Court opinion (note 2), para. 250

volumes transported.<sup>32</sup> However, the U.S. Second Circuit overruled the Tax Court and stated:

*In sum, the record shows that over four years' time half a dozen large corporations chose to use the services of Navios (U.S. Steel's shipping affiliate) despite the fact that they were not compelled to do so. In such circumstances, we think the taxpayer has met its burden of showing that the fees it paid (which were identical to those paid by the independents) were arm's length prices.*<sup>33</sup>

The U.S. Second Circuit ultimately concluded that:

*Although certain factors make the operations undertaken by Navios for (U.S.) Steel unique at one point, for example, Navios' ore-carriers were the largest of their kind in the world the approach taken by the Tax Court would lead to a highly undesirable uncertainty if accepted. In very few industries are transactions truly comparable in the strict sense used by Judge Quealy (the Tax Court Judge)... To say that Pittsburgh Steel was buying a service from Navios with one set of expectations about duration and risk, and (U.S.) Steel another may be to recognize economic reality; but it is also to engraft a crippling degree of economic sophistication onto a broadly drawn statute, which if "comparable" is taken to mean identical, as Judge Quealy would read it would allow the taxpayer no safe harbor from the Commissioner's virtually unrestricted discretion to reallocate.*<sup>34</sup>

It appears to me that if the Canadian Court of Appeals had applied the same reasoning as the U.S. Second Circuit applied in *U.S. Steel*, it would have overruled the Canadian Tax Court's opinion and accepted GECCAN's insurance-based evidence of arm's-length guarantee fees. That is, the outcome of transfer pricing litigation depends on the judge's economic sophistication.

As noted above, I believe the greater sophistication of the Canadian Courts in *GE Capital Canada* is a virtue. Others may conclude, as the U.S. Second Circuit in *U.S. Steel* did, that greater sophistication results not only in greater complexity of transfer pricing analyses, but also greater uncertainty in the ultimate outcomes of transfer pricing disputes.

#### 4. Implications for Tax Policy

My focus now shifts to the broader tax policy implications of using the arm's length standard to determine guarantee fees and interest rates payable to related parties. In this Section 4, I assume that the Canadian Tax Court opinion in *General Electric Capital Canada, Inc.* was correct in concluding that the 1% guarantee fee charged by GECUS was an arm's length result. The issue to be considered below is whether that arm's length result is best as a matter of tax policy.

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<sup>32</sup> Over the four years at issue (1957 – 1960), volumes transported for U.S. Steel, the parent company, accounted for approximately 94% of total volumes delivered to all customers (related and unrelated) at the U.S. Steel destinations (i.e., Baltimore, Philadelphia, Morrisville (Pa.) and Mobile).

<sup>33</sup> Id at para. 32.

<sup>34</sup> Id at para. 43, footnotes omitted.

Two comparisons are considered. First, under the OECD's current guidelines for bilateral tax treaties, the arm's length method of determining inter-company interest rates and guarantee fees for the domestic *subsidiary* of a foreign corporation is compared to the method of determining the comparable rates for the domestic *branch* of a foreign corporation. Second, a company's credit rating can be viewed as a valuable intangible asset and its tax treatment compared to that of patents, trademarks and most other intangibles. My ultimate conclusion is that from a tax policy perspective, the treatment of a company's credit rating under the single-entity, branch method makes more sense than the treatment of its credit rating under the separate-entity, arm's length method.

#### 4.1 Interest Expense and Guarantee Fees for a Permanent Establishment

In considering the tax policy implications of applying the arm's-length standard to inter-company interest expense and guarantee fees, I think it is useful first to compare how arm's-length rates for a corporate subsidiary of a multinational group are calculated to how such rates are determined for an unincorporated branch (which the OECD refers to as a "permanent establishment" or "PE") under the OECD's Report on the Attribution of Profits to Permanent Establishments of July 17, 2008. Under the "Working Hypothesis" of the 2008 OECD Report:

*"... the profits to be attributed to a PE are the profits that the PE would have earned at arm's length if it were a legally distinct and separate enterprise performing the same or similar functions under the same or similar conditions and dealing wholly independently with the enterprise of which it is a PE..."*<sup>35</sup>

But while the 2008 OECD Report endorsed the general principle of calculating the profit attributable to a permanent establishment as if it were a separate legal entity, the Report created a clear exception for interest rates and guarantee fees payable by a permanent establishment:

*There are a number of aspects to the recognition (or not) of dealings between a PE and the rest of the enterprise of which it is a part. First, a PE is not the same as a subsidiary, and is not in fact legally or economically separate from the rest of the enterprise of which it is a part. It follows that:*

- Save in exceptional circumstances, all parts of the enterprise have the same creditworthiness. This means that dealings between a PE and the rest of the enterprise of which it is a part should be priced on the basis that both share the same creditworthiness; and*
- There is no scope for the rest of the enterprise to guarantee the PE's creditworthiness, or for the PE to guarantee the creditworthiness of the rest of the enterprise.*<sup>36</sup>

<sup>35</sup> 2008 OECD Report, para. I-12.

<sup>36</sup> Id at para. I-36.

In short, if GECUS had organized GECCAN as its unincorporated Canadian branch, rather than as a separately incorporated Canadian subsidiary, GECUS could not have disclaimed responsibility for GECCAN's debt and, thus, would not be entitled to collect a guarantee fee for assuming that responsibility.

## 4.2 Credit Rating as an Intangible Asset

The tax treatment of a separate legal entity differs from the treatment of an unincorporated branch. In a separate-entity context, GECUS' AAA credit rating was clearly a valuable intangible asset in terms of its impact on the allocation of profit between GECUS and its affiliates. As noted above, the 1% guarantee fee that GECUS actually charged GECCAN represented 33 to 40 percent of GECCAN's pre-tax and pre-guarantee-fee profit. Broadly speaking, that 33 to 40 percent share of the payor's total profit compares favorably to the often cited rule of thumb that royalties paid by licensees for rights to use patents, knowhow and other manufacturing intangibles are typically 25 to 33 percent of their licensees' pre-royalty profits.<sup>37</sup>

However, a credit rating differs in significant ways from most other intangibles.

- Unlike most other intangibles, a high credit rating is neither the product of a formal intangible development program (such as an R&D activity) nor the byproduct of other specific activities undertaken by specific members of the consolidated group (e.g., manufacturing knowhow developed by a company's factories). Rather, as was shown in Part 2, a credit rating reflects the *consolidated* financial results of the affiliated group, not the separate-entity results of the parent company.
- A high credit rating is a manifestation of the consolidated companies' goodwill or going concern value. That is, unlike patents, trademarks, copyrights, etc., a credit rating is not a separate item of property that is owned and can be sold or transferred apart from the other assets of the company.<sup>38</sup>
- Although a parent company does not own its credit rating, it is nonetheless legally entitled under a separate-entity analysis to capture for itself the economic benefit of its high credit rating either by lending money to its subsidiaries at interest rates that are higher than its own borrowing cost or by guaranteeing the third-party debts of its subsidiaries. As Justice Hogan noted, GECUS was not required to give its subsidiaries access to its own credit facility. Rather, GECUS could provide an explicit guarantee when it was advantageous from a consolidated company perspective to do so (e.g., to GECCAN) or disclaim any guarantee when a guarantee would have been collectively disadvantageous (e.g., to GE Financial Corp.). GECUS's right to provide or disclaim explicit guarantees is the byproduct of its legal ownership and control (direct and indirect) of the stocks of its subsidiary companies, not its legal ownership of its credit rating *per se*.

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<sup>37</sup> See *Bausch & Lomb, Inc. v. Commissioner*, 92 T.C. 525, 608 (1989) and *Ciba-Geigy Corp. v. Commissioner*, 85 T.C. 172, 299 (1985).

<sup>38</sup> IRC Section 936(h)(3)(B) provides a definition of intangible property that excludes goodwill and going concern value.

- The discretion that a parent company has in capitalizing a subsidiary with debt rather than equity gives it discretion in how much debt-related expense to allocate to the subsidiary. For example, GECCAN had a 12 to 1 debt-equity ratio, as compared to GECUS's consolidated 8 to 1 debt-equity ratio. Although it would not have been advantageous from a consolidated company perspective to do so, GECUS could have chosen a debt-equity ratio for GECCAN that was less than 8 to 1; indeed, GECCAN could have been capitalized entirely with equity. GECCAN's actual 12 to 1 debt-equity ratio resulted in a high inter-company guarantee fee not only by reducing the separate-company credit rating imputed to GECCAN, but also by increasing the amount of third-party debt to which the inter-company guarantee fee applied.

In many cases, the parent company of a multinational corporation is the oldest and/or the largest legal entity in the group. But the ownership structure can often be manipulated if substantial tax savings will be realized. To illustrate, suppose two companies, Alpha Corp. and Beta Ltd., were selling similar products in the United States and Europe, respectively, reporting identical financial results and both enjoying a "B" credit rating. After friendly negotiations, the two companies agree to merge their businesses, with the erstwhile shareholders of Beta, Ltd. exchanging their shares for newly issued shares of Alpha Corp. Because the new consolidated company is twice the size of its predecessor companies and has diversified its risk, the credit rating of the parent company, Alpha Corp, is increased to "BBB", which reduces its cost of debt and improves its earnings per share.

Current interest rates for debt with the pertinent credit ratings are:

Credit <u>Rating</u>	Interest <u>Rate</u>
BBB	6.0%
BB	7.2%
B	8.0%

When Alpha Corp, the parent company, rolls over its own debt, it realizes the full benefit of the 2.0% interest cost saving (i.e., the pre-merger rate of 8.0% minus the post-merger rate of 6.0%). When the outstanding debt of its European subsidiary, Beta Ltd, is rolled over, Alpha Corp. guarantees Beta Ltd's debt to secure that same economic benefit:

- If no written guarantee had been provided, Beta Ltd's status as Alpha Corp's subsidiary together with its own stand-alone financial data would result in Beta Ltd's qualifying for a "notched up" credit rating of BB (as opposed to its pre-merger, stand-alone credit rating of B).
- The incremental benefit to Beta Ltd of Alpha Corp's written guarantee is 1.2% per annum, which is the difference between the 7.2% interest rate Beta Ltd. would otherwise pay and the 6.0% rate it obtains with Alpha Corp's written guarantee.

- Based on the method applied by the Tax Court in the *GE Capital Canada* case, the arm's length guarantee fee would be something less than the 1.2% per annum interest-rate benefit to Beta Ltd, say 0.9% per annum.

In summary, the merger of the two companies is assumed to result in an increase in the parent company's credit rating from B to BBB, a consequent reduction in the parent's interest cost of 2.0% per annum, and a commensurate increase in the parent company's net income from its own operations. The affiliated group's cost of Beta Ltd's debt is also reduced by 2.0% per annum. Beta Ltd's reported cost of debt (including the arm's length guarantee fee) is reduced by 1.1% per annum – that is, the 2.0% consolidated-company interest cost saving minus the 0.9% arm's length guarantee fee paid by Beta Ltd. to Alpha Corp.

Compare this result to the result that would obtain if the merger had been effected by having Alpha Corp's shareholders exchange their shares for newly issued shares in Beta Ltd, not *vice versa*. Under this second alternative, Alpha Corp would pay a 0.9% guarantee fee to Beta Ltd. with respect to Alpha Corp's own debt, rather than receiving a 0.9% guarantee fee with respect to Beta Ltd's own debt.

A third alternative might be to form a new parent company, Gamma Holding Company, in a tax haven and have the erstwhile shareholders in both Alpha Corp and Beta Ltd. exchange their respective shares for Gamma Holding Company's newly created shares. Since the legal organization resulting from the merger can be manipulated, tax considerations, not on economic substance, may determine the post-merger allocation of reported profit among the affiliated companies. From a tax policy perspective, this result makes no sense to me.

### 4.3 Conclusion

Allowing a parent corporation to charge a guarantee fee to its subsidiary corporation, but not to its unincorporated branch, is perfectly logical from a legal perspective, but not from a broader tax policy perspective. According to the OECD Transfer Pricing Guidelines of July 2010, a major reason for the arm's length standard is the goal of tax neutrality:

*There are several reasons why OECD member countries and other countries have adopted the arm's length principle. A major reason is that the arm's length principle provides broad parity of tax treatment for members of MNE groups and independent enterprises. Because the arm's length principle puts associated and independent enterprises on a more equal footing for tax purposes, it avoids the creation of tax advantages or disadvantages that would otherwise distort the relative competitive positions of either type of entity. In so removing these tax considerations from economic decisions, the arm's length principle promotes the growth of international trade and investment.*<sup>39</sup>

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<sup>39</sup> OECD Transfer Pricing Guidelines (2010), para. 1.8

As explained in Part 3, in *General Electric Capital Canada, Inc.* the Canadian Tax Court opinion concluded that:

- GECUS’s AAA credit rating reflected its *consolidated* financial results, not GECUS’s own separate-entity results.
- GECUS’ own treasury department managed the issuances of debt by all its subsidiaries, including GECCAN, and sought to fund GECUS’ *consolidated* business activities at the lowest possible cost.
- In the absence of GECUS’ guarantee, GECCAN would have been unable to execute its business plan because the Canadian commercial paper market was geared to the highest investment-grade borrowers (e.g., GECUS).

Because GECCAN used GECUS’s AAA credit rating to obtain the lowest possible interest rates, GECCAN enjoyed a competitive advantage over Canadian competitors with lower credit ratings and higher borrowing costs. From a legal perspective, GE Capital’s superior credit rating was attributed to the U.S. parent company. From an economic perspective, GE Capital’s superior credit rating was the result of the affiliated companies’ consolidated financial results and should be attributed for purposes of allocating income by the affiliated companies collectively, not by their parent company viewed as a separate entity. Reducing GECCAN’s taxable income by a guarantee fee could reasonably be viewed as creating a tax advantage and amplifying its inherent competitive advantage that GE Capital, viewed as an integrated company, enjoyed over its Canadian competitors.

From a tax neutrality perspective, the better alternative in my view is the unincorporated branch result – that is, calculating inter-company interest rates based on the credit rating of the parent company and denying any tax deduction for guarantee fees. While it was not legally required to do so, GECUS chose not only to directly control GECCAN’s debt issuances, but also to guarantee their repayment. Since GECCAN’s debt had the same guarantees as those of an unincorporated Canadian branch, why as a matter of tax policy should GECUS be entitled to a guarantee fee from its Canadian subsidiary, but not from a Canadian branch? But as noted before, treating a subsidiary as if it were a branch would require fundamental changes in countries’ tax laws and their bilateral tax treaties and cannot generally be achieved by tax authorities under existing law.

## Appendix A

### Calculation of Yield Adjusted for Expected Default Loss

Table A-1 illustrates how the yields on debt adjusted for expected default losses shown in Table 4 were calculated. In summary:

<u>Lines</u>	<u>Explanation</u>
1 - 5	Lines 1 to 5 show the key assumptions underlying the calculations.
6	Line 6 shows the number of years since the debt was issued.
7- 11	Lines 7 to 11 project the various debt-related amounts assuming no default occurs.
12 - 13	Line 13 shows the cumulative probability of default based on Moody's historical data. Line 12 shows the probability that debt will default during any given year, which equals the increment in the cumulative default rate shown on Line 13.
14	Line 14 equals 100% minus Line 13.
15 - 18	Lines 15 - 18 show the principal and interest amounts pertaining to debt that did <i>not</i> default in the current year or in any prior year.
19 - 20	Line 19 shows the principal amount of debt that is expected to default in a year, and Line 20 shows the interest due on that principal amount.
21	Line 21 shows the maximum possible loss on debt that defaults in a year, which equals 100% of the principal amount plus the interest payable on that principal amount.
22	Line 22 shows the portion of Line 21 that the creditor expects to recover (based on the recovery rate shown on Line 5).
23	Line 23 shows the expected cash flow that prior to maturity equals the interest received on debt that is not in default at the end of that year (Line 16) plus the recovery from debt that defaulted in that year (Line 22). In the year the debt matures, the cash flow also includes the principal amount of debt that did not default in any prior year (Line 15).
24	The expected yield equals the internal rate of return on the cash flow shown on Line 23.



# Transfer Pricing in the Courts: A Cross-Country Comparison

Julie Roin\*

## Abstract

*One open question in formulary versus “arm’s length” transfer pricing debate is the extent to which countries have already achieved some of the goals of formulary methods by accepting the use of “profit split” methodologies within their “arm’s length” pricing regimes. This paper analyzes the last ten years of transfer pricing cases in four English-speaking jurisdictions to see whether courts have used profit split methodologies to reach results similar to those that would be reached under a formulary system. The results of the survey are somewhat surprising. First, the use of profit split methodologies seems to have decreased rather than increased over time. Taxpayers have learned how to structure transactions to make these methodologies less relevant. Second, their use rarely if ever overcame the effects of taxpayers’ initial allocations of functions (including risk) among related entities. In short, the fears of those initially opposed to the use of profit split methodologies – as well as the hopes of some of their proponents – seem in retrospect to have been overblown. Whether that is good news or bad news depends on one’s perspective. One lesson that can be drawn from these cases is the difficulty of affecting tax outcomes absent the consolidation for tax purposes of related entities.*

## 1. Introduction

When the US Treasury published its “White Paper” on intercompany pricing issues in 1988, it revealed that judges used pricing models “other” than traditionally accepted, transactionally based arm’s length methodologies in almost a third of recently litigated transfer pricing cases.<sup>1</sup> This use of “other” pricing models, and in particular, judges’ reliance on “profit split” methods using industry standards as a reference, was widely decried as an unwelcome American innovation, one at odds with the international consensus that transfers between related companies should be effected (for tax purposes) at the same prices that would have prevailed had the com-

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\* Thanks are due to Prof. Andreas Oestreicher and other participants in the Conference on Fundamentals of International Transfer Pricing in Law and Economics, who read and commented on an earlier version of this Article, to Professors Wolfgang Schön and Kai Konrad for inviting me to participate, and to the Max Planck Research Center for Tax Law and Public Finance and the International Fiscal Association, without whose sponsorship the Conference could not have been held. All mistakes remain my own.

<sup>1</sup> See Office of Tax Analysis, US Dept of the Treasury, A Study of Intercompany Pricing, Discussion Draft 22 (Oct 18, 1988) (containing table of methods used to set prices in transfer pricing cases).

panies been transacting at “arm’s length.”<sup>2</sup> Although the US has largely prevailed in its quest to convince other nations that some profit split methods are compatible with arm’s length pricing norms and thus should be considered valid pricing methodologies,<sup>3</sup> another criticism of these methods has arisen: that national tax authorities, with the active connivance of judges, are now using profit split methods to surreptitiously replace the arm’s length standard for setting prices with a version of formulary taxation. While legislative bodies argue whether the arm’s length method

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<sup>2</sup> See for example, OECD Committee on Fiscal Affairs Task Force, OECD Task Force Recommendations on U.S. Transfer-Pricing Regulations, 6 *Tax Notes Intl* 93, 95 – 96 (Jan 11, 1993) (“The considerable weight given in the proposed regulations to the comparable profit approach increases the danger of arriving at a result that would not comply with the arm’s-length principle.”); Green, *The Future of Source-Based Taxation of the Income of Multinational Enterprises*, 79 *Cornell L Rev* 18, 43 (1993) (stating that “[t]he German Parliament has passed a resolution expressing its view that the comparable profit method is inconsistent with the arm’s length principle”); Muten, *Viewpoint: Inspiration or Desperation? European Reactions to U.S. Tax Thinking*, 7 *Tax Notes Intl* 1571, 1573 (Dec 20, 1993) (describing the “strong negative attitude” towards U.S. transfer pricing developments, calling them “a dangerous case of fiscal perfectionism” and noting “the U.S. comparable profits method (CPM), with its reference to the profit level of competitors, smells more of planned economies than of a competitive market economy”); Sheppard, *Canadian and German Perspectives Offered on the White Paper*, 44 *Tax Notes* 488 (1989) (Canadian tax official criticized the “‘commensurate with income’ standard as ‘hindsight,’” and its “periodic adjustment provisions... biased toward the U.S. fisc”); Yoshimura, *The “Tax War” Between the United States and Japan Under Internal Revenue Code § 482: Is There A Solution?*, 12 *Wis Intl L J* 401, 442 (1994) (“Notably, Japanese tax law does not allow the Comparative Profit Method.”).

<sup>3</sup> The OECD’s initial report on transfer pricing issues, released in 1979, see OECD Committee on Fiscal Affairs, *Transfer Pricing and Multinational Enterprises* (1979) [OECD, 1979 Report], takes a strong stand against “[t]he so-called ‘global’ methods”, including “direct methods of profit allocation, or... fixing transfer prices by reference to predetermined formulae....”. See *id.* para. 14 at 14. It describes these methods as “incompatible” with the OECD Model Double Taxation Convention, as well as “arbitrary... producing an allocation of profits which may bear no sound relationship to the economic facts....”. See *id.* The 1979 Report’s attitude towards “comparable profits” and “net yield” methods are only slightly more favorable. The results of the first “could normally be regarded only as pointers to further investigation”, see *id.* para. 71 at 42, and the second “might have some value in indicating a reasonable range of profit margins... [but] is too imprecise to be likely to be useful in isolation”, see *id.* para. 74 at 43. The 1995 version of OECD’s transfer pricing guidelines again flatly rejects the use of “global formulary apportionment.” See OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (1995) [OECD, 1995 Guidelines], para. 3.1 at III-1 (“OECD Member countries reiterate their support for the arm’s length principle and so reject the use of global formulary apportionment.”). However, the 1995 Guidelines do not contain a similar categorical rejection of “comparable profits methods”, instead stating that such methods “are acceptable only to the extent that they are consistent with these guidelines”. See *id.* In particular, the guidelines allow the use of “[e]xternal data from independent enterprises... to assess the value of the contributions that each associated enterprise makes to the transaction”, see *id.* para. 3.6 at III-3, albeit with a warning that “[t]here is no justification under the arm’s length principle for imposing additional tax on enterprises that are less successful than average when the reason for their lack of success is attributable to commercial factors”. *Id.* para. 3.4 at III-2; see also *id.* para. 3.26 at III-9 (allowing use of “the net margin that would have been earned in comparable transactions by an independent enterprise... [to] serve as a guide” under the transactional net margin method). However, the 1995 Guidelines make clear that transactional profit methods are

should be discarded in favor of formulary taxation, some worry (or exult) that in practice formulary taxation may already exist.<sup>4</sup>

To determine whether this criticism of profit split methodology is warranted, I looked at all the transfer pricing cases decided in four English speaking nations<sup>5</sup> (the US, the UK, Canada, and Australia) within the last 10 years. Litigated cases – and particularly cases that are litigated through to final judgment – are but a small sample of the transfer pricing disputes that arose between taxpayers and tax authorities during this period. Few taxpayers are willing to go to the expense necessary to litigate a case, and tax authorities often offer favorable settlement terms (or administrative dispute resolutions) for the same reason. However, these settlement negotiations should operate “in the shadow” of the litigated cases; if administrative settlement offers are significantly less attractive than the expected results of litigation, more taxpayers would opt to pursue litigation. Thus, one would not expect radically different outcomes in the two forums.

The results of this survey were surprising given the fears expressed about the profit split method. First, in the jurisdictions that I looked at, there are no examples of courts devising profit splits based on the factors used in current formulary apportionment schemes. Second, contrary to the experience of the 1980’s, judges rarely

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methods that assist in determining in cases of last resort”. Id para. 3.54 at III-18. The OECD continues to favor traditional transaction methods to transactional profit methods in its recently issued guidelines. See OECD, *Transfer Pricing Guidelines (2010)* [OECD, 2010 Guidelines], para. 2.3 at 60 (“where, taking account of the criteria described at paragraph 2.2, a traditional transaction method and a transactional profit method can be applied in an equally reliable manner, the traditional transaction method is preferable to the transaction profit method”), and emphasizes the need to ensure the “comparability” of comparators derived from independent enterprises. See id para. 2.56 at 77 (“the only profit methods that satisfy the arm’s length principle are those that ... follow the requirement for a comparability analysis as described in these Guidelines”). However, the 2010 Guidelines are clearly more favorably disposed towards use of these methods than were the prior guidelines. The section covering transactional profit methods in the 2010 Guidelines is much longer than the comparable section in the 1995 Guidelines (28 vs. 19 pages). The 2010 Guidelines for the first time contain specific rules for the use of a variety of profit methods, such as weighting net profit by sales, by costs, and by assets, as well as the use of Berry ratios. They also contain much more detailed guidance on the use of independent comparators for profit split methodologies. This extensive and detailed coverage of transactional profit methods suggests the increasing practical importance of these methods.

<sup>4</sup> See, for example, Morse, *Revisiting Global Formulary Apportionment*, 20 Va Tax Rev 593, 600 (2010) (stating that “[e]lements of formulary apportionment already exist within the U.S. federal transfer pricing system. For example, the residual profit split method...and guidance permits global trading businesses to allocate their income based on a formula...”); Benschalom, *The Quest to Tax Financial Income In A Global Economy: Emerging To An Allocation Phase*, 28 Va Tax Rev 165, 197 (2008) (describing profit split methodology as “nontransparent case-by-case formulary allocation mechanism”); Avi-Yonah, *The Rise and the Fall of Arm’s Length: A Study in the Evolution of U.S. International Taxation*, 15 Va Tax Rev 89, 92 – 95 (1995) (describing profit split method as half-way between arm’s length standard and formulary apportionment).

<sup>5</sup> Looking only at cases decided in English-speaking nations undoubtedly distorts the results of the survey, but is the necessary consequence of my monolingualism.

explicitly employed profit split methodologies.<sup>6</sup> Instead, almost without exception, judges claimed to be using the more traditional arm's length methodologies rather than profit-split methods to reach their pricing decisions. Often, they explicitly rejected tax authorities' attempts to use profit split mechanisms. Finally, even in those cases in which a court admitted to using a "profit split" methodology, the distinction between that method and traditional transactional methods was slight.

The first part of this paper provides a short history of the arm's length and formulary methodologies. The second part provides a country by country exegesis of litigated transfer pricing cases. The third and final part examines the implications that can be drawn from this exegesis.

## 2. Arm's Length vs. Formulary Income Allocation Methodologies

Countries have the right to tax all income derived within their borders. However, it has always been difficult to determine how much of the income derived by multinational business enterprises falls within particular taxing jurisdictions. Simply computing the worldwide income of a multinational enterprise is often far from easy; trying to allocate that income among countries raises a host of additional issues. How much of the combined profit should be allocated to research and development activities carried out in one country versus to the production activities carried out in a second country or the sales activities located in a third country? What if a single function is split between several countries? In the absence of oversight, taxpayers tend to allocate income to the jurisdiction with lowest effective tax rate, stripping the tax bases of higher-taxing nations.<sup>7</sup> This income stripping is often effected by manipulating the prices at which goods and services are transferred between related entities. It is hardly surprising that most countries grant their tax authorities the right to second-guess the prices set by taxpayers for inter-corporate transactions,<sup>8</sup> and that

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<sup>6</sup> Less formal consideration of profit split concerns may have operated in the background in some instances; these occasions are pointed out in the case discussions contained in Part II of the essay.

<sup>7</sup> Numerous studies indicate both the ubiquity and the success of such behavior. See, e.g., Joint Committee on Taxation, Present Law and Background Related to Possible Income Shifting and Transfer Pricing, JCX-37-10 (July 20, 2010), at 6 – 8 (describing and listing governmental and academic studies suggesting existence of tax avoidance through manipulation of transfer prices); *id.* at 51 (case studies illustrating tax planning mechanisms).

<sup>8</sup> See OECD, 2010 Guidelines, para.1.3 at 32 ("OECD member countries have agreed that for tax purposes the profits of associated enterprises may be adjusted as necessary to correct any such distortions and thereby ensure that the arm's length principle is satisfied."). As a technical matter, "transfer pricing" disputes arise only when there is a transfer between legally separate entities. However, the same income allocation issue arises in the context of intra-corporate transactions when (as is often the case in situations involving a branch and a home office) different parts of the corporation are located in different countries. The OECD applies the arm's length principle in the intra-corporate context as well as the inter-corporate context. See OECD, Report on the Attribution of Profits to Permanent Establishments (2006) [OECD, Report on the Attribution of Profits to Permanent Establishments], Part I.B-2 para. 12 at 12, online at <http://www.oecd.org/dataoecd/55/14/37861293.pdf> (describing application of arm's length principle in situations involving permanent establishments).

these statutory rights are protected under the terms of bilateral tax treaties.<sup>9</sup> National tax authorities, though, also have an incentive to distort income allocations. Left to their own devices, tax authorities would overallocate income to their respective jurisdictions in order to increase tax revenues, to the detriment of both taxpayers and other countries.

Early on, an international consensus developed in favor of the “arm’s length” principle: the income deemed generated in each country should correspond to the income that would have been generated by the portion of the enterprise located within that country had it dealt with other parts of the enterprise (whether or not those other parts were separately incorporated) at “arm’s length”, that is, as if they were unrelated, independent enterprises.<sup>10</sup> If BigCorp Australia purchases widgets from BigCorp Canada for use in manufacturing a machine tool in Australia that will eventually be sold to British customers by BigCorp UK, for tax purposes, BigCorp Australia is deemed to buy the widgets from BigCorp Canada for an amount equal to the fair market value of a generic widget and to sell its machine tools to BigCorp UK for the amount it (or other companies) charge unrelated parties for those or similar tools. Any other services or goods provided to BigCorp Australia by other members of the BigCorp Group (or vice versa) would be similarly priced at prevailing market levels. In the United States, this would be called using the “CUP” (for “comparable uncontrolled price”) method,<sup>11</sup> or if the item at issue is intangible property, the “CUT” (for “comparable uncontrolled transaction”)<sup>12</sup> method of determining the price for related party transfers.

Unfortunately, relatively few transfers between related parties involve generic widgets or machine tools with readily established fair market values. More often, they involve the transfer of unique goods or services, or goods or services bundled with unique intellectual property such as a trademark or patent protection. Further, many of the transferred items or services are not made available to independent third party purchasers; instead, all intermediate transfers take place within the related party group. Hence arm’s length prices have to be determined by reference to analogous transactions, often engaged in by analogous taxpayers. Needless to say, taxpayers and tax authorities often disagree as to what counts as an analogous transaction or an analogous taxpayer, as well as to what adjustments should be made to make the somewhat analogous transactions or taxpayers more comparable. Finally, some profit elements, such as gains generated from vertical integration, have no specific geographic home.

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<sup>9</sup> Id para. 11 at 19 (describing the role of Article 9 of the OECD Model Tax Convention).

<sup>10</sup> For a history of the development of this consensus, see Langbein, *The Unitary Method and the Myth of Arm’s Length*, 30 *Tax Notes* 625, 628–634, 638–654 (1986) (questioning the strength of this early consensus).

<sup>11</sup> See *Treas Reg* §1.482-3(b) (defining “comparable uncontrolled price method”). This regulation was promulgated under the authority of section 482 of the Internal Revenue Code [“IRC”], codified at 26 USC §482. Hereinafter, provisions of US tax statutes will be referenced to “IRC” rather than “26 USC”. The OECD’s definition of the comparable uncontrolled price method is virtually identical. See OECD, 2010 *Guidelines*, paras 2.13–2.18 at 63–64.

<sup>12</sup> See *Treas Reg* §1.482-4(c) (defining “comparable uncontrolled transaction method”).

Any pricing method which uses non-price information from comparable taxpayers or transactions to determine an “arm’s length price” is, in some sense, a profit split method. Many of the traditional, transactional pricing methodologies operate by determining an appropriate profit margin for an entity based on the functions it performs, and then using this margin to work backwards or forwards from a price set in a third party transaction to reach the appropriate internal “transfer” price. For example, under the “resale price method”,<sup>13</sup> the price paid by a distributor for goods produced by a related manufacturer is calculated by subtracting from the price paid for those goods by the distributor’s (unrelated) customers an amount equal to the distributor’s appropriate “gross profit margin”.<sup>14</sup> That margin is determined by reference either to the gross profit margins earned by the distributor on sales of other products both acquired from and sold to unrelated parties, or by the gross profit margin earned by other enterprises with respect to transactions similar to those engaged in by the distributor.<sup>15</sup> The “cost plus” method takes the cost of goods produced by a manufacturer and adds to this cost the gross profit margin determined to be appropriate for the manufacturer to construct the transfer price to a related distributor.<sup>16</sup> Again, the appropriate gross profit margin may be based on profit margins earned by the manufacturer in the context of arm’s length transactions or on profit margins earned by other, similar manufacturing enterprises in similar transactions.<sup>17</sup> Under both transfer pricing methods, the critical calculation is that of the appropriate “gross profit margin”; which of the two methods is used may depend on which function is carried out in the country doing the calculating or perhaps the enhanced availability of information about one or the other gross profit margins.

The difference between these traditionally accepted transfer pricing methods and the transactional net margin method (TNMM)<sup>18</sup> methodology accepted in the *2010 Guidelines* lies largely (though not entirely) in the fact that the traditional transfer pricing methods work with gross profit margins earned with respect to certain transactions or groups of transactions while the TNMM works off of operating profit amounts.<sup>19</sup> Working with a gross profit margin figure allows the part of an enterprise

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<sup>13</sup> For the US definition of the resale price method, see Treas Reg §1.482-3(c). The OECD’s definition of the term is again virtually identical. See OECD, 2010 Guidelines, paras 2.21 – 2.25 at 65 – 66 (containing definitions of “external comparable” and “internal comparable”).

<sup>14</sup> See Treas Reg §1.482-3(c)(2)(iii).

<sup>15</sup> See *id* at §1.482-3(c)(3)(ii)(A).

<sup>16</sup> See *id* at §1.482-3(d)(2).

<sup>17</sup> See *id* at §1.482-3(d)(3)(ii)(A).

<sup>18</sup> See OECD, 2010 Guidelines, para. 2.58 at 77 (describing “transactional net margin method”). The TNMM is quite close to what the US calls the “comparable profits method”. See Treas Reg §1.482-5 (defining comparable profits method). The US’s use of the comparable profits method, though, has long been controversial, due to fears that its tax authorities would “over-tax[] enterprises mainly because they make profits lower than the average....”. See OECD, 2010 Guidelines, para. 2.7 at 61; see also (note 2) (detailing initial furor following US introduction of the comparable profits method).

<sup>19</sup> See OECD, 2010 Guidelines, para. 2.58 at 77 (TNMM “operates in a manner similar to the cost plus and resale price methods....”).

enjoying low operating costs (relative to their competitors) to show abnormally high operating (and net) profits for tax purposes, and vice versa.<sup>20</sup>

The other “transactional profit method” accepted in the *2010 Guidelines*, the “transactional profit split method”,<sup>21</sup> identifies the combined profits of the related group derived from controlled transactions, and then “splits those combined profits between the associated enterprises on an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm’s length”.<sup>22</sup> This “two-sided” methodology looks at the functions performed by each affiliate and then splits the combined profits “in proportion to the value of their respective contributions to the generation of profit in the transaction”.<sup>23</sup> This task may be easy or hard, depending on whether “external market data” is available to “consider[] in valuing the contributions”.<sup>24</sup>

The “transactional profit split method” is quite similar to what the US calls the “profit split method”.<sup>25</sup> Under the profit split method each affiliated entity is assigned the proper return for its “routine” contributions first, with the remaining (“residual”) profit allocated to the entity performing a nonroutine functions or contributing nonroutine property, such as particularly valuable intellectual property rights.<sup>26</sup> Like the transactional profit split method, the US profit split method works reasonably well when only one entity makes nonroutine contributions; it is less successful when more than one entity makes such contributions because, by definition, no market comparable exists to help the fact-finder allocate the residual profit between such entities. If the value of either contribution were known, it would be a routine contribution; absent such values, it is unclear how one can determine the “relative value” of nonroutine contributions, and thus the appropriate profit split. Situations in which the combined profit is insufficient to allow each party the appropriate profit for its “routine” contributions also remain problematic.<sup>27</sup>

In actual cases, the line between transactional methods and transactional profit methods, particularly the TNMM, can be obscure. Certainly, the closer the evidence being used comes to being evidence of prices derived from identical transactions, the more likely it is that a court will claim to be applying a CUP or CUT methodology rather than a transactional methodology. However, as the cases discussed below reveal, the distinction between CUP, CUT and resale price and cost plus methodologies are unclear; courts often construct what they describe as a CUP by adding (or

<sup>20</sup> See id para. 2.62 at 78 (describing as “[o]ne strength” of the TNMM that “net profit indicators...are less affected by transactional differences than is the case with price...”).

<sup>21</sup> See id para. 2.108 at 93.

<sup>22</sup> See id (defining transactional profit split method).

<sup>23</sup> See id para. 2.110 at 94.

<sup>24</sup> See id.

<sup>25</sup> See Treas Reg §1.482-6 (defining profit split method). The OECD analogue is called the “transactional profit split method”. See OECD, 2010 Guidelines, paras 2.115 – 2.145 at 95 – 105 (describing application of transactional profit split method).

<sup>26</sup> See Treas Reg §1.482-6(c).

<sup>27</sup> The TNMM does not fare any better in such cases, and in fact, the OECD allows switching to the “transactional profit split method” in such situations. See OECD, 2010 Guidelines, para. 2.109 – 2.113 at 93 – 94.

subtracting) a profit margin to costs or sale prices. Further, courts do not always distinguish between gross and net profit margins.

Most of the objections to transactional profit methodologies seem to stem from the sense that tax authorities and judges allocate operating profits between enterprises or functional parts of an entity on bases other than evidence of internal or external market comparables.<sup>28</sup> Certainly the original profit split cases were short on explanation or defense of the profit splits adopted in the opinions.

While the arm's length standard has been used to allocate income between nations, subnational jurisdictions often employ a different method for allocating income derived from multijurisdictional business enterprises: the formulary approach.<sup>29</sup> Rather than try to reconstruct what would have happened had the various parts of the enterprise dealt with each other at arm's length, formulary methods use (somewhat) arbitrary mathematical formulas to allocate income between jurisdictions. Salient yet easily measured characteristics of the enterprise (sometimes denominated as "economic factors") are identified, and the combined enterprise's net income is split among jurisdictions in proportion to the amount of these factors located within and without the measuring jurisdiction. For example, historically many US states used a three-factor formula, dividing income based on the percentage of the taxpayer's sales, payroll and property located within each state.<sup>30</sup> Today, most US states have shifted towards formulas that overweight the sales element of the formula, sometimes to the complete exclusion of other factors.<sup>31</sup> The leading

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<sup>28</sup> See *id.* para. 2.74 at 83 ("Many countries are concerned that the safeguards established for the traditional transaction methods may be overlooked in applying the transactional net margin methods.").

<sup>29</sup> Jurisdictions currently using formulary apportionment include the states of the United States and the Canadian provinces. See Martens-Weiner, *Company Tax Reform in the European Union: Guidance from the United States and Canada on Implementing Formulary Apportionment in the EU 2* (2006) ("The U.S. states and Canadian provinces have used formulary apportionment for more than half a century as the principal method to distribute company profits across locations for taxation..."). Some European nations have experimented with formulary methods in limited circumstances. See *id.* ("some European nations used formulary methods in the early 20<sup>th</sup> century and many use formulae for other purposes..."); Sheppard, *Dowdy Retailer Set to Destroy European Corporate Tax Base*, pt. 2, 38 *Tax Notes Intl* 627, 632 – 634 (2005) (describing limited experiments in Denmark, France, and Italy). The European Commission's recently issued Common Consolidated Corporate Tax Base (CCCTB) proposal would allocate income among affected Member States "according to a specific formula based on three equally-weighted factors (assets, labour and sales)". European Commission Press Release, *Questions and Answers on the CCCTB*, MEMO/11/171, March 16, 2011, online at <http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/11/171&format=HTML&aged=0&language=EN&guiLanguage=fr>; see generally Roin, *Can the Income Tax Be Saved: The Promise and Pitfalls of Adopting Worldwide Formulary Apportionment*, 61 *Tax L Rev* 169, 172 (2008) (describing history of European Commission's CCCTB project).

<sup>30</sup> See Martens-Weiner, *Using the Experience in the U.S. States to Evaluate Issues in Implementing Formula Apportionment at the International Level*, US Treas Dept, OTA Paper 83 (Apr 1999), at 9 – 10, online at <http://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/ota83.pdf> (describing attempt to standardize use of "Massachusetts formula").

<sup>31</sup> See Roin (note 29), at 202; Stark, *The Quiet Revolution in U.S. Subnational Corporate Income Taxation*, *Intl Bur of Fisc Doc* 523, 528 (2001).

academic proposal for international formulary apportionment would rely solely on a sales factor.<sup>32</sup>

Formulary methods are simpler to operate, though perhaps less accurate (when judged by the arm's length standard) because they implicitly assume that the return on each factor is uniform across jurisdictions and across functions of the enterprise. The currently operational formulary methods have the advantage (for the tax administrator, not taxpayers) of ignoring hard to value intangible property, such as the assumption of business risks and ownership of intangible property. Indeed, this simplifying feature of formulary taxation underlies its appeal to many would-be reformers of the international tax rules who have been distressed by taxpayers' ability to restructure their operations to move high profit intangibles and risks to low tax jurisdictions as well as the costs of operating the current system.<sup>33</sup> Formulary taxation, particularly when combined with expansive consolidation (for tax purposes) of related entities, is regarded by some as both easier to administer and less subject to taxpayer manipulation than current arm's length methods.

Although the European Commission has released a proposal for allocating income among EU nations in accordance with a predetermined formula,<sup>34</sup> no nation or set of nations has formally adopted such an allocation method for use in assigning taxing rights over income generated by transnational business operations.<sup>35</sup> Even if determined to be the preferable allocation method, the costs of switching to formulary taxation are considerable. The first "cost" would be the effort needed to achieve multilateral agreement on a common formula and base for the tax.<sup>36</sup> Further, most bilateral tax treaties would have to be renegotiated, since virtually all of them explicitly provide for use of an arm's length standard for allocating income derived by res-

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<sup>32</sup> Clausing and Avi-Yonah, *Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment*, Hamilton Project Discussion Paper 2007-08, Brookings Institution (June 2007), online at [http://www.brookings.edu/papers/2007/~media/files/rc/papers/2007/06corporatetaxes\\_clausing/200706\\_clausing\\_aviyonah.pdf](http://www.brookings.edu/papers/2007/~media/files/rc/papers/2007/06corporatetaxes_clausing/200706_clausing_aviyonah.pdf).

<sup>33</sup> See *id.* at 14 – 16 (describing how "FA Increases Simplicity"); Martens-Weiner (note 29), at 40 – 41 (describing "[a]dvantages of formulary apportionment").

<sup>34</sup> See European Commission Press Release, *European corporate tax base: making business easier and cheaper*, IP/11/319, March 16, 2011, online at <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/11/319&format=HTML&aged=0&language=EN&guiLanguage=en>.

<sup>35</sup> The CCCTB proposal still "needs to be discussed and agreed by Member States in Council, following the opinion of the European Parliament". See European Commission Press Release (note 29). The EU's CCCTB proposal is not the only formulary proposal currently under consideration. The OECD is discussing the use of a formulary method for allocating income derived by financial institutions. See Avi – Yonah and Benshalom, *Formulary Apportionment – Myths and Prospects*, University of Michigan Law School Public Law and Legal Theory Working Paper No. 221, (Oct 2010), online at <http://www.law.umich.edu/centersandprograms/elsc/abstracts/2010/Documents/10-029aviyonah.pdf> (describing OECD proposal for the taxation of financial institutions by the location of significant people as "a major deviation [from ALS] towards a payroll formulary arrangement").

<sup>36</sup> See Roin (note 29), at 222; But see Avi-Yonah and Benshalom (note 35), at 13 (describing need for a comprehensive international tax base a "myth").

idents of the treaty partners or of entities owned by such residents.<sup>37</sup> However, an unwillingness to adopt a formulary method in toto does not prevent countries from incorporating formulary mechanisms into their generally arm's length allocation systems. Several countries, for example, incorporate formulary approaches into their rules for allocating interest deductions and other selected expenses,<sup>38</sup> and as alluded to above, there is a movement in the direction of using a formulary approach for the taxation of financial institutions.<sup>39</sup>

The question considered in this paper is whether some countries or some courts have gone beyond small-scale incorporation of formulary approaches to something approaching full-scale formulary taxation in the guise of implementing the "profit split" method of arm's length pricing. The only way to answer that question is to examine actual court decisions; accordingly, next section explores the last ten years of transfer pricing cases decided by courts in several English-speaking countries.

### 3. Judicial Price Setting

Although the tax authorities have the right to propose adjustments to taxpayers' reported income in all four of the countries discussed in this paper, taxpayers have a right to contest those adjustments in courts independent of those tax agencies. As noted above, such contests are expensive, and relatively few taxpayers take advantage of this opportunity. That does not mean that few taxpayers contest the adjustments made by tax authorities, only that most of the contests are limited to proceedings effected through agency dispute resolution processes. Unfortunately, those internal dispute resolution processes typically do not generate publicly available written opinions so that it is impossible to survey the methods used by taxpayers and the tax authorities to set prices in those contexts. Hence, this survey looks only at the relatively few contested situations that made it through the court system.

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<sup>37</sup> See Durst, *A Statutory Proposal for Transfer Pricing Reform*, 115 Tax Notes 1047 (2007), ("the U.S. cannot achieve meaningful reform unless it is willing to take the undesirable step of overriding some elements of existing treaties"); Martens-Weiner, *Redirecting the Debate on Formulary Apportionment*, 115 Tax Notes 1164, 1167 (2007) (citing statement by McLure that unilateral U.S. adoption of formulary taxation would "probably" make it "necessary to renegotiate foreign tax treaties"). But see Clausing and Avi-Yonah (note 32), at 23 – 24 (arguing that formulary apportionment consistent with treaty obligations); Avi-Yonah and Benshalom (note 35), at 24 (arguing that hybrid formulary regimes would be acceptable under current arrangements).

<sup>38</sup> In the US, domestic taxpayers are required (or allowed) to allocate deductions in accordance with prescribed formulas under a number of statutory and regulatory rules. See, for example, IRC § 864(g) (research and development expenses); IRC § 864(e) (interest expenses); Treas Reg § 1.861-8T(c) (list of formulas allowed for apportionment of deductions "related" to a class of gross income). The use of formulas in determining the taxable income of foreign taxpayers, however, is more controversial; See *National Westminster Bank, PLC v United States*, 44 Fed Cl 120 (Ct Claims 1999) (holding regulation apportioning interest expense of a domestic branch of a foreign corporation on the basis of a prescribed mathematical formula violated terms of the United States-United Kingdom Income Tax Treaty).

<sup>39</sup> See Avi-Yonah and Benshalom (note 35), at 23 – 24 (describing OECD proposal).

### 3.1 The United States

The US tax authorities have long had the power to “distribute, apportion, or allocate gross income, deductions, credits or allowances between or among” “organizations, trades, or businesses” that are “owned or controlled directly or indirectly by the same interests” as necessary “in order to prevent evasion of taxes or clearly to reflect... income...”.<sup>40</sup> In 1986, Congress added a sentence to the prevailing statute providing that, in the case of transfers or licenses of intangible property, “the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible”.<sup>41</sup> The US tax authorities have both defined and circumscribed these statutory powers through elaborate, and ever-evolving, regulations<sup>42</sup> which make clear the primacy of the “arm’s length” test in determining the income of related enterprises. The current regulations begin by stating that the purpose of the law is to “place[] a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer”<sup>43</sup>; the definition of the “true taxable income of a controlled taxpayer” is “that of a taxpayer dealing at arm’s length with an uncontrolled taxpayer”.<sup>44</sup> In addition, the United States has entered into a large number of bilateral income tax treaties containing “associated enterprises” articles. The language contained in these associated enterprise articles largely adheres to the language contained in whichever OECD model treaty was extant at the time the bilateral treaty was negotiated. Although the OECD model treaty language has changed over time, it has always embodied the arm’s length principal.<sup>45</sup>

US tax authorities have not been immune to the lure of formulary analysis. They have employed such analysis in a raft of studies – and referenced studies using formulary analysis made by other individuals and organizations – to show that multinational businesses have higher rates of profit in low-tax countries, thus buttressing their allegations that taxpayers have engaged in profit shifting.<sup>46</sup> They likely identify taxpayers for audit based on such evidence, and they rely heavily on profit split methodologies when constructing Advance Pricing Agree-

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<sup>40</sup> IRC §482; See Department of the Treasury, Current Trends in the Administration of International Transfer Pricing by the Internal Revenue Service Appendix VI 27, Ref No 2003-30-174 (Sept 2003), online at <http://www.treasury.gov/tigta/auditreports/2003reports/200330174ft.pdf> (providing chronological history of US transfer pricing statutes).

<sup>41</sup> See Tax Reform Act of 1986, P.L. 99-514, §1231(e)(1), codified at IRC §482.

<sup>42</sup> The regulations promulgated under section 482 currently take up 190 pages of fine print. See 2 Income Tax Regulations, Including Proposed Regulations 37,184 – 372 (CCH, Summer 2010 Edition). An additional 15 pages of such regulations have been proposed; See 6 *id* at 74,342 – 56.

<sup>43</sup> Treas Reg §1.482-1(a)(1).

<sup>44</sup> Treas Reg §1.482-1(b)(1).

<sup>45</sup> See OECD, 2010 Guidelines, para. 15 at 20 (“OECD member countries continue to endorse the arm’s length principle as embodied in the OECD Model Tax Convention...and in the 1979 Report...”).

<sup>46</sup> See sources cited (note 7).

ments.<sup>47</sup> However, the US courts have almost universally rejected attempts by the IRS to use profit split methods to determine prices in litigated cases.

A fairly substantial number of transfer pricing cases entered the judicial process during the period under investigation; very few of these disputes continued through the process to final judgment. Indeed, of the twelve transfer pricing cases identified by the Department of the Treasury in 2007 as “involv[ing] significant issues under section 482” that were docketed in the first level of judicial<sup>48</sup> adjudication, the Tax Court,<sup>49</sup> seven were concluded through “stipulated settlements”,<sup>50</sup> meaning the parties negotiated an end to the litigation before a judge rendered an opinion in the case. Judicial opinions have been written in only four of these cases, and the IRS lost, in whole or in part, all of them.

Two of the four decided cases, *H Group Holding Inc v Commissioner*<sup>51</sup> and *Compaq Computer Corp v Commissioner*,<sup>52</sup> were decided in 1999, slightly more than ten years ago. They are nonetheless included in this survey both because there are so few cases falling within the relevant time period and because Treasury regarded them as important.

*H Group Holding Inc* is best viewed as a transitional case. The opinion contains some of the broad, and to some analysts, troubling language drawn from the transfer pricing cases decided in the 1970’s and 1980’s, language that suggests that courts (and by implication the tax authorities) are not bound by market-based standards when determining transfer prices. For example, at one point in the opin-

<sup>47</sup> For example, the IRS’s analysis of the operations of the advanced pricing agreements (APA) process in 2001 described the “comparable profits method” as “frequently applied” under that program; Announcement and Report Concerning Advance Pricing Agreements, Announcement 2002-40, 2002-1 CB 747, 760, online at [http://www.irs.gov/pub/irs-apa/apa\\_report\\_2002\\_40.pdf](http://www.irs.gov/pub/irs-apa/apa_report_2002_40.pdf); See id at 759 (showing distribution of pricing methodologies in tables 16 and 17). Profit split methods have become, if anything, more important over time in that program. See Announcement and Report Concerning Advance Pricing Agreements, Announcement 2010-21, IRB 2010-15 (Apr 12, 2010), at 551, 567 – 68, online at [http://www.irs.gov/irb/2010-15\\_IRB/ar11.html](http://www.irs.gov/irb/2010-15_IRB/ar11.html) (showing distribution of pricing methodologies used in 2009 in tables 19 – 20); Announcement and Report Concerning Advance Pricing Agreements, Announcement 2007-31, 2007-1 CB 769, 784 – 85, online at [http://www.irs.gov/irb2007-12\\_IRB/ar18.html](http://www.irs.gov/irb2007-12_IRB/ar18.html) (showing distribution of pricing methodologies used in 2006 in tables 19 and 20).

<sup>48</sup> The IRS runs an internal dispute resolution process, and the vast majority of tax disputes are resolved at some level of this process.

<sup>49</sup> See Department of the Treasury, Report to The Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties (November 26, 2007), online at <http://www.treasury.gov/resource-center/tax-policy/Documents/ajca2007.pdf>; If the taxpayer is willing to pay the assessed deficiency in advance of the litigation and sue for a refund, such cases may also be heard by a general federal District Court or by the Court of Claims. However, few taxpayers take advantage of these alternatives in transfer pricing cases.

<sup>50</sup> The seven include *Adaptec Inc v Commissioner*, Docket Nos. 10077-00, 3480-01; *BIB USA Inc v Commissioner*, Docket No 4434-03; *BMC Software v Commissioner*, Docket No 2671-00, 2000 Tax Ct Memo Lexis 467; *Dart Container Corp v Commissioner*, Docket No 10526-01; *Glaxo SmithKline Holdings (Americas) Inc v Commissioner*, Docket No 5740-04; and *Mary Kay Corp v Commissioner*, Docket No 18150-02.

<sup>51</sup> *H Group Holding Inc v Commissioner*, 78 Tax Ct Memo (CCH) 1999-334 (1999), at 533.

<sup>52</sup> *Compaq Computer Corp v Commissioner*, 78 Tax Ct Memo (CCH) 1999-220 (1999), at 20.

ion, the judge wrote, “In reviewing the reasonableness of the Commissioner’s allocation under section 482, we focus on the reasonableness of the result, not the details of the methodology employed”.<sup>53</sup> However, the judge in this case ultimately looked to the market prices used in other, comparable transactions entered into between unrelated taxpayers when reaching its decision as to the appropriate income allocations.

*H Group Holding Inc* involved the income and expense allocations between members of an international hotel operation (Hyatt). The corporate structure of this operation was complex, beginning with two Delaware parent corporations, H Group Holding and AIC holding, owned by the same interests.<sup>54</sup> H Group Holding owned the Delaware subsidiary Hyatt Domestic, while AIC Holding owned the Delaware subsidiary HIC.<sup>55</sup> Hyatt Domestic’s subsidiaries owned and operated domestic (US) Hyatt hotels, while HIC’s subsidiaries, all foreign corporations, owned or operated foreign Hyatt hotels. In its notice of deficiency, the IRS noted that while Hyatt Domestic and HIC reported “the majority of the consolidated expenses of the Hyatt International Group” for US tax purposes, HIC’s foreign operating subsidiaries consistently reported (but did not pay U.S. tax on) “the majority of the revenue”.<sup>56</sup> The IRS contended that some of the foreign subsidiaries’ income properly belonged to HIC because HIC failed to charge those subsidiaries arm’s length prices when providing them with services or when allowing them to use valuable trademarks and other intellectual property,<sup>57</sup> and that in turn, HIC should have paid some of these fees to Hyatt Domestic, which owned the Hyatt trade name and other business intangibles and performed some services for HIC and its hotels.<sup>58</sup> The IRS used what it called a profit split methodology to determine the prices it claimed should have been

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<sup>53</sup> H Group Holding (note 51), at 552. This language was drawn from the earlier *Bausch and Lomb* case, see *Bausch & Lomb Inc v Commissioner*, 92 TC 226, 582 (1989), aff’d 933 F.2d 1084 (2d Cir 1991), and the reason it sends shivers down the backs of taxpayers is because it provides no basis for determining whether a result is “reasonable” or not.

<sup>54</sup> See *H Group Holding* (note 51), at 536 & 566 (appendix).

<sup>55</sup> See *id.*

<sup>56</sup> See *id.* at 555. In fact, the domestic operations reported losses as the foreign corporations reported substantial gains. See *id.* at 558.

<sup>57</sup> The IRS proposed five sets of income adjustments: 1) an increase in the royalties payable to Hyatt Domestic by HIC for its use of trademarks and trade names owned by Hyatt Domestic; 2) a pass through of management fees received by HIC subsidiaries for management services actually provided by HIC employees; 3) an increase in the royalties payable to HIC by its foreign operating subsidiaries for use of trademarks and trade names; 4) an increase in fees paid by foreign operating subsidiaries for corporate services provided by HIC; and 5) an additional allocation of the “excess profit” of foreign operating subsidiaries as compensation for the financial support provided by HIC. See *id.* at 548 – 49. The court increased the royalties payable to Hyatt Domestic, though by less than the IRS sought, required the pass through of management fees in those situations in which HIC employees actually performed management services (though this did not include in all the situations claimed by the IRS) increased the fees paid by foreign operating subsidiaries for HIC’s services and trademarks (though again by less than the amount claimed by the IRS), but refused to make any additional allocation of operating profit to HIC.

<sup>58</sup> See *H Group Holding Inc* (note 51), at 556.

used for these intercompany transactions.<sup>59</sup> Initially, the IRS developed its adjustments by using the amount of revenue its expert believed the various foreign subsidiaries (actually owning or managing hotels) would have earned had they been “independent” hotels and then ascribed the remaining income to some combination of HIC or Hyatt Domestic as a return for their trademarks and business intangibles.<sup>60</sup> At trial, the IRS proffered another expert, however, who advanced a four step process, again driven by a calculation of the appropriate profit split between the various entities.<sup>61</sup>

Although the Tax Court agreed that HIC had undercharged its subsidiaries in some of the situations identified by the IRS, none of the income allocations upheld by the Court were based on the profit split methodology advocated by the IRS’s expert witnesses. The Court did not categorically reject the use of profit split methodology; instead, it rejected the IRS’s application of that methodology to the facts of the case. In particular, it decided that the comparables on which the IRS’s profit split was based were inapt.

First, the IRS had contended that Hyatt Domestic was entitled to a royalty equal to 1.5 percent of foreign hotel revenues, a figure drawn from “hotel franchise rates”.<sup>62</sup> The Court, however, found that Hyatt Domestic had not provided “the level of intangibles and services...that would warrant the full charge for a franchise relationship”<sup>63</sup> and held that the IRS’s proposed reallocation, even as adjusted downward at trial, was unreasonable in light of the goods and services actually provided by Hyatt Domestic.<sup>64</sup> To calculate the proper royalty rate, the Court started with the franchise rate, decreased it by the amount typically used to defray the cost of franchise services that had not been provided to HIC or its subsidiaries, and then split the remainder, the “profit”, between profit derived from performing services and profit derived from providing trademarks and other intangibles. The Court concluded that the proper royalty payable from HIC to Hyatt Domestic amounted to .4 percent of foreign hotel revenues.<sup>65</sup>

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<sup>59</sup> Id (“Respondent’s expert concluded that the royalty was an equivalent of a profit split accounting for HIC’s capital and personnel to build an international chain and Hyatt Domestic contributing chain services and its intangibles, including the trademarks.”).

<sup>60</sup> See id at 554 (Burt report two).

<sup>61</sup> See id at 554 – 55 (describing BVS report/opinion).

<sup>62</sup> See H Group Holding Inc (note 51), at 556 – 57. Why deriving a royalty rate from franchise agreements entered into between unrelated taxpayers would be described as a “profit split” by the IRS rather than as the use of the “comparable uncontrolled transaction” method is somewhat puzzling given that royalty rates derived from royalty arrangements entered into by unrelated parties could be described as a “price” derived from uncontrolled transactions. The IRS’s decision to ask that a 1.5 percent royalty rate be used is also puzzling inasmuch as the court notes somewhat later in the opinion that both parties’ experts agreed that “the franchise rates for luxury hotels charged by U.S.-based hotel chains were the equivalent of about 2 percent of gross hotel revenue”. See id at 562.

<sup>63</sup> See id at 557.

<sup>64</sup> See id at 557.

<sup>65</sup> See id at 562.

Next, the Court considered the question of the royalty properly payable to HIC from its foreign hotel subsidiaries on account of their use of the corporate trademarks and trade names. As it had earlier in the Hyatt Domestic-HIC context, the IRS contended that the foreign hotel subsidiaries should have paid HIC a royalty equal to 1.5 percent of their gross revenues.<sup>66</sup> The Court concluded that the proper royalty rate was the same .4 percent of gross revenues,<sup>67</sup> making HIC a mere conduit for royalties received by Hyatt Domestic; it did not allow HIC to derive any profits from its relicensing of these trademarks.

However, the Court agreed that HIC, unlike Hyatt Domestic, had performed valuable services for at least some of its subsidiaries, services ranging from the provision of “[m]anuals, training, human resource development, employee benefits, contract review, financial systems and advice, business development assistance, preopening services, owner relations, marketing”, to the development of a reservation system.<sup>68</sup> Although the taxpayer argued that these services were “stewardship services” primarily benefiting HIC, or, alternatively, reimbursable at cost,<sup>69</sup> the Court disagreed. Yet the Court had difficulty determining the proper recompense for these services. After excoriating both sides for their role in leaving it “stranded in a ‘sea of expertise’”<sup>70</sup> with evidence of prices used in a number of non-comparable arrangements, the Court decided that the relationship between HIC and its subsidiaries was close to that found in a typical franchise arrangement. Thus, it determined the appropriate fee by extrapolating from the fee found in franchise agreements.<sup>71</sup> After subtracting the portion of that fee attributable to trademarks, the Court concluded that the subsidiaries should have paid a fee of 1.5 percent of gross revenues of those hotels for which HIC provided such services.<sup>72</sup> It did not even address the IRS’s argument for a profit allocation on top of that royalty.

Although the Court did not affix a name to its pricing methodology (aside from claiming that it was applying the arm’s length standard), it seems to fall squarely within the definition of the comparable uncontrolled price method. It used a price (expressed as a royalty rate) drawn from comparable transactions entered into by unrelated parties, and then adjusted that price to take into account differences between the transactions. The Court’s rejection of the IRS’s suggested profit split methodology, though, did not seem to stem from any discomfort with profit split methodology itself, only from the non-comparability of the transactions on which the IRS’s profit split case was based. Indeed, the Court seemed to have kept some sort of generic profit split consideration in mind when applying its analysis, noting for example, that “our holding allows HHK and HS reasonably adequate compen-

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<sup>66</sup> See *id.* at 562.

<sup>67</sup> See *id.* at 563.

<sup>68</sup> See *id.* at 563.

<sup>69</sup> See *id.* at 563 – 64.

<sup>70</sup> See *id.* at 566.

<sup>71</sup> See *id.* (“The reallocable services provided by HIC coincide with those provided in a franchise agreement.”).

<sup>72</sup> See *id.* Some of the foreign subsidiaries provided these services for themselves, and were not subject to the imputed royalty.

sation for their efforts as hotel management companies, unlike respondent's notice of deficiency determinations".<sup>73</sup> But at most, this profit split concern served to validate results reached through a traditional arm's length, transactionally based, methodology.

The IRS's attempt to use profit split methodology in the other 1999 transfer pricing case, *Compaq Computer Corp v Commissioner*,<sup>74</sup> was no more successful. The taxpayer, Compaq US, manufactured personal computers, of which "PCAs"<sup>75</sup> were a critical component. At issue in the case was the price Compaq US paid its Asian subsidiary, Compaq Asia, for PCAs. The IRS tried to adjust the purchase price of Compaq Asia's PCA using a "modified cost-plus or profits-based fourth method...".<sup>76</sup> The taxpayer countered with a price determined under the CUP method.<sup>77</sup>

Compaq US had three sources of PCAs: it manufactured some at its US plant, some were manufactured by Compaq Asia and purchased by Compaq US, and some were acquired from unrelated subcontractors, most of whom were located in the United States.<sup>78</sup> The PCAs coming from the different sources were basically indistinguishable, so the taxpayer used the prices it paid unrelated subcontractors for PCAs as the basis for determining the price it paid Compaq Asia for its PCAs.<sup>79</sup> The IRS argued that the PCA purchase transactions were not comparable, forcing reliance on its preferred methodology (and income adjustments).<sup>80</sup> Although most of the differences between the related and unrelated party transactions were minor, leading to easily computed price adjustments,<sup>81</sup> most of the PCAs acquired from unrelated suppliers were acquired on a "consignment" basis, meaning that Compaq US provided the materials necessary to make the PCAs and promised to purchase all the PCAs produced from those materials.<sup>82</sup> By contrast, Compaq Asia "bore the risk that its materials and components inventory would not be used or would become obsolete".<sup>83</sup> The taxpayer argued that this risk differential necessitated an adjustment in the form of a "materials markup" equal to 17.5 percent of Compaq Asia's material costs. The IRS argued, first, that the amount of the appropriate risk adjust-

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<sup>73</sup> See *id.*

<sup>74</sup> See *Compaq Computer Corp* (note 52), at 20.

<sup>75</sup> PCA's are "the electronic circuitry inside the CPU that allows the PC to operate. Each PCA consists of a printed circuit board, the communication platform to which components are attached, and any number of combinations of chips, resistors, and capacitors". *Id.* at 21.

<sup>76</sup> See *id.* at 26.

<sup>77</sup> See *id.*

<sup>78</sup> See *Compaq Computer Corp* (note 52), at 21.

<sup>79</sup> See *id.* at 26. Prior to audit and trial, the taxpayer had set prices by using a cost-plus method based on its US production costs.

<sup>80</sup> See *id.* at 33.

<sup>81</sup> See *id.* at 31 – 32 (discussing differences in design responsibilities, quality, and shipping costs).

<sup>82</sup> See *Compaq Computer Corp* (note 52), at 32 ("The unrelated subcontractors...waited until they received a firm purchase order before they committed to buying materials and components. Furthermore, Compaq U.S. contractually committed to be responsible for the materials and components inventories in the event that demand or design changed.").

<sup>83</sup> See *id.*

ment or markup was not substantiated by adequate evidence, and that without such a markup, the taxpayer could not use the CUP method at all; second, the IRS argued, as a backup, that the 17.5 percent markup was too high, and left Compaq Asia with too much profit.<sup>84</sup> To reach the right profits distribution, the IRS contended, only a 5 percent profit markup should be allowed.<sup>85</sup>

The Court found in favor of the taxpayer. Its conclusion was aided by the fact that the IRS's expert conceded that the taxpayer's "material markup" figure "was consistent with and fell within the middle of the range of material markups actually observed in the marketplace";<sup>86</sup> by contrast, according to the Court, that expert provided minimal if any factual basis for the IRS' choice of "operating profit markup".<sup>87</sup> As the transfer price determined under the CUP method was higher than the price at which Compaq US had initially reported buying Compaq Asia's PCAs, the Court held that no transfer price adjustment was necessary.

Again, the Court did not rule out profits-based methodologies per se. Rather, it found the IRS's use of the methodology inapt. At the end of its opinion, the Court made clear what it viewed as the real issue in the case: which of the two related entities, Compaq US or Compaq Asia, should be entitled to the profits generated by Compaq Asia's unusually low cost structure.<sup>88</sup> Relying on its earlier *Bausch & Lomb* decision,<sup>89</sup> the Court held that Compaq Asia was entitled to a higher net profit margin than its competitors.<sup>90</sup> Using an arm's length price for the transfer of the PCAs took precedence over ensuring that Compaq Asia earned a normal rate of return on its activities.<sup>91</sup>

At the time these two cases were decided, US treasury regulations established a pecking order for transfer pricing methodologies. The comparable uncontrolled pricing method was preferred to all other methods; it had to be utilized if the information necessary to use it was available. This preference was consistent with the regulations' general commitment to "arm's length" pricing. Direct evidence of arm's length prices is more trustworthy, and likely more accurate, than any price extrapolated from analogous transactions. Calling the "turnkey equivalent price" derived by the taxpayer (the "commission price" paid other PCA manufacturers increased by the "materials markup") a "comparable uncontrolled price" made it easier for the Court to reach its decision as a doctrinal matter; as a practical matter, though, the IRS was probably correct that this "turnkey equivalent price" was no less extrapolated (and hence open to error) than its own profit-based fourth method. Indeed, the actual calculation of this turnkey price resembled a mix of a cost-plus calculation (because

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<sup>84</sup> See *id.* at 33.

<sup>85</sup> See *id.*

<sup>86</sup> See *id.* at 35.

<sup>87</sup> See *id.*

<sup>88</sup> Compaq Asia's production costs were lower than those of either Compaq US or the other, non-Asian PDA suppliers Compaq US dealt with. See *id.* at 35.

<sup>89</sup> *Bausch & Lomb, Inc v Commissioner*, 92 TC 525 (1989), *aff'd* 933 F.2d 1084 (2d Cir. 1991).

<sup>90</sup> See *Compaq Computer Corp* (note 52), at 34.

<sup>91</sup> See *id.* ("The CUP method establishes arm's-length prices for PCA's that were sold by Compaq Asia, and a large profit margin does not prevent use of the CUP method.")

costs were increased by a profit margin) and a fourth method comparable profits method (because the profit margin was determined on the basis of industry averages rather than figures derived from identical transactions) than a CUP calculation. The only reason this pricing mechanism could be denominated a CUP method was because, as a technical matter, the derived profit margin was used to determine the price of the comparison property. It would have had to have been called something else if the margin was used to directly determine the price of the property transferred in the related party transaction. As the Court makes clear at the end of its opinion, however, the real conflict in the case lay not in the choice of pricing mechanisms, but in which corporate entity was entitled to benefit from Compaq Asia's relatively low cost structure.

*DHL Corp v Commissioner*,<sup>92</sup> though of similar vintage to the *H Group Holding Inc* and *Compaq Computer Corp* cases,<sup>93</sup> looks ahead to the more recent cases because the alleged transferee participated financially (and operationally) in the development of the intellectual property that was transferred and, allegedly, not paid for. DHL was a US based courier company which established a Hong Kong subsidiary, DHLI, through which it handled the receipt and delivery of foreign packages and documents. Some of these documents and packages went to or came from the United States, but many were both picked up and delivered abroad. Though the entities were commonly controlled, and "there was commonality and 'secunding' (sharing) of employees" at the executive level, each "generally operated separately".<sup>94</sup>

DHL was the first to use the DHL name, but it initially lacked a standard trademark or logo. DHLI paid for the design of the first such standard logo; subsequently, the two corporations cooperatively funded this logo's modernization. DHL registered the resulting trademarks and logos in the United States, and then licensed them to DHLI for "worldwide" use, excepting the United States. DHLI registered the trademark worldwide<sup>95</sup> at its own expense and in its own name although it initially paid royalties to DHL for use of this trademark. DHLI also bore the expenses of protecting and advertising the trademark in foreign markets. After DHLI bought the Central American rights to the trademark for \$100,000, it ceased paying royalties to DHL for its worldwide use of the DHL trademark despite the fact that, as a contractual matter, it had only purchased the Central American rights.

DHL's US operations did not fare particularly well, but its foreign operations thrived. Eventually, through a very complicated set of transactions, a group of foreign investors bought DHLI and the foreign rights to DHL's trademarks from DHL. The IRS then commenced an audit, at the end of which it concluded not only that most of the consideration paid for DHLI was attributable to the sale of the DHL-owned trademarks, but also that DHLI should have been paying DHL 3 percent of

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<sup>92</sup> 285 F3d 1210 (9<sup>th</sup> Cir 2002).

<sup>93</sup> The Tax Court decision in the DHL case came down in 1998, a year before Compaq was decided. See *DHL Corp v Commissioner*, 76 Tax Ct Memo (CCH) 1998-461 (1998), rev'd 285 F3d 1210 (9<sup>th</sup> Cir 2002), at 1122.

<sup>94</sup> *Id* at 1124.

<sup>95</sup> *Id* at 1130 – 31.

its revenues as a royalty for its use of the trademarks prior to that sale. It also maintained that DHLI underpaid DHL for its role in picking up and delivering packages traveling between the US and foreign destinations.

The Tax Court found for the IRS, holding that DHL received \$100 million from the sale of the foreign trademarks<sup>96</sup> and should have received considerable royalties from DHLI prior to its sale.<sup>97</sup> However, the Ninth Circuit reversed these findings on appeal, holding that DHLI's contribution towards the development and maintenance of these trademarks made it a developer or assister of the foreign trademark.<sup>98</sup> Under the regulations extant at the time, this meant that "no allocation to DHL for the value of the foreign trademark rights was appropriate, or, alternatively, that DHLI provided assistance to DHL's development, thereby entitling DHL to a complete set-off against the \$50 million allocation" of sales proceeds;<sup>99</sup> for the same reason it reversed the Tax Court's allocation of unpaid royalties to DHL.<sup>100</sup> All that was left of the Tax Court opinion was its allocation of "unpaid transfer fee payments covering the difference between the extra packages that DHL delivered for DHLI as against those that DHLI delivered for DHL," an adjustment DHL had not appealed.<sup>101</sup>

There is little question that DHLI and DHL's relationship violated arm's length standards. Neither corporation paid much if any attention to the terms of the contracts they had entered into, and their bookkeeping was sloppy at best. Their relationship operated on an informal, ad hoc basis that never would have been tolerated in an arm's length setting. However, the Ninth Circuit implicitly concluded that this did not matter because the undeclared transfers of value were reciprocal. The two wrongs made a right. The Court reached this decision despite an absence of evidence on the issue of actual reciprocity, that is, of whether the costs incurred by DHLI in connection with the development and maintenance of the trademark and logo were comparable to similar expenditures by DHL, or were appropriate in light of the value of the rights DHLI was being granted. The Court made no attempt to parse the terms of the "developer assister" agreement to see if it met third party, arm's length standards. This decision to ignore the niceties gave the taxpayers the benefit of the doubt, possibly allowing them to profit from their self-created confusion. Perhaps this generosity was warranted; it was in fact far from clear that DHL was underpaid. In general, though, courts avoid such generosity because of fears that it leads to later overreaching by taxpayers.

That no such overreaching subsequently appears to have taken place (at least in published cases) was probably due to changes in the legal landscape. Two changes were of particular importance. First, the prevailing treasury regulations were amended to eliminate the stated preference for use of the "comparable uncontrolled

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<sup>96</sup> Id at 1157 – 58.

<sup>97</sup> Id at 1162.

<sup>98</sup> Id at 1224.

<sup>99</sup> Id.

<sup>100</sup> Id.

<sup>101</sup> Id at 1224 and n 10.

price” method; new regulations were promulgated instructing taxpayers to use whichever pricing methodology was the “best method” under the circumstances.<sup>102</sup> Second and more important for the later cases, the developer and assister concept which played such a large role in the *DHL Corp* case was replaced with a much more fully specified set of rules covering “cost sharing agreements”.<sup>103</sup> A cost sharing agreement is a contractual joint venture agreement under which affiliated (or not) entities agree to share research and development costs in return for joint ownership<sup>104</sup> of any resulting intellectual property. Although the terms of such cost-sharing agreements have to meet the arm’s length standard, once the terms of the agreement have been validated, no further transfers of intellectual property (to which section 482 or treaty income reallocation rules might apply) take place. As the *DHL Corp* case itself showed, the transfer of intellectual property to a low tax foreign entity before the property has been fully developed allows much more of the income ultimately attributable to the asset to be sourced in a low tax foreign jurisdictions. The two most recently decided section 482 cases involved cost sharing agreements.

The first of these cases was *Xilinx Inc v Commissioner*.<sup>105</sup> Xilinx, a US corporation, researched, developed, manufactured and marketed integrated circuits and related software. Xilinx’ Irish subsidiaries formed an Irish, unlimited liability company, XI. Xilinx entered into a cost-sharing agreement with XI. Under the terms of the agreement, each party was required to pay a percentage of the total R&D costs in proportion to the anticipated benefits to each from the new technology that was expected to be created. Specifically, the Agreement required the parties to share: (1) direct costs, defined as costs directly related to the R&D of new technology, including, but not limited to, salaries, bonuses and other payroll costs and benefits; (2) indirect costs, defined as costs incurred by departments not involved in R&D that generally benefit R&D, including, but not limited to, administrative, legal, accounting and insurance costs; and (3) costs incurred to acquire products or intellectual property rights necessary to conduct R&D. The Agreement did not specifically address whether employee stock options (ESOs) were a cost to be shared.<sup>106</sup>

Xilinx granted approximately \$176,000,000 worth of stock options to its employees in the three years at issue, 1997, 1998 and 1999, which it deducted as business expenses; it also claimed research and development tax credits for the approximately \$84,000,000 of stock options it considered wages related to research and development activities. XI also compensated its employees in part in the form of

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<sup>102</sup> See Treas Reg §1.482-1(c) (describing the best method rule); This rule first appeared in temporary regulations issued in 1993. See TD 8470, 58 FR 5623 (1993) (Section 1.482-1T).

<sup>103</sup> The first cost-sharing regulation, Treas Reg §1.482-7, was introduced in 1996, see TD 8632, 1996-1 CB 85 (1996), and has undergone several revisions. The current version is found at Treas Reg §1.482-7T.

<sup>104</sup> Usually, the agreements are not structured to grant joint ownership of the entirety of the intellectual property rights, but instead to grant each party to the agreement geographically restricted rights. The US company typically acquires all US rights while the foreign affiliate requires the rights to foreign use of the property.

<sup>105</sup> *Xilinx Inc v Commissioner*, 508 F3d 1191 (9<sup>th</sup> Cir 2010).

<sup>106</sup> See *id* at 1192-93.

stock option grants. Because XI was a wholly owned subsidiary, these grants took the form of options on Xilinx stock. XI compensated Xilinx for these options by paying Xilinx the difference between the value of Xilinx stock on the date of exercise and the exercise price. Over the three year period, XI paid Xilinx approximately \$1,450,000 for such stock options.

The question raised in the case was whether an allocated portion of Xilinx' stock option grants should be treated as part of the costs of generating the technology covered by the Cost Sharing Agreement, and thus shared with XI. Such cost sharing would have decreased Xilinx' research and development deductions and increased its taxable income, while correspondingly increasing XI's costs and decreasing its income. The IRS contended that such cost sharing was required; the taxpayer argued that it was not.

The crux of the taxpayer's argument was that two unrelated parties in a cost sharing agreement would not share the costs of employee stock options, and that under the arm's length standard, controlled parties need only share those costs uncontrolled parties share. The IRS argued that unrelated parties to a cost sharing agreement are not in the same situation as related parties to a cost sharing agreement, and thus that the terms of cost sharing agreements between unrelated parties should not be determinative of the terms of cost sharing agreements between related parties. Specifically, the IRS argued that the reason unrelated parties would not share the cost of employer stock options was because unrelated companies would not be willing to "expose themselves to an obligation that will vary with an unrelated company's stock price". That concern was inapplicable to related company situations in general and the Xilinx situation in particular, given that XI's grant of stock options to its own employees already exposed XI to the risk of changes in the price of Xilinx stock. Further, the IRS argued that the specific regulatory rule applicable to cost-sharing agreements,<sup>107</sup> providing that "all of the costs incurred by that participant related to the intangible development area" be shared proportionately, took precedence over, to the extent it conflicted with, the general arm's length standard enunciated at the beginning of the section 482 regulations.<sup>108</sup>

Another (and perhaps more convincing) way of stating the IRS's concern is that if the corporations had not been closely related, Xilinx would not have paid as large a fraction of its research employees' salaries in the form of stock options because this cost would not have been shared under the terms of the cost sharing agreement. It was only because Xilinx and XI were related (and because of the tax advantages of shifting income to XI) that Xilinx was willing to incur this substantial cost without demanding reimbursement from its partner. Thus, to put the parties in the economic position they would have been in had they been operating at arm's length required treating the stock options as a cost under the cost sharing agreement.

The taxpayer prevailed in its argument that it should only be required to share those costs that unrelated parties would share at the first level of adjudication, the

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<sup>107</sup> Treas Reg §1.482-7(d)(1).

<sup>108</sup> Treas Reg §1.482-1(b)(1) (specifying that "the true taxable income" of controlled parties be calculated based on how parties operating at arm's length would behave).

Tax Court.<sup>109</sup> The Court refused to read the cost sharing regulation as being in conflict with the general regulation establishing the use of the arm's length standard, and it saw no difference between cost sharing agreements between related and unrelated parties. The IRS appealed the decision to the Ninth Circuit. The IRS initially prevailed in the Ninth Circuit. Two of the three judges hearing the case signed an opinion holding that the specific rule found in the cost sharing regulations took precedence over the more general arm's length standard.<sup>110</sup> However, the panel withdrew this initial opinion<sup>111</sup> and replaced it with one affirming the Tax Court. In this second opinion, the panel decided that the "all costs" language of the cost sharing regulations was ambiguous when related to the more general "true taxable income" regulation, and decided to "[r]esolve the ambiguity based on the dominant purpose of the regulations" because "[p]urpose is paramount". Finding that "[t]he purpose of the regulations is parity between taxpayers in uncontrolled transactions and taxpayers in controlled transactions",<sup>112</sup> the Court held for the taxpayers.

The second appellate decision allowed the foreign subsidiary to earn a higher return on its research and development activities than its domestic counterpart in the absence of a business explanation (such as lower labor costs) for this higher profit. This resulted from the Court's focus on the arm's length comparability of a particular part of the transaction. Had it focused instead on whether the overall structure of the arrangement – in particular, on whether the amount of compensation provided in the form of stock options comported with the use of such compensation in arm's length arrangements – a different decision may have been reached. At least part of the responsibility for the Court's narrow focus, though, must be placed on the IRS. If the IRS presented evidence of the amount of stock option compensation provided by parties to third party cost sharing agreements, it was overlooked by the deciding Courts; such evidence is not mentioned in any of the opinions.

The IRS lost yet again in *Veritas Software Corp v Commissioner*,<sup>113</sup> a 2009 section 482 case. Veritas US, a company which successfully developed and licensed storage management software programs, entered into a cost sharing agreement with its wholly owned Irish subsidiary, Veritas Ireland.<sup>114</sup> Pursuant to this agreement, Veritas US and Veritas Ireland agreed to pool their resources and research and development efforts "related to software products and software manufacturing processes....[and] to share the costs and risks of such R&D on a going forward basis",<sup>115</sup> in return Veritas Ireland received exclusive rights to the intangibles covered by the agreement within some territories and nonexclusive rights to the intangibles in other

<sup>109</sup> *Xilinx Inc v Commissioner*, 125 TC 37, 62 – 63 (2005), aff'd 592 F3d 1017 (9<sup>th</sup> Cir 2010).

<sup>110</sup> *Xilinx Inc v Commissioner*, 567 F.3d 482, 496 (9<sup>th</sup> Cir 2009), withdrawn by 592 F3d 1017 (9<sup>th</sup> Cir 2010). The third judge dissented.

<sup>111</sup> *Xilinx Inc v Commissioner*, 592 F3d 1017 (9<sup>th</sup> Cir 2010).

<sup>112</sup> *Xilinx Inc v Commissioner*, 598 F3d 1191, 1196 (9<sup>th</sup> Cir. 2010).

<sup>113</sup> *Veritas Software Corp v Commissioner*, 133 TC 297 (2009).

<sup>114</sup> Veritas Ireland was the court's designated name for a group of foreign subsidiaries and disregarded entities established by Veritas US. See *id.* at 307.

<sup>115</sup> See *id.*

territories.<sup>116</sup> The agreement also required Veritas Ireland to make certain payments to Veritas US as royalties for its use of Veritas US's existing trademarks, tradenames and intellectual property.<sup>117</sup> At issue in the case was the adequacy of the royalties set as the price of this preexisting property. Veritas Ireland made lump sum payments to Veritas US of \$118 million for the preexisting property.<sup>118</sup> The IRS contended at audit that the proper amount would have been \$2.5 billion,<sup>119</sup> though it reduced its claim to \$1.675 billion by the time of trial.<sup>120</sup>

The IRS argued that Veritas US's formation of the Irish subsidiary and its entry into the cost sharing agreement was tantamount to a sale of its foreign operations to Veritas Ireland, and thus that the proper price for that sale should be derived by discounting the cash flow expected to be generated by that transferred business<sup>121</sup> rather than by using either the comparable uncontrolled transaction or profit split methods to determine the precise price of transferred intangibles.<sup>122</sup> Alternatively, the IRS expert argued that the buy in payment should have equaled "the present value of royalty obligations expected to be paid under arm's length royalty terms applicable to the rights conferred on a go-forward basis," an amount he calculated using an "aggregate' valuation approach".<sup>123</sup> In making his calculation, the IRS expert used a 22.2 percent perpetual annual royalty, discounted at a 13.7 rate; this calculation also led to a buy-in payment of \$1.675 billion.<sup>124</sup>

The taxpayer contended that this proposed adjustment was "arbitrary, capricious, and unreasonable".<sup>125</sup> Arguing that under the regulations extant at the time the transaction took place, Veritas Ireland only had to compensate Veritas US for "preexisting intangibles",<sup>126</sup> it proceeded to contest all the elements of the IRS expert's calculation of this value, including his choice of a royalty rate, his assumption that the royalty would be perpetual, the projected income of Veritas Ireland and the discount rates employed to reduce the calculated sums to present value.

The first thing the taxpayer did was to try to establish the identity of the particular items of property transferred to Veritas Ireland under the terms of the cost sharing

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<sup>116</sup> See *id.*

<sup>117</sup> See *id.* at 309.

<sup>118</sup> See *id.* at 309.

<sup>119</sup> See *id.* at 311.

<sup>120</sup> See *id.* at 312.

<sup>121</sup> See *id.* at 311.

<sup>122</sup> As the Tax Court noted, the valuation method used by the IRS expert both "reflected sections 1.482-1T through 1.482-9T, Temporary Income Tax Regs., 74 Fed. Reg. 349 (Jan. 5, 2009) – regulations that were promulgated 10 years after the transaction and 5 months after trial" and used an expansive definition of "transferred intangibles" drawn from legislative proposals made by the administration in 2009, proposals aimed at changing existing law. Thus, the taxpayer would have had to have been "prescient" and not just "compliant" to have used this methodology. See *Veritas Software Corp.*, 133 TC at 315 – 16.

<sup>123</sup> See *id.* at 313.

<sup>124</sup> See *id.*

<sup>125</sup> See *id.* at 312.

<sup>126</sup> See *id.* at 315 (referring to Treas Reg 1.482-7(g)(2)).

agreement. It then proceeded to establish the market value of each such item.<sup>127</sup> Its expert presented evidence showing that some of the items the IRS expert treated as transferred to Veritas Ireland either had not been transferred or had negligible value.<sup>128</sup> Most importantly, its expert testified that the most valuable items transferred, the software programs that Veritas US had successfully marketed in the US, had limited lives and would generate short, rather than perpetual, income streams. This argument was supported with evidence indicating that almost all the code in the programs would be replaced within four years of the transfer as the programs were updated pursuant to the terms of the cost sharing agreement.<sup>129</sup> Thus, the taxpayer argued, most of the projected income the IRS expert was relying on to determine the value of the transferred programs constituted returns not to the original programs but to their successors, successors created under the terms of the cost-sharing arrangement.<sup>130</sup> Those programs and thus those returns belonged to Veritas Ireland ab initio under the terms of the cost-sharing agreement. Since they would never have been transferred to Veritas Ireland by Veritas US, no income allocation under section 482 could be made with respect to them.<sup>131</sup>

In addition to attacking the IRS's valuation, the taxpayer sought to establish an alternative valuation for the transferred property using the CUT method. It presented a number of third party software license agreements for use as comparables.<sup>132</sup> The IRS objected to these comparables, arguing that the licenses being granted under these agreements were for a different sort of use than that allowed Veritas Ireland under the terms of the cost sharing agreement,<sup>133</sup> and thus that there was no reason to expect the royalty arrangements to be similar. Contending that use of the CUT method was therefore inappropriate, the IRS fell back on its estimate of the appropriate buy-in payment.<sup>134</sup>

Dismissing the IRS's attempt to use the "akin to a sale" valuation approach as unsupported by the then prevailing regulations,<sup>135</sup> the Tax Court tried to determine the value of the preexisting intangibles transferred under the terms of the cost-sharing agreement. It accepted the taxpayer's argument that the preexisting computer programs had four year useful lives, and thus that their value should be determined on the basis of an assumed four year (rather than perpetual) income stream.<sup>136</sup> That

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<sup>127</sup> See *id* at 321 – 22.

<sup>128</sup> See *id* at 322 (distribution channels, customer lists and customer base, access to research and development and marketing teams).

<sup>129</sup> See *id* at 329.

<sup>130</sup> See *id* at 323 (criticizing IRS expert for taking subsequently developed intangibles into account when calculating the requisite buy-in payment, in contravention of regulations).

<sup>131</sup> See *Veritas Software Corp* (note 113), at 336 – 37.

<sup>132</sup> See *id* at 328 – 29 (listing agreements).

<sup>133</sup> The third parties were being licensed to bundle existing programs with the sales of computer hardware; Veritas Ireland was allowed to use the existing program as a base for constructing new software. See *id* at 329 and n 39 (attempting to contrast "'platform contribution' intangibles and broad 'make-sell rights'" with rights transferred under allegedly comparable agreements).

<sup>134</sup> See *id* at 329.

<sup>135</sup> See *id* at 320 – 21 and 323 – 24.

<sup>136</sup> See *id* at 336.

was enough to justify its holding that IRS's assessment was "arbitrary, capricious and unreasonable"<sup>137</sup> since it meant that most of that assessment was based on income derived from subsequently developed intangibles which had never been transferred. However, the Court did more than strike down the IRS assessment as arbitrary and capricious; it also largely accepted the taxpayer's CUT pricing analysis. Employing royalty rates derived from the license agreements proffered by the taxpayer as comparables and assuming a four year useful life for the transferred assets, the Court calculated the present value of those assets. Although the Tax Court made a few minor adjustments to the taxpayer's transfer price calculation,<sup>138</sup> the arm's length price set by the Tax Court was much closer to that used by the taxpayer in its original tax filing than to the IRS's suggested adjusted price.

Neither of the parties to the *Veritas Software Corp* case explicitly advocated use of a profit-split method, so it is hard to draw any conclusions about their willingness to use such a method if asked to do so. The choices the judges made in reaching this particular decision do seem at odds not only with the accepted profit split methodologies but also with formulary variations of that methodology.

First, the judges used a narrow definition of the value of the initial software, restricting it to the utility of particular lines of computer code so that its value was extinguished when and to the extent that that code was replaced. They did not seem to assign any value to the ideas underlying the original software's development, nor to the advantages existing code may have given subsequent programmers working to improve the product.

Further, the judges opted to rely on comparables that, as the IRS pointed out, were drawn from economically different transactions. The third party contracts provided by the taxpayer covered rights to copy and resell existing software, rather than the right to use the software as a platform for developing new, competing software. Platform or "make-sell" rights are different from mere copying rights. It is unclear why anyone would think the royalty terms (or indeed any other licensing terms) would be the same across contexts. Yet the Court held that the price terms from the copying rights agreements should be used to set the price terms of the platform agreements entered into between Veritas and Veritas Ireland. The Court's willingness to rely on those terms seems strange, rather like the proverbial searcher looking for lost keys under a street lamp, not because they were dropped there but because there is light with which to search.

On the surface, then, the Tax Court seemed to prefer deriving valuations by focusing on concrete comparisons of specifically denominated pieces of transactions rather than by stepping back and looking at the situation as a whole, as is done under most profit split methodologies. Nonetheless, some hints of an overall approach appear even in this opinion. The Tax Court was clearly offended by the fact that the IRS's assessment "would require VERITAS Ireland to allocate a buy-in payment

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<sup>137</sup> If the existing programs would only generate royalties for a four year period, most of the "perpetual royalty" claimed by the IRS as the basis for its buy-in calculation would have to be attributable to subsequently developed intangibles. See *Veritas Software Corp* (note 113), at 323 – 24.

<sup>138</sup> See id at 335 – 39.

equal to 100 percent of its actual and projected operating income to VERITAS US through 2001, resulting in \$1.9 billion in losses over that period”, a result it regarded as unreasonable given that “VERITAS Ireland prospered, not because VERITAS US simply spun off a portion of an established business and transferred valuable intangibles, but because VERITAS Ireland employed aggressive salesmanship and savvy marketing, successfully developed the EMEA and APJ markets, and co-developed new products that performed well in those markets”.<sup>139</sup> There is room to speculate that the Tax Court may be more supportive of profit split methodologies and less crabbed visions of transferred property in cases in which the tax authorities engage in less overreaching. For its part, although the IRS decided against appealing the Tax Court’s decision in the case,<sup>140</sup> it stated that the agency believed the Court’s “factual findings and legal assertions are erroneous and could be inappropriately relied on by taxpayers in planning future transactions”<sup>141</sup> and that it will continue to make similar arguments in subsequent cases.<sup>142</sup>

The apparent focus on the comparability of particular transactions to the exclusion of consideration of the overall business deal surfaces again in cases involving deductible expenses. For many years, the US has used formulas to apportion deductions that are hard to definitively attribute to particular income items. These include but are not limited to general administrative expenses, interest expenses, and research and development expenses. Some of the formulas are set by statute, while others have been set by administrative regulation. When set by statute, of course, the fact that a formula may violate section 482’s general arm’s length command is irrelevant in the case of a domestic taxpayer. Regulatory rules, however, can be challenged, as can the application of statutory rules in situations covered by a treaty. Two such cases have been brought in the relevant time period.

One of these cases, *Boeing Co v. United States*,<sup>143</sup> involved the late and, to many, unlamented DISC/FSC regime. The taxpayer, an airplane manufacturer, wanted to allocate its research and development expenses to the particular airplane models under development and then apportion those expenses between the foreign and domestic income generated through sales of those particular models. Treasury’s regulations, however, required the allocation of research and development expenses to be made on the basis of “product category”; thus, the IRS wanted to allocate all of Boeing’s research and development expenses to the general “transportation equipment” category of income, and apportioned between the foreign and domestic income generated through sales of all the products falling within that larger category. The Court upheld the validity of the regulation in the teeth of the taxpayer’s arguably

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<sup>139</sup> See *id.* at 326 – 27.

<sup>140</sup> See AOD 2010-05, 2010-49 I.R.B. 803 (Dec. 6, 2010), online at <http://www.irs.gov/pub/irs-aod/aod201005.pdf>.

<sup>141</sup> See *id.*

<sup>142</sup> One open issue is whether the Tax Court will uphold attempts by the IRS to apply the revised Temporary Regulations, discussed in note 122, to transactions entered into after their effective date, or whether it will conclude that the Temporary Regulations are inconsistent with section 482’s language.

<sup>143</sup> *Boeing Co v United States*, 537 US 437 (2003).

more precise allocation method. At issue, however, was not the use of a formula *per se*, but rather the details of its operation.

By contrast, the IRS was rebuffed when it sought to determine the income of the US branch of a UK bank by reducing its claimed deduction for interest expenses pursuant to a formula established by regulation.<sup>144</sup> The taxpayer sought a higher deduction, claiming that the regulation violated the terms of the US-UK tax treaty.<sup>145</sup> Specifically, it claimed that the treaty allowed taxation in the US of only those profits attributable to a permanent establishment “which it might be expected to make if it were a distinct and separate enterprise engaged in” the same business activity “and dealing wholly independently with the enterprise of which it is a permanent establishment”.<sup>146</sup> This required the tax authorities, according to the taxpayer, to treat loans from its headquarters just like third party loans. Unless and until the tax authorities could show that third parties would not have provided such loans under such conditions or at the stated interest rate, the interest deductions contained on the taxpayer’s books of account had to be allowed. No interest deductions could be disallowed until, and only to the extent that, the tax authorities proved that a particular loan transaction violated the arm’s length standard.<sup>147</sup> After examining the commentary to the OECD Model Treaty from which the language found in the US-UK treaty was drawn, the Court held that the IRS was not allowed to substitute its regulatory formula for this individualized examination.<sup>148</sup>

Although this decision was made under the rubric of a treaty rather than section 482,<sup>149</sup> the court’s language suggests that it would object to the use of formulary rules such as that found in the regulation<sup>150</sup> should the IRS attempt to use them in the

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<sup>144</sup> Treas Reg §1.882-5. This regulation calculated the interest deduction of banks as follows: first, the branch was assumed to have liabilities equal to 95 percent of its stated US assets (disregarding those assets resulting from interbranch lending transactions); second, the bank deducts all interest paid to unrelated third parties; and third, the bank deducts as interest paid to its related lenders or home office an amount equal to the average rate of interest paid on debt to third parties multiplied by an amount equal to the difference between the assumed liabilities (from step one) and its actual liabilities to third parties. If its actual liabilities to third parties exceed the assumed debt amount, no interest deduction is allowed with respect to liabilities claimed owed to related parties. See *National Westminster Bank PLC v US*, 44 Fed Cl 120, 129 (Ct. Claims 1999).

<sup>145</sup> See *id.* at 122.

<sup>146</sup> See *id.* at 124 (quoting from Article 7(2) of the US-UK Income Tax Treaty).

<sup>147</sup> See *id.* at 128.

<sup>148</sup> See *id.* at 130.

<sup>149</sup> Even in the absence of a treaty, section 482 would have been inapplicable because, technically speaking, no transaction occurred between “two or more organizations, trades or businesses...owned or controlled directly or indirectly by the same interests”. See IRC §482. Only one entity was involved, National Westminster Bank; the US operations constituted a legally undifferentiated branch of that single entity. However, as discussed earlier in note 8, the arm’s length pricing principle is used to determine the value of intra-corporate transfers between parts of a multinational entity.

<sup>150</sup> The regulation was promulgated under a section of the Internal Revenue Code, IRC §882, which expressly grants Treasury the power to “determine[...]in regulations...the proper apportionment and allocation” of the deductions of a foreign corporation engaged in a U.S. trade or business. See IRC §882(c)(1)(A).

section 482 context. The formula's disregard of specific interbranch transactions and its use of a liability ratio and interest rate "on the basis of worldwide assets and worldwide liabilities of the entire foreign enterprise, rather than ... on the basis of the separate, independent operations of the U.S. branch", the court held, meant that the regulation "plainly violate[] the separate entity/wholly independent provision of Article 7, paragraph 2 of the Treaty...".<sup>151</sup> The "separate entity" standard found in the treaty has as its "central directive... that the profits to be attributed to a permanent establishment are those which that permanent establishment would have made if, instead of dealing with its head office, it had been dealing with an entirely separate enterprise under conditions and at prices prevailing in the ordinary market".<sup>152</sup> This is, of course, just a restatement of the standard arm's length standard; what the treaty does is constructively separate the branch and other parts of the single entity into separate entities for purposes of determining the taxable income of each such part. A formula which fails to meet the arm's length standard when applied to transactions between a branch office and the foreign headquarters of the branch should similarly fail to satisfy the arm's length standard when applied under section 482 to transactions between a company and related entities. The underlying flaw – the failure to examine the bona fides of particular transactions – would exist in both contexts.

The Court of Claims is just one of three courts which can hear tax cases, and it hears relatively few of them. Perhaps other US courts will be more accepting of formula methods established by regulation or other administrative actions for allocating deductions. However, looking at this group of cases, it seems obvious that US courts are more averse even to non-formulary profit split approaches to transfer pricing than they were in the 1980's.

It is not entirely clear what is behind this change. It may be no more than a reflection of taxpayers' increasing sophistication. Taxpayers simply may be better at discovering and providing specific information about comparable transactions than they were in the earlier period. Meanwhile, the IRS does not seem to have improved the sophistication of its analysis; it often relied on pricing models that were not, as a factual matter, very appropriate to the transaction(s) at hand and often involved obvious over-claiming. Faced with the choice of setting prices based on vague and often unsupported generalities provided by the IRS about what should have happened or of setting prices based on information about specific prices drawn from actual transactions provided by taxpayers, US courts accorded greater weight to the latter. Though some of these decisions may be criticized as missing the forest for the trees, the IRS should be criticized for often giving the courts involved a very poor view of the forest.

The US tax authorities were not alone in having difficulty in prevailing in court. Canada's tax authorities had similar problems. Since the taxpayers involved in the Canadian cases were often affiliates of US corporations, perhaps this is not surprising.

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<sup>151</sup> See National Westminster Bank PLC (note 144), at 130.

<sup>152</sup> See *id.*

### 3.2 Canada

Canada's Income Tax Act currently contains a provision authorizing the tax authorities to "adjust...the terms and conditions" of transactions entered into between a "taxpayer...and a non-resident person with whom the taxpayer...does not deal at arm's length".<sup>153</sup> This provision allows the tax authorities both to adjust the terms of transactions entered into between related parties to conform to third party analogues<sup>154</sup> and, in the case of purposive tax avoidance, to recharacterize such transactions into the forms they would have taken had the parties operated at arm's length.<sup>155</sup> The statute directs the tax authorities to adjust "the quantum or nature" of affected taxpayers' reported income to accord with the "terms and conditions...[that] would have been made between persons dealing at arm's length".<sup>156</sup> Just prior to its rebirth as the Canada Customs and Revenue Agency, Revenue Canada issued an Information Circular<sup>157</sup> to "set[] out the Department's views on transfer pricing".<sup>158</sup> This Information Circular bluntly states that "Canada's transfer pricing legislation...embodies the arm's length principle; and ...requires that, for tax purposes, the terms and conditions agreed to between non-arm's length parties in their commercial or financial relations be those that one would have expected had the parties been dealing with each other at arm's length".<sup>159</sup> The Information Circular goes on to state that taxpayers not dealing at arm's length will be treated "as if they operate as separate entities rather than as inseparable parts of a single unified business" and should be based on a comparison between "prices or margins between non-arm's length parties on cross-border transactions" with "prices or margins on similar transactions between arm's length parties".<sup>160</sup> Many of the specific examples of how such comparisons should be drawn specifically reference the OECD's *1995 Guidelines*.<sup>161</sup> Like the *1995 Guidelines*, the Information Circular expresses some

<sup>153</sup> Income Tax Act para. 247(2).

<sup>154</sup> See id at para. 247(2)(a).

<sup>155</sup> See id at para. 247(2)(b).

<sup>156</sup> See id at para. 247(2).

<sup>157</sup> Revenue Canada, International Transfer Pricing, IC 87-2R (September 27, 1999), para. 13 at 2, online at <http://www.cra-arc.gc.ca/E/pub/tp/ic87-2r/ic87-2r-e.pdf>. The circular is prefaced by the pronouncement that "[o]n November 1, 1999, Revenue Canada will begin operations as the Canada Customs and Revenue Agency". This Information Circular replaced an earlier Information Circular, dated February 27, 1987. That earlier Circular needed to be updated to reflect both the 1998 passage of section 247 and the release of the OECD's 1995 Guidelines. See Revenue Canada, International Transfer Pricing, at paras 1 & 3, at 1.

<sup>158</sup> Id. Although pointing out that the circular "relate[s] specifically to transactions or arrangements between a taxpayer and a non-resident person", the circular continues that "many of the principles and methods outlined in this circular may also provide taxpayers with general guidance on the attribution of income between a permanent establishment and other parts of the same entity". Id at para. 5.

<sup>159</sup> Id at para. 7.

<sup>160</sup> Id at para. 9.

<sup>161</sup> OECD, 1995 Guidelines. Indeed, the Information Circular incorporates the 1995 Guidelines by reference, stating that "[t]he OECD Guidelines should be consulted for a more detailed discussion of the principles contained in Parts 2 to 6 of this Circular". Revenue Canada, International Transfer Pricing (note 157), at para. 4.

skepticism about the use of “transactional profit methods”,<sup>162</sup> however, of the two transactional profit methods, it expresses a preference for the “profit split method” over the “transactional net margin method (TNMM)”.<sup>163</sup> Like the US, Canada recognizes cost sharing agreements, though they are called “Qualifying Cost Contribution Arrangements (QCCA)”.<sup>164</sup>

There were four cases involving international transfer pricing issues decided by Canadian courts during the period between 2000 and 2010. Although the tax authorities won two of the four, they lost the most important ones. As in the US, the Canadian courts actively sought to avoid using either of the profit split methods.

In the first of these cases, *Gulfmark Offshore N.S. Ltd v The Queen*,<sup>165</sup> it was the taxpayer who sought to use a formulary-type method for the allocation of deductible expenses. The taxpayer sought to deduct some of its interest expenses against the income generated by its Canadian permanent establishment.<sup>166</sup> It argued that under the terms of the Canadian-UK tax treaty, it should be entitled to deduct as an expense of its Canadian business operations the percentage of its total interest expense equal to the percentage determined by taking the permanent enterprise’s revenue and dividing it by the worldwide revenue of the enterprise.<sup>167</sup> Appealing to the concept of the fungibility of money, the taxpayer argued that its interest expense was equally an expense of maintaining all of its assets, a “general overhead expense benefiting all of [its] ships”.<sup>168</sup> The Federal Court of Appeals, however, like the initial trial court, held that a tracing rule should be applied for purposes of determining against which income the interest expense should be taken. Because “the record shows that the consolidated loan was used to finance a new ship”<sup>169</sup> which was not part of the taxpayer’s Canadian permanent establishment, the Federal Court of Appeals upheld the lower court’s holding that the appellant was not entitled to a deduction for any portion of this interest expense under the terms of the Canadian-UK tax treaty. The Court of Appeals ruled that the taxpayer failed to meet the “evidentiary burden of

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<sup>162</sup> The Circular “endorses” the OECD “view” that “transactional profit methods are used as methods of last resort, when the use of traditional transaction methods cannot be reliably applied or cannot be applied at all”; *Id* at para. 52.

<sup>163</sup> *Id* at para. 60.

<sup>164</sup> See Income Tax Act para. 247(1); Revenue Canada, International Transfer Pricing (note 157), at paras 120 – 138.

<sup>165</sup> *Gulfmark Offshore N.S. Ltd v The Queen*, 2007 FCA 302, [2008] 1 CTC 85 (Fed Ct of Appeal 2007), online at <http://canlii.org/en/ca/fca/doc/2007/2007fca302/2007fca302.html>.

<sup>166</sup> Technically speaking, like the earlier discussed National Westminster Bank PLC case (notes 144 – 52), *Gulfmark Offshore* is not a transfer pricing case because it involved only one taxpayer; hence, there could be no transfer between “related parties”. The taxpayer was nonetheless able to invoke transfer pricing principles to measure its branch income because those principles were made applicable by the terms of the Canadian-UK tax treaty, as properly interpreted to accord with the OECD’s “Accepted OECD Approach” for attributing profits to permanent establishments. See OECD, Report on the Attribution of Profits to Permanent Establishments, Part I.B-2, para. 12 at 12, (describing application of arm’s length principle in situations involving permanent establishments).

<sup>167</sup> See *Gulfmark Offshore NS Ltd* (note 165), at para. 10.

<sup>168</sup> See *id* at para. 28.

<sup>169</sup> See *id* at para. 27.

showing that its proposed method for apportioning the interest expenses was acceptable for establishing the expenses of the Highland Pride as a separate business”.<sup>170</sup> The Court of Appeals did leave open the possibility that the taxpayer’s allocation method could be acceptable with the right evidence,<sup>171</sup> though it was unclear of what such evidence would consist.<sup>172</sup>

The Canadian tax authorities won the next transfer pricing case, *1143132 Ontario Ltd v The Queen*.<sup>173</sup> Once again, it was the taxpayer rather than the Canadian tax authorities that was seeking use of a formulary, profit split method and the tax authorities opposing its use. However, not much should be made of this case because it stretches the truth to denominate it a “transfer pricing dispute”; it was really an abuse situation and ultimately decided on grounds other than the choice or implementation of a transfer pricing methodology. The Canadian taxpayer manufactured equipment and related promotional material which it sold to customers in Canada and the United States. Sales to US customers were channeled through a Barbadian subsidiary referred to in the opinion as “Barco”. Although Barco “bought” products from the taxpayer and “resold” them to US customers, Barco employees performed almost no useful business functions and claimed minimal operating and overhead expenses. Their activities were limited to re-typing US customer invoices and banking receipts. By contrast, employees of the Canadian parent corporation manufactured the products, drop shipped the products to US customers, provided general management services and performed all the marketing tasks. The parent company also assumed all business risks. Nonetheless, the pricing scheme used by the taxpayer had been designed to assign 40 percent of the combined profit to Barco.

The tax authorities argued that the parent’s products should have been sold to Barco for “the price for that particular sale that was negotiated at arm’s length between the Appellant and the customer in the United States”. Technically, the Canadian tax authorities said that they were seeking to use the CUP method, with the parent company’s sales to US customers serving as the comparables for the sales to Barco.<sup>174</sup> The Canadian tax authority’s suggested pricing scheme gave the entire

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<sup>170</sup> See *id* at para. 29.

<sup>171</sup> See *id* at para. 27.

<sup>172</sup> The holding in this case is consistent with that in the US case *National Westminster Bank PLC* (note 144), in as much as in both cases, the courts rejected formulary methods of allocating interest expenses and instead allocated those expenses in accordance with the forms in which taxpayers had cast their debt transactions. *National Westminster Bank PLC* (unlike *Gulfmark Offshore N.S. Ltd*) makes clear that treaty definitions of acceptable expenses prevail over conflicting national statutes and regulations, thereby requiring the US to allow branches of treaty-protected enterprises to claim deductions disallowed under their generally prevailing law. Presumably, given the general primacy of treaty law over statutory law, Canadian courts would do the same should they be faced with that question. In *Gulfmark Offshore N.S. Ltd*, unlike *National Westminster Bank Plc*, it was the taxpayer rather than the tax authorities that sought to use a formulary apportionment method.

<sup>173</sup> *1143132 Ontario Ltd v The Queen*, 2009 TCC 477 (Tax Ct 2009), online at <http://www.canlii.org/en/ca/tcc/doc/2009/2009tcc477/2009tcc477.html>.

<sup>174</sup> See *id* at para. 7(y).

profit from US sales to the parent company; Barco was left not only with no net income but a small loss under this pricing regime.

The taxpayer never challenged the underlying facts, and did not call any witnesses at the trial court level. Unsurprisingly, at trial, the Court decided in favor of the pricing scheme advanced by the Canadian tax authorities. On appeal, the taxpayer came up with a novel argument: it claimed that Barco was really a Canadian company because its central management and control was in Canada. Because Barco was a Canadian company, the taxpayer argued, section 247(2) could not apply to transactions between Barco and its corporate parent. Further, since 247(2) by its terms did not apply, the proposed adjustments fell outside the statutory reassessment period.<sup>175</sup> The Court held the taxpayer to the form in which it had cast the transaction, found that Barco was a foreign corporation, and upheld the tax authority's pricing decision.

Inasmuch as the taxpayer never directly contested the transfer pricing issue, this case is of limited value in determining Canadian courts' approach to such issues. The next two cases were much more substantial, both in terms of the money at stake and in the extent to which they focused on transfer pricing issues. The Canadian tax authorities were much less successful in these cases.

In *General Electric Capital Canada Inc v The Queen*,<sup>176</sup> the issue was the value of related party guarantees of GE Capital Canada's third party debt. GE Capital Canada paid GE Capital US to guarantee its debt to third party creditors. GE Capital Canada claimed deductions for these payments, arguing that the related party guarantees reduced its borrowing costs because GE Capital US had a higher credit rating, and that the guarantees allowed it to borrow money as if GE Capital Canada, too, enjoyed this credit rating. It contended that the guarantee was worth at least 100 basis points to GE Capital Canada,<sup>177</sup> and that the fee for the guarantee should be priced accordingly. The tax authorities argued that GE Capital Canada received no economic benefit from the related party guarantee, and as a result, the "arm's length" price for this guarantee should have been zero.<sup>178</sup>

The crux of the tax authority's argument was that GE Capital Canada benefited from GE Capital US's high credit rating with or without the explicit guarantee because the Canadian corporation was a "core subsidiary" which GE Capital US would "support... in times of financial stress, even if it was not contractually obliged to do so".<sup>179</sup> As a result, GE Capital Canada received nothing of value when it received the explicit guarantee and no company operating at arm's length would pay

<sup>175</sup> Canadian tax authorities have an extended period during which they may reassess tax liabilities arising under para. 247(2). In the case at hand, the reassessment occurred in the period after the expiration of the normal reassessment period and before the expiration of the extended reassessment period. See 1143132 Ontario Ltd (note 173), at para. 8.

<sup>176</sup> *General Electric Capital Canada Inc v The Queen*, 2009 TCC 563 (Tax Ct 2009), online at <http://www.canlii.org/en/ca/tcc/doc/2009/2009tcc563/2009tcc563.html>, aff'd 2010 FCA 344 (Fed Ct of Appeal 2010), online at <http://www.canlii.org/en/ca/fca/doc/2010/2010fca344/2010fca344.html>.

<sup>177</sup> See *General Electric Capital Canada Inc* (note 176), at para. 64.

<sup>178</sup> See *id* at para. 1.

<sup>179</sup> See *id* at para. 169.

anything for such a valueless guarantee.<sup>180</sup> Further, citing a paragraph from the commentary to the OECD transfer pricing guidelines, the tax authorities contended that GE Capital Canada should not be expected to reimburse GE Capital US for the value of GE Capital US's implicit guarantee because it was an "incidental benefit[] attributable solely to its being part of a larger concern".<sup>181</sup> Thus, no deduction was warranted on account of either the implicit or explicit guarantee, even though there was no doubt that the relationship with GE Capital US benefited GE Capital Canada's credit rating and lowered its borrowing costs.

The taxpayer had two arguments. First, it contended that the OECD commentary, properly understood, did not justify failing to recognize the commercial significance of an explicit guarantee provided to improve the credit of another group member. Indeed, the taxpayer pointed out, the very OECD commentary cited by the tax authorities to deny the existence of an "intra-group service...where an associated enterprise by reason of its affiliation alone has a credit-rating higher than it would if it were unaffiliated" went on to explicitly provide that "an intra-group service would usually exist where the higher credit rating was due to a guarantee by another group member...".<sup>182</sup> The value of this explicit guarantee, it continued, should be determined without reference to the value of any implicit guarantee. After all, the taxpayer argued, the overriding policy goal of the arm's length policy was to place GE Capital Canada and GE Capital US in the positions they would have been in if they had been dealing with each other at arm's length. If they had been dealing at arm's length there would have been no implicit guarantee. In the taxpayer's words, "[a]ll factors of influence flowing from the non-arm's length relationship must be ignored to ensure an arm's length result".<sup>183</sup> Thus, it argued, the implicit guarantee – the benefits of group membership asserted by the Canadian tax authorities as being tantamount to a shared commercial attribute by all group members – should be ignored when determining the proper price of the explicit guarantee for tax purposes. Secondly, the taxpayer introduced evidence that the explicit guarantee bolstered GE Capital Canada's credit rating beyond that provided by the implicit guarantee<sup>184</sup> and argued that it had properly determined a price for this additional benefit.

The Tax Court adopted the first part of the tax authorities' argument. It held that GE Capital Canada was not entitled to reimburse GE Capital US for the "cost" (or benefit) of the implicit guarantee arising out of their related party status. It justified this seeming departure from the arm's length standard by construing GE Capital US as the primary beneficiary of that implicit guarantee because, it concluded, it was

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<sup>180</sup> See *id.* at para. 168 ("The guarantee arrangement was simply a clearer indication of the implicit support that already existed in favour of the Appellant.").

<sup>181</sup> See *id.* at para. 67 (quoting OECD, 1995 Guidelines, at para. 7.13). The tax authority also pointed to language in the same section of the guidelines specifically applicable to credit support to buttress its argument. See *id.* ("[N]o service would be received where an associated enterprise by reason of affiliation alone has a credit rating higher than it would if it were unaffiliated." (quoting OECD, 1995 Guidelines, at para. 7.13)).

<sup>182</sup> See OECD, 1995 Guidelines, at para. 7.13.

<sup>183</sup> See *General Electric Capital Canada Inc* (note 176), at para. 180.

<sup>184</sup> See *id.* at para. 275 (describing testimony of Dr. Chambers).

that corporation's creditors who would be shaken by (and demand higher recompense as a result of) a default by GE Capital Canada.<sup>185</sup> This analysis turned the benefit of the implicit guarantee into an incidental benefit to GE Capital Canada, thereby allowing its cost, like that of stewardship expenses, to be treated under the arm's length standard as a cost of the parent company rather than its Canadian subsidiary.<sup>186</sup> The Court further accepted the tax authorities' position that GE Capital Canada, acting at arm's length, would have paid for an explicit guarantee only to the extent that it raised its credit rating above that that would have existed solely due to the implicit guarantee.<sup>187</sup>

The case then came down to two factual questions: first, did the explicit guarantee raise GE Capital Canada's credit rating above that which it would have enjoyed as a result of the implicit guarantee, and second, if it did, how much would an independent party have been willing to pay for that credit rating improvement? The Canadian tax authorities did not fare as well on those two issues.

The question of the effect of the explicit guarantee on GE Capital Canada's credit rating devolved into a battle of experts. The taxpayer and the tax authority presented conflicting expert testimony on the effect of the explicit guarantee on GE Capital Canada's credit rating. After considering the testimony, the Tax Court concluded that the explicit guarantee raised the taxpayer's credit rating by three notches,<sup>188</sup> which worked out to "approximately 183 basis points or 1.83%".<sup>189</sup> This was a substantial benefit which parties operating at arm's length would both pay for, and expect to be paid for.

The next question, though, was what the appropriate charge would be. Both parties acknowledged the absence of comparable uncontrolled transactions, and that neither the retail price and cost plus methods were appropriate given the facts of case. Between them, the parties suggested three alternative pricing models. The first, the insurance approach, looked to what an insurance company would charge for the credit protection. The Court viewed this alternative with suspicion, both because it thought the insurance market too thin and undeveloped to generate a price for this sort of guarantee and because the risks assumed by an insurer were sufficiently different from the risks assumed by GE Capital US (given GE Capital US's control over the timing, terms and payment of any debt offerings) to make any price determined by the insurance market reliable as a comparable.<sup>190</sup> Nor did the expert's pricing model take into account the existing implicit guarantee.<sup>191</sup> In short, the Court rejected the insurance approach for the same reasons it regarded the comparable uncontrolled transactions approach as untenable.<sup>192</sup> The Court viewed the other two

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<sup>185</sup> See *id* at paras 199 – 201.

<sup>186</sup> See *id* at para. 199.

<sup>187</sup> See *id* at para. 210 ("I believe an arm's length person would not contract for a service if that person feels the service would provide no benefit in the circumstances.").

<sup>188</sup> See *General Electric Capital Canada Inc* (note 176), at para. 301.

<sup>189</sup> See *id* at para. 305.

<sup>190</sup> See *id* at para. 254.

<sup>191</sup> See *id* at para. 255.

<sup>192</sup> See *id* at paras 257 and 304.

proffered methods, the “CDS methodology” and the “yield approach”, as indistinguishable. Both tried to calculate the benefit of the explicit guarantee by estimating the interest cost savings generated by the guarantee. However, neither method provided a basis for splitting the interest cost savings between the purchaser and the seller of the guarantee, the critical question in determining a price for a guarantee.<sup>193</sup> Ultimately, the Court simply split the 1.83% benefit between the two corporations, stating that a 1% guarantee fee was appropriate.<sup>194</sup> It did provide any explanation for why it split the transactional gains in this fashion.

The tax authorities received part of what they wanted from the case. They prevailed on the legal issue that a Canadian subsidiary should not pay for an implicit guarantee provided by reason of the non-arm’s length nature of its relationship to a more credit-worthy company. The Court’s conclusion that that such an undeniably valuable benefit does not justify recompense under the arm’s length standard has caused considerable comment in the transfer pricing community. However, because the Court upheld the taxpayer’s initial transfer price determination,<sup>195</sup> the tax authorities ultimately collected no additional revenue from this taxpayer.<sup>196</sup> From an out-

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<sup>193</sup> See *id.* at para. 258.

<sup>194</sup> See *id.* at para. 305.

<sup>195</sup> See *id.* at para. 307 (holding that withholding tax adjustment unwarranted because of “my conclusion that the guarantee fee paid by the Appellant did not exceed the amount of an arm’s length price”).

<sup>196</sup> The audacity of this scheme shows why GE’s tax department is so well-regarded (by the tax community) and reviled (by the popular press). See David Kocieniewski, *G.E. Turns the Tax Man Away Empty-Handed*, *The New York Times* (March 5, 2011), at A-1 (“G.E.’s giant tax department, led by a bespectacled, bow-tied former Treasury official named John Samuels, is often referred to as the world’s best tax law firm”; reporting that G.E.’s reported tax burden was “7.4 percent of its American profits, about a third of the average reported by other American multinationals...[and] even those figures are overstated”). The parent company undercapitalized its subsidiary, relative to its business needs, so that it could siphon off a large part of what otherwise would have been the subsidiary’s business profits in the form of a fee for the guarantee necessary to remedy the effects of that undercapitalization. Although the Canadian government collected a withholding tax on the guarantee payments, the amount it collected was less than it would have collected had the subsidiary had higher profits subjected to Canadian income tax, followed by the payment of a taxable dividend to its US corporate parent. The Court’s acceptance of the arrangement allowed GE to pay tax on most of the income generated from its Canadian operations at the then lower US corporate income tax rate while avoiding triple taxation of amounts distributed to its shareholders as dividends. See Roin, *The Grand Illusion: A Neutral System for the Taxation of International Transactions*, 75 *Va L Rev* 919, 941 – 943 (1989) (explaining how US tax credit rules fail to properly account for foreign taxes paid with respect to intercompany dividends). It is easier to sympathize with GE’s goal of avoiding an unwarranted third set of taxes on shareholder dividends than its goal of paying corporate income taxes at the lower of the US or Canadian tax rates. Even the latter is not impossible, however, given that a significant portion of any “business profits” that would have been earned by GE Capital Canada were in fact returns on capital – pure time value of money gains that could have been earned by investing, say, in US (or Canadian) Treasury securities – rather than returns to the business activities carried out in Canada. In the absence of any standards for what would constitute an acceptable debt-equity ratio for a business like GE Capital Canada (other than the thin capitalization rules with which it apparently complied) it is unclear whether the Canadian treasury was underpaid given the actual contribution of GE Capital Canada’s business activities to the overall return, especially given the substantial withholding tax imposed by Canada on the guarantee payments.

sider's perspective, the Court's opinion, like many written in US transfer pricing cases from the 1970's and 1980's, failed to explain how the Court arrived at its final pricing decision. Finally, there is nothing in the opinion to suggest that the Court's decision was in any way based on any particular formula, let alone a formula similar to those in use either in Canada for the allocation of provincial income or in the US for the allocation of interstate income or under consideration by the EU for use in allocating intra-EU income.

Both parties brought an appeal to the Federal Court of Appeal. The taxpayer contested the Tax Court's decision that the existence and value of the "implicit support", the "affiliation benefits...are relevant and must be considered in determining the arm's length price" of the explicit guarantee.<sup>197</sup> Canadian tax authorities defended the Tax Court's decision on that point, while arguing that the Tax Court erred when it took into consideration the effect removing the explicit guarantee would have had on GE Capital Canada's credit rating for purposes of identifying the relevant transaction and not just for purposes of deriving a value for the explicit guarantee.<sup>198</sup> The tax authorities also appealed the Tax Court's failure to consider what it considered "four relevant characteristics in assessing the value of the explicit guarantee" and its failure to conduct a "'reasonableness' check" on its valuation determination.<sup>199</sup>

The Federal Court of Appeal rejected the taxpayer's argument, holding that the Tax Court's decision to take the existence of the implicit guarantee into account in determining the value, if any, of the explicit guarantee was correct.<sup>200</sup> Although it accepted the government's argument that the Tax Court should not have "re-cast the transaction on the basis that the explicit guarantee had, in fact, been removed and assess the impact of the removal",<sup>201</sup> it found that this error was harmless.<sup>202</sup> It found no other errors, either substantive or procedural, in the Tax Court proceeding, dismissed the appeal, and left the income determinations made in the Tax Court proceeding intact.<sup>203</sup>

It is worth noting that the Canadian tax authority is continuing to litigate similar issues. GE Capital Canada is at the early stages of a dispute with transfer pricing overtones involving a Nova Scotia unlimited liability company.<sup>204</sup> Meanwhile, HSBC Bank Canada is currently contesting the Canadian tax authority's decision to disallow deductions claimed for payments made to an affiliate for deposit insurance

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<sup>197</sup> See *Canada v General Electric Capital Canada Inc*, 2010 FCA 344 at para. 47.

<sup>198</sup> See *id* at para. 63.

<sup>199</sup> See *id* at para. 75.

<sup>200</sup> See *id* at para. 59 ("[T]here is no doubt that the existence of the implicit guarantee is relevant to the inquiry and must be considered in identifying the arm's length price.").

<sup>201</sup> See *id* at para. 66.

<sup>202</sup> See *General Electric Capital Canada Inc* (note 197), at para. 67 ("That being said, I do not believe that this error would have altered the conclusion which the Tax Court Judge reached.").

<sup>203</sup> See *id* at para. 93.

<sup>204</sup> See *General Electric Canada Company v The Queen*, Tax Court File No. 2010-3493(IT)G and *GE Capital Canada Funding Company v The Queen*, Tax Court File No. 2010-3494(IT)G.

covering deposits already insured under the Canadian government's deposit insurance scheme.<sup>205</sup>

The appeal in the *General Electric Capital Canada Inc* case came down shortly after the Federal Court of Appeal decided *GlaxoSmithKline Inc v The Queen*.<sup>206</sup> Although *GlaxoSmithKline Inc* was issued in the summer of 2010, the case involved the taxable years 1990 through 1993. Therefore, this case<sup>207</sup> was decided entirely under the precursor to paragraph 247 of the ITA, the former subsection 69(2) of the ITA. Like current paragraph 247, subsection 69(2)<sup>208</sup> granted the Canadian tax authorities the right to recompute a taxpayer's income in line with arm's length norms. At issue in the case was the transfer price of a chemical component of a pharmaceutical component.

Glaxo Canada, the Canadian taxpayer, was a wholly owned, second tier subsidiary of a UK corporation, Glaxo Holdings. Glaxo Holdings was the "ultimate parent" of a multinational group of companies ("Glaxo World"<sup>209</sup>) engaged in the discovery, development, manufacture and distribution of branded pharmaceutical products. One of these pharmaceutical products was the anti-ulcer drug Zantac, made from the chemical ranitidine. Glaxo Canada purchased ranitidine from a member of Glaxo World, which it then packaged and resold under the Zantac name. Glaxo Canada operated under a License Agreement with Glaxo World. Under the terms of this License Agreement, Glaxo Canada paid Glaxo World 6% of its net sales of Zantac and other drugs in return for the right to manufacture, use and sell Glaxo products and to use Glaxo trademarks in Canada, to receive technical assistance, marketing and legal support, and to access improvements in drugs as well as new products. The

<sup>205</sup> See *HSBC Bank Canada v. The Queen*, 2011 TCC 37 (Tax Ct 2011), online at <http://www.canlii.org/en/ca/tcc/doc/2011/2011tcc37/2011tcc37.html> (dismissing motion filed by appellant).

<sup>206</sup> *GlaxoSmithKline Inc v The Queen*, 2010 FCA 201 (Fed Ct of Appeal 2010), online at <http://www.canlii.org/en/ca/fca/doc/2010/2010fca201/2010fca201.html>. Indeed, the Federal Court of Appeal stated its belief that its view of the issues before it in *General Electric Capital Canada Inc* was "consistent with the recent decision of this Court in *Glaxosmithkline Inc. v. Canada*". See *General Electric Capital Canada Inc*, (note 197), at para. 58.

<sup>207</sup> *General Electric Capital Canada Inc*, by contrast, involved some years covered by the former subsection 69(2) of the ITA and other years covered by paragraph 247 of the ITA. See *General Electric Capital Canada Inc* (note 197), at paras 10 – 11. The parties in that case agreed, and the Tax Court accepted that there was no "meaningful difference" between those statutory provisions "for present purposes". *Id.* at para. 12.

<sup>208</sup> Subsection 69(2) provided in relevant part that:

"Where a taxpayer has paid or agreed to pay to a non-resident person with whom the taxpayer was not dealing at arm's length as price, rental, royalty or other payment....an amount greater than the amount....that would have been reasonable in the circumstances if the non-resident person and the taxpayer had been dealing at arm's length, the reasonable amount shall, for the purpose of computing the taxpayer's income under this Part, be deemed to have been the amount that was paid or is payable therefor."

<sup>209</sup> "Glaxo World" is the name the court used to refer to the worldwide group (aside from Glaxo Canada) of related Glaxo entities. Different corporate entities played different roles in the described transactions; as it ultimately made no difference which of these foreign corporate entities participated in particular transactions, in the interest of simplicity this essay refers to all transactions involving a foreign affiliate of Glaxo Canada as transactions with "Glaxo World".

License Agreement also required Glaxo Canada to purchase its ranitidine from Glaxo World.<sup>210</sup>

The Canadian tax authorities did not directly challenge the terms of the License Agreement. Instead, they contended that Glaxo Canada overpaid for the ranitidine it purchased from Glaxo World. Their downwards adjustment in ranitidine prices to alleged arm's length levels substantially increased Glaxo Canada's taxable income and tax liability for the affected years.<sup>211</sup> The taxpayer challenged those readjustments.

The case turned on whether the price of ranitidine should be set by the price generic drug companies in Canada paid to acquire ranitidine from unrelated companies, with a minor adjustment for the cost of testing and granulating the generic to match GlaxoWorld standards, or whether, because of the taxpayer's obligation to buy ranitidine from a member of GlaxoWorld under the terms of the License Agreement, the price should be set by the price unrelated European licensees paid GlaxoWorld for ranitidine.<sup>212</sup> The taxpayer argued that its obligations under the License Agreement ought to be taken into consideration in determining the "reasonableness" of the price it paid for the ranitidine<sup>213</sup> while the government argued that purchase of the ranitidine should be considered on its own terms, as a transaction separate from the License Agreement.<sup>214</sup> Viewed in isolation from the License Agreement, simply as a purchase of ranitidine, the government argued that Glaxo Canada paid too much for the substance.

The Tax Court held for the government, stating that as a matter of law, the taxpayer's obligations under the terms of the License Agreement had no bearing on the question of the price of ranitidine.<sup>215</sup> As between the two sets of arm's length sales, the sales of generic ranitidine in Canada and the sales to European customers of GlaxoWorld, the Tax Court held the Canadian sales were most comparable because market conditions in Europe could be quite different from Canadian conditions.<sup>216</sup> And there was no question but that Glaxo Canada paid Glaxo World far more than other Canadian drug companies paid for generic ranitidine.

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<sup>210</sup> See GlaxoSmithKline (note 206), at para. 16.

<sup>211</sup> In addition, the tax authorities recharacterized the allegedly excessive payments for ranitidine as dividends subject to withholding tax. See *id.* at para. 18.

<sup>212</sup> GlaxoWorld did not set a standard ranitidine price; rather, it used "what is referred to as a resale-price method.... Glaxo World and its distributors agreed that a gross margin of 60 percent would be retained by the distributors and the ranitidine was priced accordingly". *Id.* at para. 13 (quoting from lower court opinion). Thus, as a technical matter, the tax authorities sought to use the CUP method to establish the transfer price while the taxpayer sought use of the resale price method of price setting.

<sup>213</sup> The taxpayer argued that the proper test under subsection 67(2) was the price that "would have been reasonable in the circumstances had the parties been dealing at arm's length" and that the "License Agreement between it and Glaxo Group" was not just a "highly relevant" but a "key" circumstance in determining the price it would be willing to pay. See *id.* at para. 60.

<sup>214</sup> See *id.* at para. 61.

<sup>215</sup> See *id.* at para. 64 (quoting para. 64 of the Tax Court opinion).

<sup>216</sup> See *id.* at para. 38.

The Federal Court of Appeal reversed. It held that the terms of the License Agreement had to be taken into account in determining whether the amount paid by Glaxo Canada was a reasonable one.<sup>217</sup> The Federal Court of Appeal regarded the obligation to buy over-priced ranitidine as part of the price Glaxo Canada paid Glaxo World for use of the Zantac trademark, a trademark that allowed it to charge its customers a considerable premium over generic ranitidine drugs.<sup>218</sup> The fact that unrelated European licensees were willing to enter into similar license agreements with purchase terms similar to the License Agreement entered into by Glaxo Canada showed, according to the court, that the seemingly excessive price “‘arose from the market power attaching to Glaxo Group’s ownership of the intellectual property associated with ranitidine, the Zantac trademark and other products covered by its License Agreement’” rather than “‘the non-arm’s length relationship between appellant’” and GlaxoWorld.<sup>219</sup> What appeared to be an excessive price for ranitidine was, in the view of the Federal Court of Appeal, actually just another method for extracting the monopoly rents allocable to the trademark, no more offensive (from a tax perspective) than an increase in the License Agreement’s stated royalty rate would have been.<sup>220</sup>

The Federal Court of Appeal was unwilling to go further, however, and determine the correct transfer price for the ranitidine. It felt it lacked the information necessary to determine whether the transactions entered into with independent European licensees were fully comparable to the Canadian transactions; after all, market conditions (and thus the value of the Zantac trademark) could differ across jurisdictions. Instead, it remanded the case to the Tax Court for determination of “‘the reasonable amount’” “‘in the light of a full record on the issue’”. In doing so, though,

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<sup>217</sup> See *id* at para. 78.

<sup>218</sup> See *id* at para. 79.

<sup>219</sup> *Id* at para. 80 (citing appellant).

<sup>220</sup> As an economic matter, the appeals court was undoubtedly correct; the price paid for the ranitidine was part of the price extracted by the Glaxo Group for Glaxo Canada’s use of the Zantac trademark. The Canadian tax authorities, relying in part on the US case, *Bausch & Lomb Inc v Commissioner*, 92 TC 525, *aff’d* 933 F2d 1084 (2d Cir 1991), had argued that the transfer price and the amount of royalties paid under the trademark license should be evaluated, and priced, separately. See Respondent’s Memorandum of Fact and Law, *GlaxoSmithKline Inc v Her Majesty the Queen*, Federal Court of Appeal Court File No. A-345-08, at \*19 paras 41 – 42. However, the intellectual property at issue in *Bausch & Lomb Inc* was a production patent which had no direct bearing on the market value of what that court viewed as essentially fungible items (contact lenses). The intellectual property at issue in the Glaxo case, trademark protection, had everything to do with market power and market pricing of the final good. Although the Glaxo Group could have arranged matters so that Glaxo Canada paid a higher royalty and purchased generic ranitidine which it then re-milled and packaged as Zantac, the same could be said of any arrangement involving the import of trademarked goods, whether or not the parties to the arrangement are related. All payments for trademarked or patented goods could be (and perhaps should be) recharacterized as in part a payment of a royalty and in part a payment for the generic equivalent. Until the Canadian tax authorities begin to do this more generally, though, it is hard to justify selective enforcement of such a rule. At any rate, the tax authorities failed to ask specifically for a bifurcation of the price paid for related party products between the royalty and ranitidine components.

that court was ordered to take “consideration of the License Agreement [into account] as a circumstance”<sup>221</sup> relevant to its determination.

Because the Federal Court of Appeal did not set a transfer price, it remains unclear exactly how that price will be set – if it will end up being set by reference to a comparable uncontrolled price (the European licensees) or something else, such as a profit split method. Moreover, the Federal Court of Appeal’s judgment may not stand; the Supreme Court of Canada just agreed to hear both an appeal filed by the government and a cross-appeal filed by the taxpayer in this case.<sup>222</sup> At the very least, it will be some time before this transfer pricing question will be answered. Interestingly, the evidence produced in the case made clear that the terms of the License Agreement originally had been set by the taxpayer in an effort to ensure a particular profit split.<sup>223</sup> Apparently, taxpayers are much less upset when they use such methods than when the tax authorities use them. Of course, that may be because taxpayers get to determine how to split the profits in the first circumstance and not in the second.

Even after this case is finally decided, questions may remain as to the difference, if any, between the pricing standards set by former subsection 69(2) of the Income Tax Act and those contained in the current paragraph 247. The language of subsection 69(2), in particular its reference to behavior “that would have been reasonable in the circumstances”, may be (but need not be) read to imply the use of a point of reference more internal to the taxpayer’s situation than the more generic and universal-sounding “arm’s length standard” language used in paragraph 247. Although the court in *GlaxoKlineSmith Inc* relied on the particular language of subsection 69(2) to link the formally separate license and purchase transactions, it provided no clue in that case as to whether the same linkage would be achieved under the language of paragraph 247. This issue could have been confronted in the *General Electric Capital Canada Inc* case, but both parties to that case assumed that the provisions were indistinguishable, and the neither the Tax Court nor the Federal Court of Appeal challenged that assumption.<sup>224</sup> Given that unrelated parties operating at arm’s length can and sometimes do (as illustrated by the French example proffered by the taxpayer in *GlaxoKlineSmith Inc* as a comparable) engage in formally separate but economically linked transactions, there does not seem to be any insuperable barrier to reaching a similar conclusion under paragraph 247.

### 3.3 United Kingdom

Prior to 1999, section 770 of the Income and Corporation Taxes Act of 1988 provided the basis for transfer pricing adjustments. For tax purposes, the profits and losses gen-

<sup>221</sup> See *GlaxoSmithKline Inc* (note 206), at para. 83.

<sup>222</sup> See *The Queen v GlaxoSmithKline Inc.*, Supreme Court File No. 33874.

<sup>223</sup> See *GlaxoSmithKline Inc* (note 206), at para. 13. Moreover, the taxpayers stressed to the court that “Glaxo Canada’s profitability, including profits from the manufacture and sale of Zantac, was commensurate with the profitability of its competitors”. See Appellant’s Memorandum of Fact and Law, *GlaxoSmithKline Inc. v. Her Majesty the Queen*, Court of Appeal File No. A-345-08 at \*13 para. 30.

<sup>224</sup> See *General Electric Capital Canada Inc* (note 206), at para. 12.

erated by sales between related parties<sup>225</sup> effected at a price either “less than the price at which it might have been expected to fetch if the parties to the transaction had been independent persons dealing at arm’s length...or greater than the arm’s length price”<sup>226</sup> were to be “comput[ed] ...[and] like consequences shall ensue as would have ensued if the property had been sold for the arm’s length price”.<sup>227</sup> The coverage of this rule was broadened when it was replaced, in the Finance Act of 1998, by Section 770A, which imposed a new transfer pricing rule denominated as Schedule 28AA. Schedule 28AA applies where any “provision...has been made or imposed as between any two persons...by means of a transaction or series of transactions”,<sup>228</sup> one of the affected persons was “directly or indirectly participating in the management, control or capital of the other; or the same person or persons were [so participating]”,<sup>229</sup> “the actual provision...differs from the provision...which would have been made as between independent enterprises”,<sup>230</sup> and as a result, “a potential advantage in relation to United Kingdom taxation” is conferred on one of the “affected persons”.<sup>231</sup> In affected situations, “the profits and losses of the potentially advantaged person...shall be computed for tax purposes as if the arm’s length provision had been made or imposed instead of the actual provision”.<sup>232</sup> The legislation specifically provided that “this Schedule shall be construed...in such manner as best secures consistency” between it and “double taxation arrangements [which] incorporate...the OECD Model”<sup>233</sup> as well as the OECD transfer pricing guidelines, both currently extant and developed after the date of enactment.<sup>234</sup> There have been only two transfer pricing cases heard decided during the relevant period in the UK under these statutes.

In the first of these cases, *Waterloo plc et al v Inland Revenue*,<sup>235</sup> the UK taxpayer financed<sup>236</sup> an employee stock option plan that was used to compensate

<sup>225</sup> The provision applied “where any property is sold and – the buyer is a body of persons over whom the seller has control or the seller is a body of persons over whom the buyer has control or both the buyer and the seller are bodies of persons over whom the same person or persons has or have control...”. Section 770(1)(a).

<sup>226</sup> Section 770(1)(b)(i) & (ii).

<sup>227</sup> Section 770(1).

<sup>228</sup> Schedule 28AA1(1)(a).

<sup>229</sup> Schedule 28AA1(b).

<sup>230</sup> Schedule 28AA1(2)(a).

<sup>231</sup> Schedule 28AA1(2)(b).

<sup>232</sup> Schedule 28AA1(2).

<sup>233</sup> Schedule 28AA2(1)(b).

<sup>234</sup> Schedule 28AA2(3).

<sup>235</sup> *Waterloo plc et al v Inland Revenue*, [2002] STC (SCD) 95 (Special Commissioner’s Decision 2001).

<sup>236</sup> *Waterloo*, the UK taxpayer, provided interest free loans to an “employee share option trust”; See *Waterloo plc et al*, [2002] STC (SCD) 95, at paras 27 – 29; This trust used the funds to purchase shares of *Waterloo* stock, see *id* at para. 28, which were distributed to employees exercising their purchase rights under the terms of stock options they had been granted in the course of their employment. Initially, the recipients of these stock options were picked by *Waterloo*’s board of directors, see *id* at paras 23 – 25; eventually, these decisions were devolved to divisional management committees. See *id* at para. 37. After 1996, the trust began using newly issued shares of *Waterloo* stock rather than shares purchased on the open market in the operation of its employee stock option plan. See *id* at para. 17.

employees of not only the taxpayer but also employees of many of its foreign subsidiaries. Waterloo, the UK taxpayer, was the publicly traded parent company<sup>237</sup> of a multinational group with 185 subsidiaries in 26 countries, organized in five operating divisions.<sup>238</sup> The question was whether the taxpayer's involvement in the plan provided its subsidiaries with a "business facility" for which it should have been recompensed under section 770 of the Income and Corporation Taxes Act 1988.<sup>239</sup>

The Commissioner had little difficulty dismissing the taxpayer's contention that the stock option trust was not a "facility" because "the provision of share options for group employees was not for business purposes" or "remuneration".<sup>240</sup> He found that these options "were clearly benefits that Waterloo believed would incentivize chosen employees....for the benefit of the Waterloo business worldwide".<sup>241</sup> Nor did he think that the particular form through which the benefit was delivered, the trust, took it outside the coverage of the statute.<sup>242</sup> Therefore, The Commissioner held, the taxpayer's income should be adjusted in accordance with the dictates of section 770.

The Commissioner did not determine by how much the taxpayer's income should be changed, however, as that question was not before him. He made clear, though, that he did not see any serious difficulties in coming up either with the cost of the program<sup>243</sup> or with allocating that cost among the various subsidiaries.<sup>244</sup> Although "reluctant to be more specific", his opinion intimated that the allocation ought to be made in through a formula.<sup>245</sup>

The United Kingdom reorganized its tax tribunal system in April of 2009, replacing four former separate tax tribunals with one unified first-tier tax tribunal. This new tribunal, appropriately named the "First Tier Tax Tribunal", hears most appeals against the tax authorities, Her Majesty's Revenue and Customs (HMRC). One of its

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<sup>237</sup> See Waterloo plc et al (note 236), at para. 15. Its shares are listed on the London Stock Exchange. See id.

<sup>238</sup> See id at para. 17.

<sup>239</sup> Section 770 required that "where any property is sold and (a) the buyer is a body of persons over whom the seller has control....; and (b) the property is sold at a price ....[which is] less than the price which it might have been expected to fetch if the parties to the transaction had been independent persons dealing at arm's length....then in computing for tax purposes the income, profits or losses of the seller where the actual price was less than the arm's length price... the like consequences shall ensue as would have ensued if the property had been sold for the arm's length price....". See id at para. 5.

<sup>240</sup> See id at para. 48 (argument of taxpayer's counsel).

<sup>241</sup> See Waterloo plc et al (note 236), at para. 51.

<sup>242</sup> See id at para. 65.

<sup>243</sup> See id at para. 102 ("[I]t would presumably consist of such expenditures as the borrowing cost of acquiring sufficient funds to purchase the shares available to meet the options, trustee fees, a management and administrative cost and any other reasonable costs to meet the needs of providing the facility....and a fee of a suitable margin over cost could be agreed.").

<sup>244</sup> See id at para. 107 ("It would seem to us to be practical to devise some fair formula for an appropriate apportionment of an aggregate arm's length price between resident and non-resident subsidiaries that benefit from the facility.").

<sup>245</sup> See id.

first cases was *DSG Retail Ltd v HMRC*,<sup>246</sup> a case involving the largest retailer of electrical goods in the UK<sup>247</sup> and the income it and its foreign subsidiary derived from selling warranty and service contracts covering those products.<sup>248</sup> Technically, neither the warranties nor service contracts entered into with customers were issued by a DSG affiliate. However, the contractual obligations of the warrantors<sup>249</sup> and the service providers<sup>250</sup> were insured by an Isle of Man subsidiary of DSG International, DISL. This Isle of Man subsidiary derived considerable income from its reinsurance activities. The issue in the case was whether some of that income should have been shared with DSG because DSG provided DISL with a valuable business opportunity (the “opportunity to enter into an attractive insurance contract”) for which it should have been paid under the arm’s length principal.<sup>251</sup>

The Tribunal readily found that DSG helped DISL both by making available and negotiating the terms of the contracts with, at first, the independent insurer<sup>252</sup> and, later, the third party service provider.<sup>253</sup> The question then became at what price a business operating at arm’s length would have made the facility available to DISL in the first year, and thereafter, what the terms (including price) of this facility would have been. The Tribunal considered and rejected as too dissimilar a number of possible comparators before concluding that it would have to employ the profit split method of analysis. In applying that analysis, it gave DISL a “normal” return on its capital and assigned the entire residual profit to DSG because DSG had both marketing and negotiating power. It was DSG’s employees, after all, who sold the policies to customers. Moreover, as DSG was the largest retailer of electronic goods in the UK, it effectively had a monopoly over the sale of these products and could

<sup>246</sup> *DSG Retail Ltd v HMRC*, [2009] UKFTT 31 (TC) (FTTT 2009), online at <http://www.bailii.org/uk/cases/UKFTT/TC/2009/31.html>.

<sup>247</sup> DSG International plc is the British parent company of a group of British companies, including the named taxpayer, which together comprised the largest retailer of electrical goods in the UK. See id at para. 2.

<sup>248</sup> See id at para. 3. Initially, the contractual relationships took the form of warranty contracts but the companies began using service contracts both to avoid an increase in insurance taxes and to gain favorable VAT treatment. See id.

<sup>249</sup> See id at para. 13 (DSG affiliate reinsured 95% of warranty risk).

<sup>250</sup> See id at para. 39(3) (DSG affiliate reinsured 100% of the risk).

<sup>251</sup> See id at para. 75. Some of the transactions were governed by Section 770 of the Taxes Act 1988; transactions in the later years were covered by the law contained in Schedule 28AA. Id at para. 4. According to the Tribunal, under section 770, “one takes the facts of the transaction as they are and asks whether a price would have been charged for entering into the transaction if the parties had been at arm’s length, whereas under Schedule 28AA one asks whether the terms of the transaction would have been different if the parties had been at arm’s length”. In addition, Schedule 28AA para. 2.2, while not incorporating the OECD transfer pricing guidelines “wholesale” does require the schedule to “be interpreted in such a way as secures consistency between para 1 of the schedule and the OECD model in accordance with the Transfer Pricing Guidelines”. *DSG Retail Ltd* (note 246), at para. 77. Regardless of the degree of explicit incorporation, however, the Tribunal declared that “the approach of the OECD model is a useful aid which we should apply in the absence of any other guidance as they are the best evidence of international thinking on the topic”.

<sup>252</sup> See id at para. 82.

<sup>253</sup> See id at para. 87.

earn super-normal (monopoly) profits. This monopoly also would have given DSG bargaining power in its negotiations with DISL had they bargained at arm's length (except for one short period of time when DSG was transitioning between the insurance and service contracts<sup>254</sup>). Thus the Tribunal concluded that had DSG and DISL bargained at arm's length, DISL would have been forced to return some of its premium to DSG.<sup>255</sup> The Tribunal found itself unable to determine the proper amount of DISL's "normal return", however, because it could not figure out how to come up with a proper beta to use in applying the capital asset pricing model without using the benefit of hindsight,<sup>256</sup> and decided to "adjourn so as to allow the parties to see if they can agree" on such a figure.<sup>257</sup> Having established the ground rules, it left it up to the parties to figure out to apply them given the facts of the case.<sup>258</sup>

On the basis of this limited evidence, it seems that the UK First Tier Tax Tribunal is more open to the use of profit split – and formula based – methods of setting prices than courts in Canada and the US. Nonetheless, the Tribunal's version of the profit split method hews closely to the TNMM profit split method, and thus to traditional arm's length pricing mechanisms as well. The Tribunal looked at the particular functions assigned to the involved entities and sought to use profit margins derived from market comparables to assign returns for those function. Thus, any prices ultimately derived in accordance with these standards should be more similar to those derived by using traditional cost-plus or resale-price methods of calculation than to those that would be generated under any of the formulary methods of taxation advocated by critics of arm's length pricing.

### 3.4 Australia

The Australian Taxation Office (ATO) receives its authority to adjust transfer prices from Division 13 of the Income Tax Assessment Act 1936. Section 136AD of this Division grants the Commissioner of Taxation the power of reassessment when a taxpayer supplies or acquires property from a non-Australian party with which it is not dealing at arm's length for a consideration different from the arm's length consideration. Section 136AE of this Division grants the Commissioner similar powers when determining the income and expenditure of Australian permanent establish-

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<sup>254</sup> The Tribunal concluded that DISL would be entitled to a higher profit assignment for this period of time. See *id.* at para. 154(5).

<sup>255</sup> See DSG Retail Ltd (note 246), at para. 153.

<sup>256</sup> See *id.* at para. 154.

<sup>257</sup> See *id.*

<sup>258</sup> The parties did in fact reach a settlement. See Press Release, DSG International plc (Feb. 27, 2009) PR 11/09. For an extended discussion of this case and another captive insurance case that arose in the US (*UPS v Commissioner*, Tax Ct Memo 1999-268, revd 254 F.3d 1014 (11<sup>th</sup> Cir 2001)), see Ainsworth, *Transfer Pricing, Business Restructurings and Intangibles – Case Studies*, online at <http://ssrn.com/abstract=1691576>; The Tax Court decided against the taxpayer in UPS on grounds that the formation of the captive insurance company was a "sham". After that holding was reversed by the Eleventh Circuit and remanded for consideration of the transfer pricing issues, the parties settled. See Ainsworth, *Transfer Pricing, Business Restructurings and Intangibles*, at 5.

ments.<sup>259</sup> In the case of both separate legal entities and permanent establishments, “the arm’s length principle provides the economic foundation for taxation...”<sup>260</sup> Like the tax authorities in the other countries studied, ATO gives effect to cost-sharing agreements, albeit under the name of “cost contribution arrangements”.<sup>261</sup> Although the ATO prefers to use traditional transfer pricing methodologies to arrive at an arm’s length result, it has been a leader in “promoting the increased use of transactional profit methods...”<sup>262</sup> when traditional methods fall short.<sup>263</sup> In this crowd, however, it does not take much to be a leader; further, the Australian court decisions do not exhibit any substantial move in the direction of “formulary” taxation. And again, there are relatively few litigated cases.

The first case in the series, *Daihatsu Australia Pty Ltd v Commissioner of Taxation*,<sup>264</sup> deals with the procedure rather than the substance of a transfer pricing dispute but is nonetheless worth mention. Daihatsu Australia was an importer and wholesale distributor of motor vehicles and spare parts manufactured by its Japanese parent company.<sup>265</sup> The Australian Tax Office (“ATO”) contended that Daihatsu Australia overpaid its parent company for the vehicles it imported from 1992 through 1996.<sup>266</sup> Daihatsu Australia challenged these assessments on grounds that they had not been issued in good faith.<sup>267</sup> The authorities’ bad faith consisted of failing “to ensure that the comparable data used in the comparability analysis was reliable...relying instead on the assurances of ATO economists” and of paying insufficient attention to the taxpayer’s proffered comparables.<sup>268</sup> As evidence of this lack of care and good faith, the taxpayer pointed to the fact that the Division 13 determinations were in “identical form for each year save for the reference to the respective year of income and the amount to be included in the assessable income” and their use

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<sup>259</sup> See TR 2001/11-Income tax: international transfer pricing – operation of Australia’s permanent establishment attribution rules para. 3, online at <http://www.austlii.edu.au/au/other/rulings/ato/ATOTR/2001/tr2001-011/tr2001-011.html> (“the results and methodologies involved are similar to those in applying Australia’s transfer pricing rules to international dealings between separate legal entities... There are, however, differences between the two groups of rules that may produce different outcomes in the PE setting.”).

<sup>260</sup> See *id* at para. 4.

<sup>261</sup> See TR 2004/1-Income tax: international transfer pricing – cost contribution arrangements para. 3, online at <http://www.austlii.edu.au/au/other/rulings/ato/ATOTR/2004/tr2004-001/tr2004-001.html>.

<sup>262</sup> See Markham, *Transfer Pricing of Intangible Assets in the US, The OECD and Australia: Are Profit-Split Methodologies the Way Forward?*, [2004] UWS Law Rev 3; (2003) 8(1) University of Western Sydney Law Review 56, at text at note 31, online at <http://www.austlii.edu.au/au/journals/UWSLawRw/2004/3.html>.

<sup>263</sup> See *id* at text at note 68.

<sup>264</sup> *Daihatsu Australia Pty Ltd v Commissioner of Taxation*, [2001] FCA 588 (Fed Court of Appeal 2001), online at <http://www.austlii.edu.au/cgi-bin/sinodisp/au/cases/cth/FCA/2001/588.html>.

<sup>265</sup> See *id* at para. 11.

<sup>266</sup> See *id* at para. 12.

<sup>267</sup> See *id* at para. 41.

<sup>268</sup> See *id*. The taxpayer objected to the ATO’s failure to issue a position paper to the taxpayer prior to making the assessments, thereby “robbing...[the taxpayer] of the opportunity to show why the comparable data ought not to have been relied upon”. See *id* at para. 43.

of “an averaged median figure...across the tax years in question”.<sup>269</sup> The taxpayer also complained about the general inadequacy of the transfer pricing methodology used by the ATO.

There was no doubt that the taxpayer’s assessments had been generated in a rush. The ATO knew that Daihatsu was being sold to Toyota and wanted to make sure that its audit was completed and its assessments issued before Daihatsu Australia “commence[d] dissipating its assets as part of the intention to cease business in its own right in Australia”.<sup>270</sup> The question facing the Federal Court of Appeal was whether so many corners had been cut in accelerating the process<sup>271</sup> that it constituted a violation of “good faith” under the “Hickman principle”<sup>272</sup> and thus fell outside the Commissioner’s statutory assessment powers.

The Court held that the case was not one of those “rare and extreme cases where the absence of a bona fide attempt to assess the taxpayer’s income has been made out”.<sup>273</sup> Though the transfer pricing determination had been made “in an environment of haste and of imperfect information”,<sup>274</sup> it was devoid of “any imputation of dishonesty, of some improper or ulterior motive, or of deliberate impropriety”.<sup>275</sup> Most importantly for the purposes of this paper, the Court accepted in principle the use the TNMM profit split method to determine the appropriate transfer price,<sup>276</sup> though it also stated that the resulting assessment was open to the same challenge as assessments calculated pursuant to other transfer pricing methods.<sup>277</sup>

The parties may have settled the case after this decision came down; at any rate, there is no further published record of it. Thus, it is impossible to know whether the TNMM profit split ended up being applied, or if the parties agreed to use some other pricing mechanism. The TNMM profit split method, though a profit split method which allocates net (rather than gross) income amounts, is a far cry from formulary taxation. It accepts taxpayer’s division of functions between related entities, and looks to market evidence of the return appropriate to each function for purposes of setting transfer prices.

The next case in the series is *Roche Products Pty Ltd v Commissioner of Taxation*,<sup>278</sup> involving the Australian subsidiary (“Roche Australia”) of the multinational pharmaceutical and medical supplies group (“the Roche Group”).<sup>279</sup> Roche Group’s parent corporation, Roche Holdings Ltd, was a Swiss company.<sup>280</sup> Despite the fact

<sup>269</sup> See *id* at para. 26.

<sup>270</sup> See *id* at para. 21.

<sup>271</sup> See *id* at para. 43 (complaining about the “speed and superficiality” of the process).

<sup>272</sup> See *id* at para. 1.

<sup>273</sup> See *id* at para. 48.

<sup>274</sup> See *id* at para. 51.

<sup>275</sup> See *id* at para. 48.

<sup>276</sup> See *id* at para. 17 (describing use of method).

<sup>277</sup> See *id* at para. 52 (claim that assessment was excessive would be a “Part IVC matter”).

<sup>278</sup> *Roche Products Pty Ltd v Commissioner of Taxation*, [2008] AATA 639, 70 ATR 703 (Administrative Appeals Tribunal 2008), online at <http://www.austlii.edu.au/cgi-bin/sinodisp/au/cases/cth/AATA/2008/639.html>.

<sup>279</sup> See *id* at para. 2.

<sup>280</sup> See *id*.

that the transactions and some of the affected parties may have enjoyed the protections of double tax agreements, the court, the Administrative Appeals Tribunal of Australia, analyzed the case solely under the statutory arm's-length test found in section 136AD of Australia's statutory law because "the parties spent little time dealing with the words of either set of provisions and effectively accepted that the same result would obtain whichever was applied".<sup>281</sup>

The case is really three cases in one because Roche Australia had three separate operating divisions, and the Commissioner challenged prices paid to affiliates for products handled by each of these divisions. The divisions were sufficiently different in their operations that these pricing disputes had to be analyzed separately. The three divisions were the prescription division, the consumer division, and the diagnostics division. The prescription division handled the sale of prescription drugs, the consumer division dealt with over the counter drugs, and the diagnostic division handled the lease and sale of diagnostic equipment and agents used by hospitals.

Prescription drugs were made available to customers at a fixed price through the government's Pharmaceutical Benefits Scheme, with the difference between the fixed price and the full price of the drug – a price set by the government's Pharmaceutical Benefits Pricing Authority – paid to the pharmacy through the Pharmaceutical Benefits Scheme. Roche Australia's prescription division "develop[ed] a demand" for its (usually patent-protected) products by "informing medical practitioners and the health industry generally about the properties of the drug".<sup>282</sup> It also did a small amount of secondary manufacturing and packaging in Australia,<sup>283</sup> but for the most part it purchased finished pharmaceutical products from foreign affiliated companies. The Commissioner alleged that Roche Australia overpaid for these pharmaceuticals, and adjusted its Australian income accordingly. Although Roche (Australia) admitted that these purchases were not at arm's length, it contended that the Commissioner's adjustments were excessive<sup>284</sup> and sought to establish an arm's length price that was higher than that set by the Commissioner.

The Commissioner initially argued that a combination of the cost plus and resale price methods should be used to determine the appropriate profit for the pharmaceutical division; prices for particular products could then be set by using those margins.<sup>285</sup> Its expert derived the profit margins it used for this exercise from profit margins earned by a group of allegedly comparable companies performing allegedly comparable functions.<sup>286</sup> The Tribunal, however, pointed out that the government expert's sources for determining gross profit margins were really more consonant with "a profit based method, with all their disadvantages".<sup>287</sup> Once the taxpayer introduced evidence of comparable sales by Roche (Australia) at trial, the Commissioner's position changed. It began arguing that its expert's analysis should be

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<sup>281</sup> See *id.* at para. 17.

<sup>282</sup> See *id.* at para. 45.

<sup>283</sup> See *id.* at para. 50.

<sup>284</sup> See *id.* at para. 5.

<sup>285</sup> See *id.* at para. 70.

<sup>286</sup> See *id.* at paras 71 – 72 (describing method used by Dr. Wright).

<sup>287</sup> See *id.* at para. 75.

regarded as a “sanity check’ for any conclusion that is drawn from the direct evidence” of comparable uncontrolled sales.<sup>288</sup> Implicitly, the Commissioner argued that the substantial discrepancy between its expert’s results and the apparent results under the comparable uncontrolled price and resale price methods generated from looking at Roche (Australia)’s actual transactions should cast doubt on the comparability of the sales being proffered by the taxpayer as evidence of arm’s length prices or profit margins.

The taxpayer’s evidence was drawn from sales of prescription drugs to Australian generic drug distributors. These sales provided evidence of two types. First, some of the transactions involved sales of compounds that members of the Roche Group were selling to Roche (Australia); the prices at which these third party sales took place were proffered to set the Australian arm’s length price for the particular compounds.<sup>289</sup> In addition, the gross profit margin earned by Roche (Australia) on these sales was proffered as evidence of the appropriate gross profit margin to be used when establishing prices for patented drugs purchased from members of the Roche Group.<sup>290</sup> The taxpayer asked the Tribunal to determine the transfer price of patented pharmaceuticals through the application of the resale price method, using the gross profit margin obtained from its sale of generic drugs.

The Tribunal opted not to use the Commissioner’s pricing analysis. It faulted the Commissioner’s expert, finding problems not only with the pricing method advocated in her testimony<sup>291</sup> but with her application of the method to the facts of the case.<sup>292</sup> Instead, the Tribunal adopted the taxpayer’s suggested resale price mechanism, while making some adjustments in its application. In particular, the Tribunal disagreed with the taxpayer’s expert’s decision to leave a particularly profitable set of drug transactions out of the gross profit margin calculation. Taking those transactions into account together with the testimony of some of the taxpayer’s witnesses of a general industry practice of negotiating around a 40% gross profit margin, the Tribunal determined that Roche Group prices should have been set at a level that allowed Roche (Australia) a 40% gross profit margin rather than its actual 37% or 38% margin.<sup>293</sup> This left Roche (Australia) with a significantly larger Australian tax

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<sup>288</sup> See *id* at para. 116.

<sup>289</sup> In general, the evidence showed that the Roche affiliates charged Roche (Australia) less for these compounds than they charged its generic competitors. See Roche Products Pty Ltd (note 278), at para. 139.

<sup>290</sup> Roche (Australia) did not own the patents, its affiliates did, so that any profit attributable to the patent protection should have been earned by those affiliates. See *id* at para. 153. Roche (Australia) provided similar services with respect to patented and unpatented products, and thus the gross margins should have been similar for both types of products. See *id* at para. 164.

<sup>291</sup> See *id* at para. 115 (criticizing method because it “requires multiple subjective determinations which admit of error at every step”).

<sup>292</sup> See *id* at paras 117 – 19 (criticizing decision to use advertising agencies as “comparables” for valuing marketing function and coming up with separate profit figures for functionally integrated activities); paras 119 – 22 (criticizing use of “anecdotal knowledge” in choosing within the interquartile ranges for expenses and sales margins and for choices of comparable enterprises).

<sup>293</sup> See *id* at para. 165.

liability than it had initially reported, but one that remained far below the liability that the Commissioner had advocated.

The transfer pricing determinations for products sold to Roche (Australia)'s consumer division took a different course. Both sides agreed that no comparable sales could be found for the products sold by this division, and that as a result, some "profits based methodology" would have to be used to determine the appropriate transfer prices.<sup>294</sup> Both sides' experts presented evidence of operating profits (EBIT,<sup>295</sup> or earnings before interest and taxes) from allegedly comparable companies, reaching relatively similar results. The real dispute here was whether this profit had to be realized with respect to each of the drugs marketed by the consumer division, or whether it was the profitability of the division as a whole that mattered. The Commissioner argued that the prices should be set in such a way that Roche (Australia) would have earned at least the identified EBIT from each of the specific, identified drug transactions.<sup>296</sup> The taxpayer contended that as long as the operating profits of the consumer unit as a whole<sup>297</sup> met the EBIT, there was no need to set EBIT derived prices for each individual product. This distinction mattered because some of Roche (Australia's) products were very profitable, bringing the overall profits of the consumer division within the taxpayer's suggested EBIT range<sup>298</sup> without any adjustments. The Commissioner's position would have led to the re-pricing of some loss-producing products, increasing the total amount of the taxpayer's profits.

The Tribunal accepted the taxpayer's position. It rejected the Commissioner's approach in part because, to generate the claimed correct operating profit with respect to the particular drug transactions at issue, "the unavoidable conclusion of the uplift proposed by Dr. Wright is that the arm's length market price for Rennie's, Aleve and Elevit should have been nothing, or, even worse, a negative price. This cannot be right."<sup>299</sup> Given that the "overall operating profit of the Consumer Division is well in the arm's length range", the Tribunal concluded that "the acquisition prices for the Category 1 products were arm's length as well".<sup>300</sup>

One of the most interesting parts of this part of the opinion, however, was the Tribunal's criticism of both parties for focusing exclusively on EBIT and operating profits instead of the gross profit margin figures that they had deemed relevant when pricing transactions in the Prescription Division.<sup>301</sup> It found the absence of any discussion of gross margins particularly troubling given undisputed evidence

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<sup>294</sup> See *id.* at para. 168.

<sup>295</sup> See *id.* at para. 93.

<sup>296</sup> See *id.* at para. 175 ("Dr. Becker ignored the overall operating margin of Roche Australia's Consumer Division of 8.1 percent and concentrated on the five Category 1 products.").

<sup>297</sup> See *id.* at para. 169.

<sup>298</sup> Indeed, the taxpayer argued that the overall profit was at the "high" end of the range. See *id.* at para. 93 (testimony of Dr. Frisch).

<sup>299</sup> See Roche Products Pty Ltd (note 278), at para. 176.

<sup>300</sup> See *id.* at para. 177.

<sup>301</sup> See *id.* at para. 172 ("I wonder whether there was enough 'standing back and looking at the canvas in this case' or whether the case was too influenced by the ideas of US economists steeped in their traditions of transfer pricing issues rather than the application of Australian legislation.").

that “it was the operating expenses that caused potentially profitable operations to result in losses”.<sup>302</sup> When the Tribunal looked at the gross profit margins, it found them to be “healthy” for all but one of the products,<sup>303</sup> and for that product, it decided that the real problem was “overwhelmingly associated with its marketing failure”, so much so that it “would still have been a disaster if it had been given to Roche Australia”.<sup>304</sup>

It is hard to characterize the method used by the Tribunal to set the transfer prices in the consumer division, given the *mélange* of factors on which it relied in reaching its conclusion. On the one hand, one can claim that the Tribunal relied on profit-split methodology. On the other hand, given the Tribunal’s comments, it is hard to know whether it would have accepted that methodology (and particularly its reliance on net margin figures) had its results been at odds with the results that would have been reached using the resale price method and gross profit margins. Indeed, the Tribunal’s focus on a factor that should be ignored under a “true” profit split method – selling costs – indicates substantial discomfort with a net margin approach to pricing. It might be more accurate to view this portion of the case as presenting a road map for future taxpayers of a way to combat challenges based on net profit comparables: introduce evidence of unusually high expenses. Also noteworthy is the Tribunal’s method of deriving the appropriate gross income margin. It simply appropriated the margin used in the prescription drug portion of its opinion, despite the absence of evidence that this was an appropriate margin for the consumer drug context. There is no particular reason to think that the two contexts would have similar gross margins. Though most of the profits derived by both divisions could be said to come from developing demand for their drugs, the prescription division targeted its sales efforts at doctors and hospitals while the consumer division targeted consumers. No evidence was presented to show that expected, let alone actual, operational costs of demand development were similar in both contexts.

The final division, the diagnostics division, sold or leased equipment used by hospitals. Unlike some purveyors of these devices, Roche (Australia) did not sell or lease equipment at a discount while requiring its customers to buy expensively marked up supplies and reagents. Instead, it sold and leased equipment for its “full value”; while it marketed the necessary supplies and reagents, its prices for these items had to be competitive because its customers were allowed to purchase these on the open market, from other unrelated purveyors.<sup>305</sup> Whether due to this marketing strategy<sup>306</sup> or for other reasons, the diagnostics division lost money in all but one of

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<sup>302</sup> See *id* at para. 174.

<sup>303</sup> See *id* at para. 177 – 78. The Tribunal made this decision on its own initiative, presumably by comparing the profit margins in the consumer division to those in the prescription division, as no evidence was introduced as to gross profit margins other companies for over the counter drugs.

<sup>304</sup> See *id* at para. 178. The Tribunal does not seem to consider, or to be concerned by, the possibility that the disaster may have been made larger by an elevated transfer price.

<sup>305</sup> See *id* at para. 57.

<sup>306</sup> See *id* at para. 184 (some evidence before the court that “one of the reasons the Division was unsuccessful was that it did not tie purchasers of its equipment to use of its products.”).

the years covered by the litigation.<sup>307</sup> The gross profit margin on its products varied from 15.7 percent to 50 percent.<sup>308</sup> Lacking evidence of sales prices for comparable products, the Commissioner again adopted a profit based method, and calculated an “arm’s length operating margin” based on profits earned by a group of comparable companies. If Roche (Australia) had a matching margin, its loss of \$7,841,000 would have turned into a profit of \$2,298,000.<sup>309</sup>

The taxpayer did not provide any pricing evidence, arguing simply that that “it was not possible to use” any of the pricing methods, including the net profit based transactional net margin method.<sup>310</sup> Instead, its expert simply contended that its transactions took place at arm’s length prices and that business model failed.<sup>311</sup>

The Tribunal began its discussion by expressing its discomfort with net profit based methodology which “inevitably attributes any loss to the pricing” to the exclusion of other sources of losses, such as higher than average operating expenses.<sup>312</sup> Given the total lack of evidence of comparable sales or other indicia of arm’s length prices or even of how the prices for the goods were set, the Tribunal decided against making any “positive finding” on “a dispute associated with an assertion and a rebuttal”.<sup>313</sup> It held, instead, that “based on the totality of the evidence” that the prices at which the diagnostics division acquired its products were arm’s length prices.<sup>314</sup>

Though the Tribunal was largely dismissive of the Commissioner’s experts and theories and held for the taxpayer on the majority of the particular transfer pricing disputes, the Tribunal’s pricing adjustments were substantial, on the order of \$45 million (Australian).<sup>315</sup> These adjustments were generally below those sought by the Commissioner<sup>316</sup>, but they exceeded the Commissioner’s proposed adjustments in three out of the 10 years covered.<sup>317</sup>

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<sup>307</sup> See *id.* at para. 180.

<sup>308</sup> See *id.*

<sup>309</sup> See *id.* at paras 103, 182.

<sup>310</sup> See *id.* at para. 95.

<sup>311</sup> See *id.*

<sup>312</sup> See *id.* at para. 185.

<sup>313</sup> See *id.* at para. 187.

<sup>314</sup> See *id.* at para. 188. It is perhaps more accurate to say, on the basis of a lack of evidence on either side.

<sup>315</sup> To place this number in context, the ATO initially proposed an adjustment of \$126 million, which was reduced to \$110 million after objections filed at the administrative level; See Australian Taxation Office, Decision Impact Statement: Roche Products Pty Ltd v. Commissioner of Taxation (Jan. 23, 2009), online at <http://law.ato.gov.au/atolaw/view.htm?DocID=LIT/ICD/NT2005/7/00001> (figures in Australian dollars). Most commentators view the outcome of the case as a win for the taxpayer. See Kotarba, Better than the “Best”: Transfer Pricing Methodology in the Wake of Roche: Dorsey & Whitney Student Writing Prize in Comparative and International Law, 48 Colum J Transnatl L 140, 142 n 7 (2009) (listing commentators).

<sup>316</sup> See Roche Products Pty Ltd (note 278), at para. 193.

<sup>317</sup> See *id.* at para. 195.

The most recent transfer pricing case to come out of Australia, *SNF (Australia) Pty Ltd v Commissioner of Taxation*,<sup>318</sup> involved the Australian subsidiary of a French multinational engaged in manufacturing and selling chemicals used in mining, paper processing and sewage treatment.<sup>319</sup> The Commissioner contended that the taxpayer overpaid related manufacturing companies<sup>320</sup> for the chemicals it resold to Australian customers. All of the sellers were residents of countries with which Australia had entered into bilateral double taxation agreements, so any statutory reassessments had to be consistent with the terms of the “associated enterprises” article of the relevant treaty.<sup>321</sup> The Federal Court of Australia did not reach the issue of whether the statutory and treaty arm’s length standards differed in any way, however, because it did not uphold the government’s statutorily based transfer pricing adjustments.<sup>322</sup>

In the years at issue, the taxpayer claimed for tax purposes that it had operated at a loss. The multinational group as a whole, though, operated at a profit during this period.<sup>323</sup> The taxpayer relied on the CUP method to prove the legitimacy of its loss; it presented evidence that “in the majority of cases the price paid by the taxpayer was less than that paid by independent third parties buying comparable volumes in comparable markets”,<sup>324</sup> although in most cases there was also a least one independent purchaser who paid less than SNF (Australia).<sup>325</sup>

The Commissioner argued that the sales relied on by the taxpayer were not comparable, either because they were to customers outside of the Australian market or otherwise “vastly different”.<sup>326</sup> However, its major argument was that it was inappropriate to use the CUP method at all. It contended the taxpayer’s Australian operations were effected for the purpose of establishing a “foothold for SNF products in the Australian market” for the benefit of the suppliers and parent company, and that those suppliers, not the Australian taxpayer “should have borne the costs of establishment and penetration” by reducing their transfer prices for the chemicals enough

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<sup>318</sup> *SNF (Australia) Pty Ltd v Commissioner of Taxation*, [2010] FCA 635, [2010] ATC 20-190 (Fed Court of Appeal 2010), online at <http://www.austlii.edu.au/cgi-bin/sinodisp/au/cases/cth/FCA/2010/635.html>.

<sup>319</sup> See id at paras 2 – 3 (“flocclulants and coagulants”).

<sup>320</sup> These companies were resident in France, the United States and China. See id at para. 4.

<sup>321</sup> See id at para. 5. Since the taxpayer prevailed under Division 13, there was no need to inquire as to whether additional protection against Australian tax would have been provided by an applicable double tax agreement. See id at para. 21 (“The Commissioner accepted in opening submissions that if he could not succeed in this proceeding under Div. 13, he could not otherwise succeed under the relevant DTA. The Commissioner submitted that the issue of the stand alone taxing power of each DTA was to be left for another occasion.”).

<sup>322</sup> See id.

<sup>323</sup> See *SNF (Australia) Pty Ltd* (note 318), at para. 14; The taxpayer ascribed its poor performance to “a combination of intense competition, poor management, defalcations by an employee, excessive stock levels, an insufficiently high level of sales per sales person, and a series of bad debts”. Id at para. 13.

<sup>324</sup> See id at para. 76.

<sup>325</sup> See id at para. 82.

<sup>326</sup> See id at paras 92 – 96.

to allow the Australian taxpayer a profit.<sup>327</sup> It argued that had the parties been operating at arm's length, the Australian company would have required the suppliers to deal with it on terms that guaranteed it a profit. It would not have been willing to suffer start-up losses, but would have insisted on returns equivalent to those enjoyed by established chemical distributors. Using the TNMM method, the Commissioner worked backward from what it thought SNF (Australia)'s net profit margin should have been to determine the price the affiliates should have charged for the chemicals.

The Court rejected the Commissioner's analysis. Finding that there was a global market, with many participants, for the chemicals sold to SNF (Australia) and that "the arm's length price as determined by that free market was, on the evidence, almost always in excess of the prices paid by the taxpayer",<sup>328</sup> the Court held that the taxpayer "satisfied the burden upon it to satisfy the Court that the consideration the taxpayer paid for the products was the arm's length consideration".<sup>329</sup> The Court relied on evidence of global prices for the products, rather than the relatively few, arguably comparable, sales in Australia in applying the CUP methodology to the Australian sales.<sup>330</sup>

Although the Court decided for the taxpayer in this case, it clearly felt uncomfortable simply dismissing the Commissioner's contention that the parent company should have absorbed the Australian company's losses because those losses were being incurred for the good of the larger corporate entity.<sup>331</sup> The Court admitted that SNF (Australia) would have been unlikely to continue in business for 13 consecutive losing years had it not been part of the larger SNF group,<sup>332</sup> and that SNF continued to support the enterprise only because of its "long term strategic plans".<sup>333</sup> However, it noted that SNF supported SNF (Australia)'s operation in a variety of ways, and indeed, that the prices charged by related suppliers were "reduced" in some instances even as those affiliates bore currency risks on sales to SNF (Australia).<sup>334</sup> As the Court believed that the reported losses were real losses, not "artificially inflated",<sup>335</sup> and that they were attributable in large part to poor performance by employees of

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<sup>327</sup> See *id* at para. 96(v).

<sup>328</sup> *Id* at para. 149.

<sup>329</sup> See *id* at para. 156.

<sup>330</sup> See *id* at para. 146 ("I accept that on their own, the transactions relied upon that took place in Australia would not support the CUP analysis undertaken by the taxpayer. However, particularly in view of the fact there is a global market, putting together all the comparable transactions relied upon by the taxpayer; the burden placed upon the taxpayer is satisfied.").

<sup>331</sup> Even in the short term, one could argue that the Australian operations generated a profit for the group as a whole. The foreign chemical suppliers, for example, may have been less profitable if the Australian subsidiary had not existed since they would have had fewer sales against which to spread their fixed costs. Further, it is possible that the presence of the Australian subsidiary prevented the development of another enterprise that might, over time, have expanded into and therefore reduced the profitability of other SNF affiliates. But see *id* at para. 169 (pointing out that the "SNF group lost some money on its sales to the taxpayer as it was selling to the taxpayer at below the cost of production").

<sup>332</sup> See *id* at para. 170.

<sup>333</sup> See *id* at para. 170.

<sup>334</sup> See *id* at paras 167 – 168.

<sup>335</sup> See *id* at para. 171.

SNF (Australia),<sup>336</sup> in the end the Court felt more comfortable allowing the loss to stand than with lowering the price of the affiliates' products below the price those affiliates would have charged unrelated enterprises.

This case is, at base, like the *Xilinx Inc* case in the US in that the when viewed on a transactional basis, the transactions seem to accord with arm's length norms; however, from the bigger picture perspective, it is hard to believe that the transactions would have taken place on the same terms had the entities not been related. Indeed, it is likely that they would not have taken place at all. Even the Court admitted that "an independent distributor would have exited the marketplace if they made the quantum of losses that the taxpayer had made during the relevant period".<sup>337</sup> Yet this was not enough to make the Court recast the transactions in any way.

## 4. Analysis

Looking over the collection of cases decided in the four jurisdictions reveals two striking facts. The first is that there is no support for the proposition that the courts in these countries<sup>338</sup> have sub silentio adopted a version of the CCCTB or any other formulary methodology. The second and more surprising fact is the relative paucity of cases in which judges claimed to rely on a transactional profit method to determine a transfer price, even among the smaller class of cases in which its use would be plausible.<sup>339</sup> Moreover, regardless of the method of analysis, courts gave full effect to the taxpayers' division of ownership and responsibility between entities. Though it certainly would be incorrect to state that profit split methodologies play no role in the decided court cases, it seems that the courts' use of these methodologies has declined in tandem with increases in their use by tax authorities at the administrative level. The question is what, if anything,<sup>340</sup> this split in methodological preferences means. The possible implications of this split are discussed in this last section of the essay.

### 4.1 The Paucity of Profit Split Cases

Over the past thirty years, transactional profit methods, and particularly profit split methods, have gone mainstream. Once relegated to use by US tax authorities, they

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<sup>336</sup> See id at para. 166.

<sup>337</sup> See id at para. 170.

<sup>338</sup> This is, of course, not a random selection of countries. It is possible that courts in non-English speaking countries – or countries with less of an historical connection to the development of the arm's length method – have been more amenable to formulary approaches to transfer pricing during this period.

<sup>339</sup> There were only sixteen cases decided in the ten year period. Of those sixteen, five raised issues to which the choice between profit split or other methodologies was irrelevant. In only three of the remaining eleven cases could the courts be viewed as relying on a profit split, rather than transactional, pricing methodologies. In those three cases, the profit split methodologies were transactionally based, like the TNMM, rather than formulary in the CCCTB sense.

<sup>340</sup> It is possible, and perhaps even plausible to some, that there are simply too few cases decided at the judicial level for their results to be significant, either operationally or otherwise.

are now part of the arsenal of most tax authorities.<sup>341</sup> Indeed, few question the increasing dependency of national tax authorities on those methods at the audit and administrative resolution levels.<sup>342</sup> However, counterintuitively, national courts seem to be on a different trajectory. While uniformly accepting the use of such methods as a theoretical matter, and perhaps relying on them in a very general and unspecific fashion,<sup>343</sup> courts seem to be if anything increasingly averse to using them to determine specific outcomes in the cases before them. The question is what accounts for this phenomenon.

The most obvious possibility is that the disparity merely reflects case selection. National tax authorities routinely offer taxpayers settlements based on profit split analysis. Taxpayers willing to accept outcomes based on these analyses generally can work out a settlement at the administrative level. The only cases that end up in court involve taxpayers who think they have facts supporting a more favorable result, and such facts generally are derived from comparable transactions. If tax-

<sup>341</sup> See (note 3) (tracing increasing acceptance of these methods in OECD transfer pricing materials).

<sup>342</sup> At the very least, national tax authorities seem to start with a metric, the “average taxpayer”, and then require taxpayers claiming tax results materially different from that average to prove their entitlement to those different tax results. If the economic profile of that “average taxpayer” is reasonably similar to that of the taxpayer in question (often a big “if”), that seems like an intelligent method of identifying audit targets, both at the taxpayer and the individual expenditure level. It is very close at the theoretical and practical level to the IRS’s use of the “DIF” or Discriminate Function, a mathematical function based on information drawn from other taxpayer returns, to identify individuals for audit. See Lederman and Mazza, *Tax Controversies: Practice and Procedure* 91–92; 3rd ed. (2009) (describing use of computer formulas to target US individuals for audit). The IRS reports much more extensive use of the “comparable profits method” and the “profit split” methods than of traditional transfer pricing methods in the context of advanced pricing agreement negotiations, many of which are bilateral or multilateral agreements. See IRS, *Announcement and Report Concerning Advance Pricing Agreements 2010-21* at 567–68 (note 47) (tables of methods used); IRS, *Announcement and Report Concerning Advance Pricing Agreements 2008-27*, 2008-1 CB 751, 766, online at [http://www.irs.gov/irb/2008-15\\_IRB/ar13.html](http://www.irs.gov/irb/2008-15_IRB/ar13.html) (tables of methods used). Nor is the United States alone on this score; Australian tax authorities also seem to start with the presumption that taxpayers have to prove their entitlement to profit results that differ from the norm. See *SNF (Australia) Pty Ltd v Commissioner* (No 2), [2010] FCA 823 paras 6, 12–13, online at <http://www.austlii.edu.au/cgi-bin/sinodisp/au/cases/cth/FCA/2010/823.html> (finding “not unreasonable” tax commissioner’s decision to reject taxpayer’s proffered settlement prior to trial on grounds that it failed to leave the taxpayer “in a position of making a reasonable profit overall during the years in dispute” when rejecting claim for indemnity for legal costs because “[t]he proceedings raised a significant question of law”).

<sup>343</sup> In some of the cases in which courts specifically rejected the tax authorities’ proffered profit split proposals to determine transfer prices, vague notions of appropriate profit splits lurked in the background. In *Veritas Software Corp*, for example, the Court repeatedly stressed the value added by the activities of the Irish subsidiary after the transfer of the software. See *Veritas Software Corp* (note 113), at 309–310 (detailing functions performed by VERITAS Ireland) and 327 (“VERITAS Ireland prospered, not because VERITAS US simply spun off a portion of an established business and transferred valuable intangibles, but because VERITAS Ireland employed aggressive salesmanship and savvy marketing...”). The taxpayer in the *GlaxoSmith-Kline Inc* case presented the reasonableness of the taxpayer’s profits as an argument in its favor. See discussion in note 223.

payers (or their attorneys) are good at assessing the strengths and weaknesses of their cases, one would expect only the strongest cases, with the best facts, to be litigated in court; not surprisingly, taxpayers win a high percentage of these cases.

This is not a wholly convincing explanation, however. After all, tax authorities also have an opportunity to evaluate the strength of taxpayers' legal arguments and factual evidence in the course of the administrative process. If a taxpayer's case is exceptionally strong, one would expect the tax authorities to adjust their settlement offer accordingly. Given the costs of litigation, it is in neither party's interest to go to court if an administrative settlement is possible. Effective separation requires taxpayers to be systematically better at judging the strength of their cases than are tax authorities. It is hard to understand why this would be true. Although taxpayers certainly start out with more information about their pricing decisions than do the tax authorities, it should be in their interest to provide all favorable information to the tax authorities during the administrative process. Thus, it is hard to come up with an asymmetric information story which would explain such disparate evaluations.

Perhaps tax authorities have a different agenda entirely. Rather than minimizing costs by maximizing the number of current settlements, they may have a longer run cost minimization strategy that involves forcing taxpayers to use cheaper to administer profit-split based pricing methodologies. One way of achieving that end would be to increase the cost of using CUP or other traditional arm's length methodologies by ignoring evidence relevant to these methodologies at the administrative level. Although taxpayers may be able to use this evidence to prevail in court, they first have to bear the financial burden of litigation. In many cases, this burden will exceed the tax benefits that may be derived from this litigation. In short, tax authorities may be using the cost of litigation as a club to try to force taxpayers to abandon traditional transfer pricing methods in favor of "more efficient", somewhat formulaic profit split pricing methods. If taxpayers know walking in that the tax authorities will take this position, they may not go to the expense and effort of developing the evidence necessary to pursue traditional pricing strategies. As a result, they may fail to recognize even those situations where a the traditional pricing methodologies would leave them better off. Tax authorities could come out ahead by losing most if not all litigated cases if enough taxpayers are dissuaded from litigating.

It is hard to know whether such an approach would be a cost-effective strategy for a tax authority. But the legal questions raised in the litigated cases (as well as the requirements in many jurisdictions that taxpayers prepare contemporaneous documentation justifying their transfer price determinations) make this strategic explanation implausible. Many of the litigated cases involved discrete legal issues – from the treatment of employee stock options in *Xlinx Inc* to the import of "implicit" capital guarantees in *General Electric Capital Canada Inc*, to the location of profits attributable to particular business advantages (cost advantages in *Compaq Computer Corp*, intellectual property rights in *Roche Products Pty Ltd* and marketing and negotiating power in *DSG Retail Limited*) – tangential to the profit-split versus arm's length debate, in that the answers to these questions impact

outcomes reached under all of the extant transfer pricing methodologies. The remaining cases involved disputes over the comparability of the entities or transactions used to determine comparable prices or profit margins, again legitimate issues under all the pricing methodologies. These do not seem to be the sort of random or petty disputes one would expect to see if litigation was being used by tax authorities simply trying to punish taxpayers for daring to insist on using traditional pricing methodologies.

Having ruled out the strong case and strategic litigation explanations, another possible explanation for the relatively infrequent use of profit split methods in litigated cases remains: taxpayers may be better able to use traditional methodologies than in the past because they have better access to direct evidence of prices and profit margins across a wide variety of transactions. As more taxpayers have become embroiled in transfer disputes, they and the organizations that they participate in seem to have come to appreciate the benefits of sharing information about prices and profit margins. There is much more information available about profit margins (both net and gross) at the industry and sub-industry level in books and other sources put together by accounting firms, consultants and trade associations than there was twenty years ago. Some of what was once regarded as closely guarded trade secrets is now shared knowledge used by both sides in transfer pricing disputes. As a result, taxpayers – and tax authorities – often have several plausible comparators, and with them, several plausible arguments for how a price ought to be set in a given situation.

The cases that did not raise discrete legal issues generally turned on the question of the relative degree of comparability of the proffered comparators. This is precisely the factual issue the OECD's *2010 Guidelines* suggest ought to be the determinative factor in setting transfer prices.<sup>344</sup> The closer the comparable to the transaction under investigation, the less extrapolation is required to determine the appropriate price and the fewer the opportunities for erroneous assumptions about "normal results" to creep in. Even in the absence of a regulatory pecking order of pricing methods, courts preferred evidence of comparable prices to evidence of comparable profit margins; they preferred evidence of comparable profit margins of particular functions to evidence of profit margins of particular types of entities. When taxpayers provided explanations, backed up by evidence, of their departure from industry or transactional norms (excessively high sales costs or abnormally low labor costs, for example), courts took this evidence into consideration whether using a traditional gross profit based pricing or net profit based profit split method. Basically, taxpayers were always rewarded for coming up with evidence countering the assumptions underlying the pricing models employed by tax authorities, or evidence which provided a basis for an alternate pricing calculation. The methodology employed by the courts in these cases, then, may simply reflect the maturing of the transfer pricing dispute process, a maturing that has provided taxpayers with information about the type of evidence, as well as the type of methodologies, courts find

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<sup>344</sup> See OECD, 2010 Guidelines, para. 2.10 at 61 (explaining preference for "higher degrees of comparability").

convincing. It would be surprising if they did not use that knowledge to advance their interests.

Courts' obsession with transactional level evidence and fairness, while generally laudable, does have one serious side-effect: it leads them to underweight the possibility that the overall structure of arrangements between related entities are distorted. The consequences of that flaw are discussed below.

## 4.2 Accepting Structural Arrangements

Functionally based approaches to transfer pricing are consistent with both traditional arm's length pricing methods and OECD approved transactional profit split methods. They also, as described below, may continue to give taxpayers the advantage over tax authorities in transfer pricing cases.

In theory, if all transactions between related entities were fairly (accurately) priced, one would not see higher rates of profit in low tax countries than in high tax countries when the business operations generating the high profits start in high tax countries. That is, even if high value technology is transferred to a low tax subsidiary at an early stage of development, before much of its value has been developed, an accurate transfer price should compensate the transferor for the likelihood that the intellectual property right will generate above market profits. If that likelihood is high, the transfer price should leave the entity carrying out the initial development (and the jurisdiction in which the initial research was carried out) with the bulk or even all of the excessive return. The return to subsequent development activities would generate only a normal return. The same could be said of transfers of business risks. Yet viewed from a number of parameters, entities located in low tax jurisdictions seem to be earning supernormal profits, at least compared to those earned by related companies resident in high tax countries.<sup>345</sup> The question is how that can happen in a world where tax authorities intensively target transactions between related parties for transfer pricing enforcement.

One possibility is that the third party comparables accepted by tax authorities or courts are systematically wrong. Unrelated businesses may not enter into arrangements with third parties under circumstances in which they expect the development of supernormal profits. Thus, the comparison between similar looking transactions entered into between related and unrelated parties may be an apples-to-oranges comparison rather than the apples-to-apples comparison they appear to be. For example, the royalty rates set for normally profitable intellectual property may be an inappropriate comparator for agreements dealing with particularly valuable intellectual property; though the profit margin created through the use of such royalty rates might be appropriate for run-of-the-mill medicines, it might well be inappropriate for truly blockbuster drugs. The distributor's costs (and business risks) may not be as high when it is distributing a blockbuster drug which has few or no substitutes as when it handles more run-of-the-mill items, and thus its profit margin should not be as high. By contrast, the originator of the patent should earn a higher-than-normal

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<sup>345</sup> See studies listed in note 7.

profit. Yet finding evidence that a taxpayer knows of the special features of transferred property prior to transfer may be close to impossible.<sup>346</sup>

Another possibility is that current transfer pricing methods fail to take into account some transfers that are hard to see or price. Although explicit transfers of business risk in the form of insurance (and insurance premiums) are examined and priced, implicit transfers of business risk and business opportunities often are not. For example, when a business sets up a foreign entity to exploit a foreign business opportunity, it not only confers a benefit on that entity in the form (often) of a business plan and a workforce in place, it also implicitly gives the new entity the benefit of a covenant not to compete. No parent company is likely to set up a competitor to its subsidiary. Such covenants may have substantial value because they confer monopoly power – or at least some freedom from competitive pressures – on the subsidiary just as effectively as does a patent or other intellectual property right. Though exclusive license agreements between unrelated parties confer similar benefits, their value may be considerably lower. By virtue of entering into such a relationship with a third party, the unrelated licensor is often admitting that it lacks the capability to effectively exploit the business opportunity being conferred. No such admission can be inferred from a license to a related entity, particularly a newly formed entity. Yet implicit covenants not to compete are never taken into account for tax purposes.

Further, courts generally fail to consider whether a particular allocation of functional responsibilities conforms to arrangements entered into between unrelated parties, and even when they do notice discrepancies, they do not act on that information. In both the *Roche Products Pty Ltd*<sup>347</sup> and *SNF (Australia) Pty Ltd*<sup>348</sup> cases, courts were faced with situations in which loss-making operations continued for years longer than would have been tolerated by an independent enterprise.<sup>349</sup> While the courts realized that the continuation of these operations was effected to further the ends of the overall enterprises, they allowed the taxpayers to allocate the losses to the local enterprises rather than to the parent company or to other members of the international group. Likewise, in *Xilinx Inc*,<sup>350</sup> no one inquired into whether such exten-

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<sup>346</sup> The super-royalty provision added to the end of I.R.C. § 482 was supposed to provide US tax authorities with a mechanism for rectifying such hard to prove inaccuracies. However, its ex post approach continues to be vilified by other nations. See OECD, 2010 Guidelines, para. 2.128 at 99 (“It is critical for the tax administration to acknowledge that the taxpayer could not have known what the actual profit experience of the business activity would be at the time that the conditions of the controlled transaction were established. Without such an acknowledgement, the application [of the transfer pricing method]...would be contrary to the arm’s length principle....”).

<sup>347</sup> *Roche Products Pty Ltd* (note 278).

<sup>348</sup> *SNF (Australia) Pty Ltd* (note 318).

<sup>349</sup> In the Roche case, this was true only of the diagnostics division. See the discussion contained at text and notes 303 – 12. In SNF, the Australian operation generated nothing but losses for 13 years, a result the court admitted would have been unacceptable to any third party enterprise, yet the court refused to disturb the loss allocation. See *SNF (Australia) Pty Ltd* (note 318), at paras 170 – 71.

<sup>350</sup> *Xilinx Inc*, 598 F3d 1191.

sive stock option compensation agreements were employed by participants in cost sharing arrangements entered into between unrelated entities.

National tax authorities and legislatures increasingly seem to be sensitive to these structural problems. Whether they will come up with effective mechanisms for dealing with them remains to be seen. Some forced restructuring – not just repricing – may become possible in the US under the temporary regulations discussed (but not applied) in *Veritas Software Corp.*<sup>351</sup> The outcome in that case may have been different if different if the Court had accepted the IRS's characterization of the transaction as “akin to a sale”. The language contained in paragraph 247(2) of the Canadian Income Tax Act should also allow Canadian tax authorities to make such arguments<sup>352</sup> while the tax authorities in the UK might be able to stretch the language found in schedule 28AA to do the same.<sup>353</sup>

Finally, even perfect transfer pricing enforcement will not undo the damage created by imperfect source rules or treaty arrangements that allow for the double non-taxation of income. Taxpayers do not have to be related to take advantage of rules that treat income attributable to marketing intangibles as income from the sale of inventory rather than royalties.<sup>354</sup> Related taxpayers may be in a better position to take advantage of the gaps and inconsistencies of such rules because they are more attuned to joint tax minimization, but better transfer pricing rules alone will not solve these sorts of problems.

## 5. Conclusion

Both taxpayers and tax administrators have learned a great deal about transfer pricing methods in the last twenty years. Interestingly, much of that learning has been used by taxpayers to enhance their ability to use traditional, transactionally based methods to defend their chosen transfer prices, countering tax authorities' push towards use of profit split – though not formulary – methods for setting prices. Although the accuracy of these transactional methodologies has improved in some respects, serious flaws remain. Some maintain that these flaws are responsible for income allocations regarded as implausibly favorable to taxpayers. Others are more sanguine, or more suspicious of the alternatives, such as formulary taxation. This survey of recent cases provides some support for both of these perspectives.

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<sup>351</sup> See text and accompanying notes 121 – 124.

<sup>352</sup> See text at notes 153 – 55.

<sup>353</sup> See text at note 228 – 32.

<sup>354</sup> See note 220.

# Comments on Julie Roin: “Transfer Pricing in the Courts: A Cross-Country Comparison”

*Andreas Oestreicher*

## Abstract

*Based on a brief summary of the research question, on the methodological approach, and on the results of the paper under discussion the following comments on Julie Roin’s paper focus on two major concerns involving both methodological aspects and the expected subject of transactional profit methods. A first reservation concerns the low number of court cases which may hardly provide a reliable basis for general statements both in terms of numbers and the selected sample. This reservation results from a review of the court cases subjected to analysis and a classification of these cases by type of transaction. The second reservation concerns the expected characteristics of (one-sided) profit methods in relation to the (two-sided) profit split method. It emerges that these methods differ in more aspects than they have in common. The use of one-sided profit methods does not necessarily take place in the context of a profit split methodology and should also not be confused with replacing the arm’s length prices with a version of formulary taxation. Doubt may arise, however, whether a simple allocation of profits using one or more allocation keys is in line with the behavior of third parties dealing at arm’s length.*

## 1. Introduction

In the interests of contributing to the interdisciplinary debate on the issue of transfer pricing, as a business economist I am glad to comment on Julie Roin’s paper regarding “Transfer Pricing in the Courts: A Cross-Country Comparison” dealing with the question of whether “Profit Split Methodology [is] a way to Formulary Allocation: Lessons from Recent Transfer Pricing Cases” (as was initially indicated in the title). When I first read that the paper concerns “all the transfer pricing cases decided in four English speaking nations (the U.S., the U.K., Canada, and Australia) within the last 10 years” I was somewhat alarmed: would I manage to read the paper and look at the relevant court cases in time? Fortunately, the paper consists of “only” some 50 pages and has to cover no more than 16 court cases. However, when taking into account the fact that transfer prices frequently have to be determined on the basis of multinational enterprise structures which are in themselves often highly complex, it will be apparent that sophisticated content, arguments, and impacting factors have to be presented and assessed. As a consequence the numerous pages required by the courts in reaching their opinion already make it clear that analyzing transfer pricing court cases for the purposes of the paper at hand must have constituted a time-consuming and laborious task. My comments on this paper refer to a November 2010

version of the manuscript referred to in the following as Roin, 2010. This version may deviate from the one presented in the conference proceedings.

## 2. Research Question

As a result of the “White Paper” on inter-company pricing put forward by the U.S. Treasury in 1988, transactional (net) profit methods gained new international acceptance. Accordingly, both the OECD and national legislators extended their canon of admissible transfer pricing methods. Statistics make it clear that profit methods enjoy considerable popularity in practice. In Advance Pricing Agreements, which are typically concluded in cases where the facts and circumstances are of high complexity, application of profit methods clearly dominates.<sup>1</sup> Moreover, it is reported that “national tax authorities with the connivance of judges, are now using profit split methods to surreptitiously replace the arm’s length standard for setting prices with a version of formulary taxation”, so that while legislative bodies still argue “whether the arm’s length method should be discarded in favor of formulary taxation, some say in practice formula taxation already exists” (Roin, 2010, 1). Against this background the question considered in the paper by the author is “whether some countries or some courts have gone beyond small-scale incorporation of formulary approaches to something approaching full scale formulary taxation in the guise of implementing the ‘profit split’ method of arm’s length pricing”. (Roin, 2010, 6).

## 3. Methodological Approach

In seeking an answer to her research question, the author takes the approach of conducting a survey covering all the transfer pricing cases decided in four English speaking nations (U.S. [5+2], UK [2], Canada [4], and Australia [3]) within the period of the last 10 years. To this end, she provides a brief description of the facts and circumstances of the cases, records the positions of the petitioner or appellant and of the respondent involved, states the court decisions, and offers a short concluding comment.

## 4. Results

On the basis of her survey, the author comes to the conclusion that there are “no examples of courts devising profit splits based on the factors used in current formula apportionment schemes”. Moreover she even reports that “profit split methodology” is applied in only a very few cases. Her observations reveal rather “that judges used more traditional arm’s length methodologies to explain the pricing decisions they

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<sup>1</sup> In the USA, for example, the profit methods account for some 80 percent of transfer pricing arrangements, cf. IRS, 26. 2. 2007, IRB 2007, 769; IRS, 27. 3. 2008, IRB 2008, 751; IRS, 27. 3. 2009, IRB 2009, 760; IRS, 29. 3. 2010, IRB 2010, 551: in this context, the preference appears to be for some form of a comparable net profit method (some 65 percent), whereas the profit split method accounts for some 10 percent.

reached”, which in her view is very probably due to the fact “that in most situations, there is now enough information to make the profit split largely unnecessary”. For the judges, the evidence seems to be the more convincing the greater the similarity between the transactions under investigation and the comparable transactions. Even if no fixed order is prescribed, it further becomes apparent, she maintains, that a comparable uncontrolled price is preferred to comparable gross margins, whereas net margins are only in third place when it comes to application. Moreover, she finds that the judges “often rejected the tax authorities’ attempt to use a profit split mechanism”. Finally, she concludes that “even when the courts used a ‘profit split’ the distinction between that method and a traditional transactional method was slight” (Roin, 2010, 2, 49 et seq.). In addition, the “courts’ obsession with transactional level evidence and fairness” is believed to have the serious side-effect that the courts give too little weight to the overall structure of arrangements between the related entities. Explanations given are that (1) third party comparables are systematically wrong, (2) current transfer pricing fails to take account of business transfers, and (3) the benefits of headquarters’ “supervisory” services are not properly taken into account (Roin, 2010, 50 et seq.).

## 5. Comments

### 5.1 General

The present paper and its results may not be received without a certain amount of concern. This concern involves both methodological aspects and aspects of content. However, I share the author’s conclusions with regard to possible distortions concerning the overall structure of related entities, even if these conclusions do not emerge directly from her examination of the court cases. These are also the grounds on which Germany introduced a new provision subjecting transfer of functions to taxation and on which the OECD brought in a new chapter on business restructurings. Moreover, the author deserves applause for her observation that the benefits of headquarters’ “supervisory” services may scarcely be assessed in their entirety on the basis of transactional level evidence.

### 5.2 Methodological Issues

My first reservation is of a methodological nature. It concerns the low number of court cases, which in view of (1) the complexity of multinational enterprises and (2) the numerous differences between the courts theoretically and actually dealing with these cases (level of the court, location, jurisdiction, professionalism, etc) may, for reasons of the numbers alone, hardly provide a reliable basis for general statements. Besides, these cases do not form a representative and coincidentally selected sample of the universal picture. [Table 1](#) provides an overview of the court cases subjected to analysis. [Table 2](#) classifies these cases by type of transaction.

**Table 1:** Overview of relevant court cases

Jurisdiction	#	Case	Date	Transfer pricing issue	Outcome
U.S.	1	H Group Holding, Inc.	1999	Provision of services ; use of valuable trademarks and other intellectual property	Royalty rates found in 3rd party franchise agreements; comparables based on gross rather than net profits: the court decided that the comparables on which the IRS's profit split was based were inapt
	2	Compaq Computer Corp.	1999	Purchase of electronic components (local cost advantages)	Comparable uncontrolled prices adjusted instead of a modified cost-plus or profits based fourth method
	3	DHL Corp.	2002	Use of valuable trademark	DHLI's contribution towards the development and maintenance of trademarks was considered to make DHLI a developer or assister of the foreign trademark
	4	Xilinx, Inc.	2010	Sharing of employee stock option costs under a cost sharing agreement	Costs that unrelated parties would share are required to be shared, i.e. employee stock option costs to be included
	5	Veritas Software Corp.	2009	Resources, research and development effort related to software products and software manufacturing processes; payments for pre-existing property?	The court accepted the taxpayer's comparison with comparable 3rd party licence transactions although these agreements did not give the other party the right to use its software as a platform for new software that would compete with the existing software
	6	Boeing Co.	2003	Development expenses to particular airplane models under development	Allocation of research and development expenses must not be made on the basis of "product category"
	7	National Westminster Bank	1999	Amount of interest costs deductible in a permanent establishment context	The Court held that the IRS was not allowed to substitute its regulatory formula for an individualized examination
Canada	1	Gulfmark Offshore N.S. Limited	2007	Allocation of deductible (interest) expenses equal to the percentage of revenue	For purposes of determining the interest expense that should be taken into account, a tracing rule should be applied
	2	Ontario Limited	2009	Sale of manufactured equipment and related promotional material	Use of the CUP method, with the parent company's sales to US customers serving as comparables for the sales to a Barbadian subsidiary
	3	General Electric Capital Canada Inc.	2009	Value of related party guarantees regarding debt to third party creditors at reduced borrowing costs	No reimbursement for the "cost" or benefit of the implicit guarantee arising out of a related party status (like stewardship expenses); payment for an explicit guarantee only to the extent that this raises the credit rating above the level that would have existed due to implicit guarantee
	4	GlaxoSmithKline, Inc.	2010	Transfer price of a chemical component purchased, packaged and resold under the terms of a license agreement	The license agreement (covering the use of a valuable trademark) has to be taken into account in determining whether the amount paid was reasonable
U.K.	1	Waterloo plc et al	2002	Involvement in an employee stock option plan (deductible business expenses)	Allocation of costs among the various subsidiaries ought to be made through a formula
	2	DSG Retail Limited	2009	Income derived from reinsuring the contractual obligations of warrantors from selling warranties on electrical goods	Determination of the subsidiary's income employing a "profit split method" (normal return on its capital for the sub whereas the entire residual profit is assigned to the principal)
Australia	1	Daihatsu Australia Pty Limited	2001	Transfer pricing of imported motor vehicles	Use of a TNMM profit split (?) to determine the appropriate transfer price was accepted ("a far cry from formulary taxation")
	2	Roche Products Pty Limited	2008	(Lease and) sale of prescription drugs [for the most part finished pharmaceutical products], over the counter drugs, and diagnostic equipments as well as agents used by the hospital	As to generic products the court accepted a resale price mechanism; regarding consumer products the parties agreed on some "profits based methodology" (EBIT), disputing on whether this profit had to be realized with respect to each of the drugs (no) or to the division as a whole (yes); as to the diagnostics division, the government again adopted a profit based method (operating margin based on profits earned by comparables)
	3	SNF (Australia) Pty Limited	2010	Manufacturing and selling chemicals used in mining, paper processing, and sewage treatment	The Court rejected the view that it was inappropriate to use the CUP method at all (and work backward from what the Commissioner thought SNF (A)'s net profit should have been based on the argument that there was a global market.

The court cases available relate in large part to transactions which can be valued separately and for which more or less direct comparable values can be ascertained. The court decisions, however, also include a not insignificant number of transactions for which international administrative practice and – in cases concerning permanent establishments – the provision of many (if not all) double tax treaties forego a sophisticated arm’s length test, offering instead simple allocations (Table 2).

**Table 2:** Classification of relevant court cases by type of transaction

Type of transaction	No. of cases	Detailed subject	Transfer pricing method applied
Purchases	6/8	Printed circuit assemblies (Compaq), manufactured equipment (Ontario), generic drugs (GlaxoSmithKline <sup>2</sup> ), motor vehicles (Daihatsu), patented drugs, OTC drugs and diagnostic equipment (Roche), and medical products (Australia SNF)	Comparable price method (4), transactional net margin method (3), resale price / gross margin method (1)
Specific expenses	5	Employee stock option plans (Xilinx) and research and development (Boeing) under a cost sharing agreement, interest costs in a permanent establishment context (Bank, Gulfmark), and employee stock options in an affiliated enterprise setting (Waterloo)	Allocation (5)
Royalties	3	Trademarks and trade names (H Group Holding, DHL), and software (Veritas)	Comparable uncontrolled transaction method (2), assister rules (1)
Services	1/2	Management functions (H Group Holding) and guarantee of debt to third party creditors (General Electric)	Comparable uncontrolled price method (1), some fourth method (1)
Others	1	Business opportunity (DSG)	Transactional net margin method (1)

With reference to purchases, the high availability of comparable data is apparent in that in four instances it was possible for the cases to be resolved on the basis of comparable uncontrolled prices.

<sup>2</sup> On March 24, 2011 the Crown’s application for leave to appeal to the Supreme Court of Canada in the case of GlaxoSmithKline Inc. was granted, as was the taxpayer’s application for leave to cross-appeal.

The cases dealing with expense allocation may be seen as having only slight relevance to the question pursued by the paper. Twice the issue addressed the question of whether employee stock option costs may be charged on in the group; one further question concerned whether research and development costs have to be allocated according to the specific model or the product category; finally, the permanent establishment cases were about whether departures must be made from the interest allocation acceptable and usual in the permanent establishment situation (in the permanent establishment context the OECD introduced the arm's length test for interest costs only in 2010).

Courts were also able to identify comparable prices for two out of three royalty transactions and one out of two services transactions, while only in one case the taxpayer sought to apply a profit split. In the case of DHL trade name development the court applied "assister rules", as was still permissible at this time, thereby making determination of prices unnecessary.<sup>3</sup>

As far as the services cases are concerned, it was not possible to achieve a clearly understandable comparison of prices or margins when determining an arm's length price of an explicit guarantee from the parent company in relation to the impact which a company's group membership has on its reputation in general. In this case the court carried out a not precisely defined split of the advantage between the parties.<sup>4</sup> In the case involving the transfer of a business opportunity due to the given allocation of functions the obvious course was to allocate a normal return for carrying out the insurance service, whereas the residual profit was left for the principal company.

My methodological reservation regarding the poor sample is recognized also by the author when she writes that usually only cases come to court of taxpayers "who think they have facts supporting a more favorable result [in comparison to the results of a profit split analysis, amendment in brackets added by the present author], and such facts generally are derived from comparable transactions" (Roin, 2010, 47). In the eyes of the author, this argument, however, relates to the question of why profit split cases are so few and far between. But for her this point is of no significance when it comes to the question of whether or not it is admissible to draw generalizations from the results.

## 5.3 Conceptual Issues

### 5.3.1 General

A second reservation deals with the question of content. It concerns the characteristics of the (two-sided) profit split method in relation to the (one-sided) profit methods. Moreover, it appears to me to be necessary to go into the differences

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<sup>3</sup> Concerning the attribution of intangible assets, the U.S. Treasury now prefers legal to economic ownership; moreover the excess expenditure test has been abolished, cf. Sec 1.482-4T(f)(3),(4) U.S. Treas.Reg.

<sup>4</sup> On December 15, 2010, the Federal Court of Appeal, Canada, dismissed appeal with costs, Federal Court of Appeal, Ottawa, Ontario, Docket: A-1-10.

between the profit split method and formulary apportionment. I am convinced that due to the differences between these two concepts the current legal situations in the countries do not allow any scope “to replace the arm’s length standard for setting prices with a version of formulary taxation” (Roin 2010, 1). If one compares the profit split approach with the concept of formulary apportionment it emerges that these approaches have more to divide them than they have in common.

### 5.3.2 Profit Methods and Profit Split Methods

The paper defines profit split method as “in some sense any pricing method which uses non-price information from comparable taxpayers or transactions to determine an arm’s length price”. In this sense also the resale price method, the cost plus method – both of which determine the taxpayers’ remuneration using a gross margin, the transactional net margin method (TNMM) and the comparable profits method are all profit split methods. When applying the resale price method, the appropriate transfer price is calculated by subtracting from the price paid by a distributor’s (unrelated) customer an amount equal to the distributor’s appropriate “gross profit margin”. The cost plus method takes the cost of goods produced by a manufacturer as the point of departure and adds to this cost the “gross profit margin” determined to be appropriate for the manufacturer. Finally, the TNMM works with net profit margins with respect to certain transactions or groups of transactions, while the comparable profits method looks at the overall profits earned by entities performing similar functions. The author’s reason for classifying these “profit methods” as “profit split methods” is the consideration that since in all cases “there are at least two entities involved, proper allocation requires determining the profits of all participating entities. [...] Each entity is assigned the proper return for its ‘routine’ contributions first with the remaining profit allocated to the entity performing [...] non-routine functions or contributing valuable intellectual property rights” (Roin 2010, 4).

The profit split method may make use of the differentiation between “routine” and “non-routine” contributions (resulting in the attribution of a routine profit element to the routine contribution and the residual to the “entrepreneur”). If this is the case the gross or net margin methods function as an integral part of the profit split method; they do not, however, solve the issue of allocating the residual profit in the event of there being more than one entity making non-routine contributions. With a view to solving the issue of splitting the (residual) profit earned by more than one entity making non-routine contributions (“profit split”), the OECD discusses several approaches for estimating the division of total or residual profits to which independent entities would have agreed. Prominent examples are the contribution analysis, the capital employed method, or the comparable profit split method.

Irrespective of this, the OECD Guidelines make it clear that one-sided methods (e.g. the resale minus method or the transactional profit method) “only require examining a financial indicator or profit level indicator for one of the parties”.<sup>5</sup> Moreover,

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<sup>5</sup> OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2010), (hereinafter referred to as OECD, 2010), 3.20

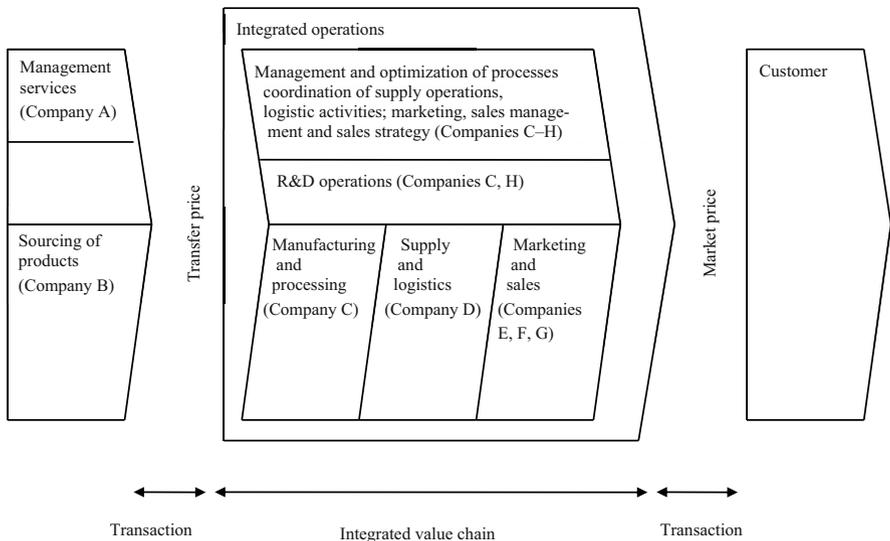
“once a one-sided method has been chosen, there is no need to take account of financial data of the other party” (OECD 2010, 3.22).

### 5.3.3 Profit Split Method and Formulary Apportionment

Besides the necessary differentiation between the “profit methods” and the “profit split methods” it should also be noted that the profit split method and the concept of formulary apportionment are based on different foundations.

The determination of corporate taxable income according to the concept of formula apportionment uses a fixed formula to divide the (consolidated) group income of corporations among the members of the corporate group. To this end, formula apportionment requires common definitions of taxable income, consolidation, and apportionment formulae. The determination of group income includes a loss offset at group level and may include the elimination of intercompany profits. As far as apportionment mechanisms are concerned, it emerges that assets, number and cost of employees, and sales get the highest levels of approval.

The transactional profit split method, on the other hand, is of a transactional nature. It first identifies the profits to be split for the associated enterprises from the controlled transaction. It then splits those combined profits between the associated enterprises on an “economically valid basis”. In this context, the profit split method neither necessarily includes all transactions of a controlled enterprise nor is it required to include all associated enterprises that together form a consolidated group.



**Figure 1:** Value chain of a given group of companies

As a consequence, in the example above (Figure 1), the application of a profit split may be limited to the companies C to H, whereas the services of the companies A

and B have to be valued on the basis of comparable transactions. Moreover, it is conceivable that companies C to G, while performing routine functions (manufacturing and processing, supply and logistics, and marketing and sales) separately, for which routine margins can be determined, are characterized by integrated management and cooperation with respect to research and development. Consequently, the business relationships may be best reflected if the profit from the integrated operations (market price minus transfer price less routine profits elements attributed to the companies C to G in return for their performing routine operations) is allocated according to a certain allocation key among the companies involved. In this process, it is possible for the residual profits arising in the management and research and development area to be differentiated and shared out among the participating enterprises according to different appropriate allocation keys. Under a contribution analysis, the division of combined profits is often based on the relative value of the functions performed by each of the associated enterprises participating in the controlled transactions. In practice, however, the division of profits under a transactional profit split method is generally achieved using one or more allocation keys, so that in this regard the differences between the profit split method and formulary apportionment become obscured. Hence, doubt may arise whether the simple distribution of profits among the parties involved based on their contribution to the coalition given by the multinational enterprise, is in line with the arm's length principle, because according to this principle companies are expected to look first and foremost at maximizing their own profit rather than maximizing that of the group as a whole. These doubts appear also to have occurred to the OECD. According to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration, an alternative approach could seek to replicate the outcome of bargaining between independent enterprises in the free market (OECD 2010, 2.122). Here the question changes into how to allocate the profits resulting from the sale of a product or service between the parties to the transaction, taking account of both their unique and valuable contributions and all their alternatives for action.<sup>6</sup>

## 6. Conclusion

The research question of Julie Roin's paper is whether, in the context of allocating income among the companies of a multinational enterprise, some countries or courts de facto support formulary taxation "in the guise of implementing the 'profit split' method of arm's length pricing". The author finds "that judges used more traditional arm's length methodologies to explain the pricing decisions they reached", which in her view is very probably due to the fact "that in most situations, there is now enough information to make the profit split largely unnecessary", while often rejecting the tax authorities' attempt to use a profit split mechanism (Roin 2010, 2). As a result, the courts' fondness for "transactional level evidence and fairness" is

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<sup>6</sup> A nice example for this kind of analysis is given by Vögele, Gonnet and Gottschling, *BNA Tax Planning International Transfer Pricing* (11/2008), 1 et seqq.

believed to have the serious side-effect that the courts give too little weight to the overall structure of arrangements linking the related entities.

I have some reservations whether the present examination of actual court decisions support these findings. First, there are only few court cases that by the nature of the underlying transactions are subject to a profit split. Given the multitude and complexity of intra-group transaction, the number of court cases dealing with transfer pricing issues does not offer a sufficient basis to produce empirically valid results. Moreover, the use of one-sided profit methods (resale minus method or TNMM) as is documented to be applied from time to time does not evidence the use of a profit split methodology, as this use does not necessarily take place in the context of the application of the (two-sided) profit split methodology.

Second, not only does the profit split method differ from the profit method, but also the profit split method from formulary apportionment. Application of the profit split methodology, therefore, should not be confused with replacing the arm's length standard for setting prices with a version of formulary taxation. However, in order to reflect the notion of companies dealing at arm's length in an integrated setting, the profit split approach should take account of the action alternatives open to the participating players in the transactions subject to the profit split.

Nevertheless, I share the author's conclusions that focusing on transactional level evidence and fairness tends to result in a failure to take proper account of the integrated nature of multinational enterprises, even if these conclusions do not emerge directly from her examination of the court cases.

## **Part 4:**

### **Separate Accounting, Profit Split and Formulary Apportionment**

# Assessing the Normative Differences Between Formula Apportionment and Separate Accounting

Thomas A. Gresik

## Abstract

*Formula apportionment and transfer pricing are the two common responses by governments to the problem of apportioning the income of multi-state businesses in order to calculate state by state tax liabilities. This paper grounds the current debate over the efficacy of these two methods by arguing first, that the fundamental differences are due to adverse selection and moral hazard problems, and second, that the fundamental economic differences are tied to how each method influences firm investment and output decisions. In this context, each method for apportioning corporate income to each state generates its own set of economic inefficiencies. This paper argues for the importance of a normative comparison of formula apportionment and transfer pricing to assess their economic inefficiencies and describes some recent research that quantifies the differences between these two methods.*

## 1. Introduction

The tremendous growth in transnational economic activity over the last few decades has led many countries and international organizations to re-evaluate and in some cases redesign the methods used to calculate the taxable income earned by multinational firms in each country in which it conducts business. Separate accounting is the most commonly used system and has been used by countries for over 50 years. Formula apportionment is the system used at the sub-national level in many countries and its use dates back at least to American states in the early 1900s. Recent interest in formula apportionment by the European Commission has elevated the debate about the relative merits of separate accounting versus formula apportionments to the multinational level. The purpose of this brief essay is to summarize some of research on the economic differences between these two systems. The particular focus will be on the normative properties of each class of systems as opposed to the positive or equilibrium behavior induced by specific implementations of each system.

Fundamental to a system of separate accounting is the concept of an arm's-length transfer price. Whenever a multinational firm conducts an intra-company transaction, a transfer price is set by the firm to shift taxable income from the downstream subsidiary receiving the good or service to the upstream subsidiary providing the good or service. In practice, multinationals set their transfer prices to reflect both the economic valuation of the transaction and differences in corporate tax rates applied by the local jurisdictions of the downstream and upstream firms. To moderate the profit-shifting incentive, countries routinely audit the transfer

prices of multinational firms. Penalties are assessed if a country can determine that a transfer price differs significantly from an arm's-length price, that is, the price at which two unrelated companies would make a comparable transaction. Because many intra-company transactions involve proprietary knowledge or specialized intermediate products, identifying the correct arm's-length price can be difficult. Several of the other papers in this volume discuss some of the legal and accounting challenges associated with defining arm's-length prices. Over time a number of "best practices" for determining arm's-length prices have been developed and the Organization for Economic Cooperation and Development (OECD) has been instrumental in helping countries identify and/or develop these best practices and in promoting a level of harmonization in separate accounting guidelines. In the most recent revision of transfer price guidelines, the OECD takes a clear position on the separate accounting/formula apportionment debate stating, "OECD member countries ... do not consider global formulary apportionment a realistic alternative to the arm's-length principle". (OECD 2010, 1.21) Key objections to formula apportionment include the fact that apportionment formulas are "arbitrary and disregard market conditions" (OECD 2010, 1.25), that "[c]ontrary to the assertions of its advocates, global formulary apportionment may in fact present intolerable compliance costs" (OECD 2010, 1.27), and that "[d]ifficulties would also arise in determining the sales of each member and in the valuation of assets" (OECD 2010, 1.28).

Formula apportionment systems attempt to sidestep the problem of valuing every intra-company transaction by requiring a company to report its total worldwide profit (or union-wide profit in the case of the EU) to each country and by then using a pre-determined formula to allocate total profit to each country. The most common formulas are based on the company's shares of labor costs, assets, and revenues in each country. Depending on the specific factors used in a given formula, formula apportionment can, but need not, avoid costly auditing and compliance costs. Since the conference associated with this volume took place, the European Commission (EC 2011) has taken the opposite position of the OECD and recommended the adoption of a formula apportionment plan referred to as the Common Consolidated Corporate Tax Base (CCCTB). The rationale for this recommendation can be found in the Commission's earlier-stated goals to promote "greater efficiency, effectiveness, simplicity and transparency in company tax systems and remove the hiatuses between national systems which provide fertile ground for avoidance and abuse" (EC 2001, p.10)

Clearly, both the OECD and the EC positions reflect concerns about compliance costs, economic efficiency given market and firm heterogeneity, and valuation accuracy. The fact that both organizations reached different conclusions could be due to differences in the relative weight put on each concern or it could be due to differences in how each organization conceptualizes the broader economic problem separate accounting and formula apportionment methods are intended to solve. To better understand the role of social preferences in the evaluation of both systems and to better understand the broader economic rationales for each method, it would be helpful to develop a model in which the general problem of profit allocation arises, alter-

native separate accounting and formula apportionment methods can be assessed, and the role of preference differences can be incorporated.<sup>1</sup>

## 2. The Fundamental Economic Problem

Separate accounting and formula apportionment are reactions by governments to three challenges created by multi-jurisdictional firms: cost or revenue complementarities across subsidiaries, the inability of governments to perfectly observe key economic characteristics of each firm (private information), and the inability of governments to observe all economic decisions made within each firm (moral hazard). In the absence of economic complementarities, a multinational firm is just a set of independent companies and the task of calculating each subsidiary's national income is no different than the task of calculating a domestic firm's taxable income. In this case, none of the challenges to taxing multinationals described in Gresik (2001) exist. Even with complementarities within a multinational, if governments have complete information about all dimensions of a multinational's operations and opportunities, then first-best non-distortionary tax policy can be implemented without resorting to either transfer prices or apportionment formulas. The presence of moral hazard reflects the reality that when tax policy relies on realized firm costs, either those observed directly or those determined by transfer prices, tax rate differences across countries create the incentive for a firm to manipulate its costs to shift both the real and the apparent location of its worldwide taxable profit and private firm information inhibits the ability of governments to back out these manipulations. Any successful, comprehensive multinational taxation policy needs to acknowledge these three primary reasons that distinguish multinational taxation from domestic taxation.

The perspective organizations use to evaluate the many different economic effects of competing profit allocation methods is also important. The most basic perspective views the profit allocation problem as an *ex post* problem. The multinational's decisions have already been made. Each country then need only figure out how much of the multinational's realized worldwide profit to claim as taxable income. This view neglects the fact that by specifying a set of procedures for allocating a firm's profit across several countries, future investment and production decisions of multinational firms will be affected. The reality is that both separate accounting procedures and apportionment formulas distort each multinational's economic decisions. Both methods create different economic distortions so the true issue is which method creates socially less costly distortions. This second perspective also misses a third important effect: tax competition. In addition to influencing the economic decisions of multinationals, the profit allocation rules a set of countries

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<sup>1</sup> One dimension of this debate I will not take up in this paper is the issue of compliance costs. Mintz (2004) emphasizes the potential for lower compliance costs associated with formula apportionment consistent with the EC position while Hellerstein and McLure (2004) correctly point out that some factors, such as assets, suffer from the same valuation issues as do transfer prices, which is consistent with the OECD position. Since the formula proposed by the EC includes asset shares, some potential for "avoidance and abuse" will persist.

adopt will also influence the incentives countries face to set their corporate tax rates. For example, the incentives for a firm to use its transfer prices to shift profits into a low-tax country also create an incentive for countries to lower their tax rates on the margin. This means a group of countries, such as the EU, may need to trade off differences in profit-shifting incentives against differences in tax competition incentives.

There is a large literature that focuses on the effects of separate accounting on firm decisions and a smaller but still sizable literature on the effects of formula apportionment on firm decisions. Fewer papers exist that seek to compare the two methods in a common economic framework and that seek to assess their tax competition implications. Key papers in this emerging literature include Sørensen (2003), Gérard (2005), and Nielsen, Raimondos-Møller, and Schjelderup (2010). These papers analyze both methods when governments have complete information about firm decisions and characteristics and in which all firms are identical. Kind, Midelfart, and Schjelderup (2005) also includes a role for trade costs. None of these papers allow for firm heterogeneity and all are positive (equilibrium) studies that compare a specific separate accounting method to a specific apportionment formula. Gresik (2010a) extends this literature by introducing heterogeneous firms to allow for differential economic benefits and costs regardless of which profit allocation method is used and private information to reflect the fact that governments lack full information about each firm to determine a socially optimal profit allocation. For the purposes of this discussion, two results from Gresik (2010a) are worth noting. First, comparing separate accounting with imperfect auditing of transfer prices to an apportionment formula that depends only on revenue shares, separate accounting will generate lower equilibrium tax rates than formula apportionment if auditing is sufficiently accurate. Otherwise, a revenue-share formula creates stronger tax competition incentives. Second, both methods create profit-shifting incentives that differ significantly depending on the economic characteristics of the multinationals.

### **3. Incorporating Differences in Social Preferences**

With both separate accounting and formula apportionment creating incentives that influence firm decisions and corporate tax rates, the EC focus on efficiency is very appropriate as is the OECD emphasis on choosing a method that can accommodate variations in market and firm characteristics. In order to assess the positions of both organizations, two analytic hurdles still must be addressed. First, separate accounting and formula apportionment are terms that refer to an infinite number of possible regulations for evaluating transfer prices and an infinite number of formulas. Any specific equilibrium analysis, as in the above papers, is subject to the criticism that one simply chose a poor set of separate accounting rules or a poor apportionment formula or, in line with the OECD's critique of formula apportionment, the specific procedures may appear arbitrary. Ideally, one would like to identify and compare the best separate accounting rules and the best apportionment formula. Second, the optimal rule or formula one identifies will depend on the preferences of the group of countries with regard to the different sources and levels of inefficient investment

and production decisions and of tax revenues. Within the economist's toolbox, the techniques of mechanism design allow one to deal with the first hurdle and taking a normative approach which seeks to identify the best feasible outcomes across all possible social preferences allows one to deal with the second hurdle.

#### **4. Normative Differences between Separate Accounting and Formula Apportionment**

Gresik (2010b) develops a methodology for comparing the normative differences between separate accounting and formula apportionment and reports on some initial comparisons. The paper seeks to derive the firm-specific outcomes or allocations generated by the optimal separate accounting method and by the optimal formula apportionment method from the perspective of a union of two countries whose preferences value tax revenues, multinational profit, and/or the benefits of output in the union (e.g. consumer surplus). Firms have private information about their technological efficiency related to intermediate good production and firms can influence the realized costs the union can observe in each country through managerial decisions that are not observable outside the firm. Differences in private information across firms create a heterogeneous set of firms and a potentially heterogeneous set of responses by firms to any profit allocation procedures adopted by the union. Tax rates are set exogenously so the paper does not address the issue of tax competition incentives.

The analysis captures two basic ideas. The first is a firm's private information and its private decisions create opportunities for the firm to earn information rents through its strategic response to the union's profit allocation rules. These rents represent a social cost to the union. Thus, one difference between the optimal separate accounting rule and the optimal apportionment formula will come from how these two methods generate or limit information rents. The second is that with heterogeneous firms, even a simple rule or formula that appears to "disregard market conditions" (OECD 2010) can reflect differences in market conditions through the decisions of each firm.

The analysis shows that the optimal separate accounting rule and the optimal apportionment formula will generate economically important differences in firm decisions, firm profits, and union welfare. These outcome differences are due to a fundamental difference in how separate accounting and formula apportionment calculate tax revenues and the critical difference is in how the two methods influence a firm's unobservable choices. To identify the link between the profit allocation method and a firm's internal decision suppose there are two countries in the union. A multinational conducts final good production and sells its final good in both countries but final good production requires an intermediate good that is only produced in country 1. In this case, intermediate good production is the source of a cost complementarity between the multinational's subsidiaries. A firm's internal (unobservable) decisions affect the level and rate of change of its intermediate good costs at the expense of its unobservable costs or vice versa. An example of this trade-off in the context of separate accounting is where a multinational will increase its purchases of

the intermediate good from an outside supplier at a price above its own marginal costs (the value of which associated with the outsourced level of production being unobservable to those outside the firm) in order to establish a high-price comparable. Let  $t_1$  denote the corporate tax rate in country 1 and let  $t_2$  denote the corporate tax rate in country 2.

Under separate accounting, the firm sets a transfer price that shifts  $TP$  dollars from country 2 to country 1. Then the firm's after-tax economic profit can be defined as

$$\begin{aligned} \text{After-tax economic profit} = & (1 - t_1)(\text{Net Country 1 Revenues} - \text{Intermediate} \\ & \text{Good Costs}) \\ & + (1 - t_2)(\text{Net Country 2 Revenues}) + (t_2 - t_1)TP - \text{Unobservable Costs.} \quad (1) \end{aligned}$$

The "Unobservable Cost" term reflects opportunity costs that inform the firm's decisions but are not subject to taxation because tax authorities cannot credibly measure them and capital (equity) costs that are also important for calculating economic profit but not taxable profit. One can also include tax haven costs in this category.

If country 1 is the low-tax country, then a one Euro increase in  $TP$  will increase the firm's after tax profit by  $t_2 - t_1$  Euros. This is the classic profit-shifting effect that transfer price regulations seek to limit but in a world of private firm information do not eliminate. Moreover,  $TP$  depends on the transfer price the regulations ultimately allow the firm to set and the volume of sales in country 2. This means the transfer price regulations will distort the firm's production and, to the extent that the regulations employ procedures such as Cost-Plus or a transactional profit method that rely on observable revenues and costs, the regulations will distort the firm's internal decisions and result in higher observable costs (in effect to support higher transfer prices), lower unobservable cost, and higher total costs. The separate accounting methods transmit these cost inefficiencies through country 1's tax rate, because realized costs in country 1 are tax-deductible while unobserved costs are not, while the transfer revenues determine a firm's rent. Thus, the optimal transfer price regulations give the union the ability to influence firm output and rents at the cost of less efficient firm production.

Under formula apportionment, a formula based on the firm's observable decisions and its observable revenues and costs in each country determines its effective tax rate. Let  $A$  (*observable revenues and costs, production levels*) denote the fraction of the firm's union profit taxed in country 1. The firm's effective tax rate equals  $T = At_1 + (1 - A)t_2$  since the apportionment formulas effectively defines an average of both countries' rates. This effective tax rate can vary for every firm since the formula depends on production and resource decisions made by each firm. Now a firm's after-tax economic profit under formula apportionment can be defined as

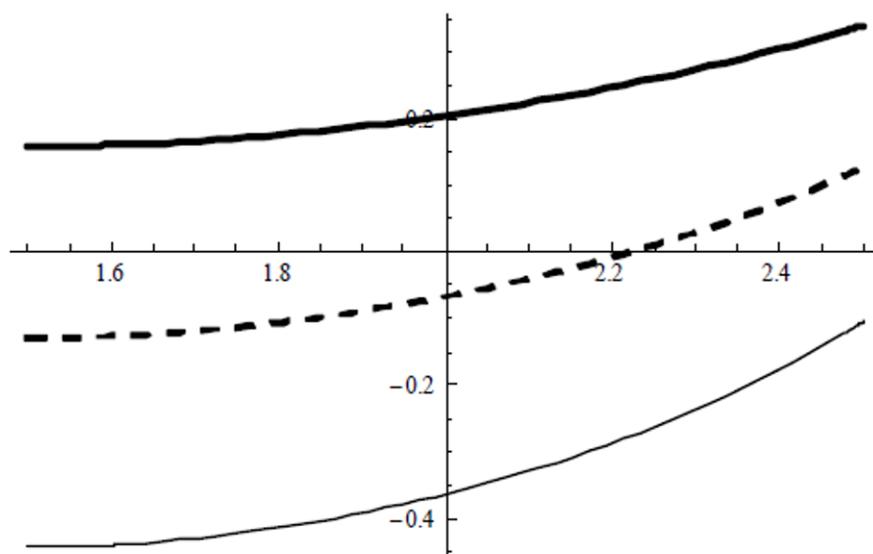
$$\begin{aligned} \text{After-tax economic profit} = & (1 - T)(\text{Net Country 1 Revenues} + \text{Net Country 2} \\ & \text{Revenues} - \text{Intermediate Good Costs}) - \text{Unobservable Costs.} \quad (2) \end{aligned}$$

Note that in the absence of unobservable costs, the effective tax rate under formula apportionment is non-distortionary which would mean that, contrary to empirical

studies such as Hines (1996), firm decisions are unaffected by the countries' tax rates. The key feature of (2) is that since the effective tax rate the firm faces depends on the apportionment formula, the apportionment formula can now influence a firm's internal decisions. With formula apportionment, the right formula can increase each firm's cost efficiency. This advantage comes at the cost of reduced control over firm rents because all the incentive effects from an apportionment formula are transmitted through the effective tax rate.

An analysis of the differences in the after-tax economic profit definitions of equations (1) and (2) shows that the fundamental trade-off between optimally designed separate accounting and formula apportionment rules is that of rent extraction (which affects tax revenues) versus cost efficiency. In some cases, the optimal apportionment formula can leave all firms with significantly higher economic rents relative to the optimal separate accounting formula. If country 1's tax rate is low, the efficiency distortions generated under separate accounting will also be small and the union welfare losses from extracting fewer firm rents are larger than the efficiency gains. In this situation, the OECD position favoring separate accounting is consonant with the EC goal of overall economic efficiency. Higher tax rates in country 1 generate larger efficiency distortions under separate accounting. Now the gains to union welfare from greater cost efficiencies can more than offset the welfare losses from less rent extraction and thus support the EC's position.

Interestingly, the welfare differences between formula apportionment and separate accounting are not uniform across firms, and if one ranks firms in terms of technological efficiency (each firm's private information), then the welfare differences favoring formula apportionment increase as technological efficiency decreases.



**Figure 1:** Tax revenues under formula apportionment minus tax revenues under separate accounting as a function of a firm's technological efficiency for three different country 1 tax rates ranging from low (thin solid line) to intermediate (dashed line) to high (thick solid line).

Figure 1 is based on a detailed example worked out in Gresik (2010b) for the case when the union is interested in maximizing tax revenues across all firms. All three curves show that formula apportionment has the best prospect for raising higher tax revenues than separate accounting from the least technologically efficient firm. This occurs because the optimal apportionment formula provides the strongest cost-efficiency-improving incentives by offering larger marginal rents to the firms with the greatest technological advantage (low value types in Figure 1) and to the firms with the lowest technological advantage (high value types in Figure 1) in order to increase the taxable income of these firms. In contrast, the optimal separate accounting rules provide the strongest cost-efficiency-improving incentives to the firms with the greatest technological advantage, and do so at a lower rent cost than the optimal apportionment formula. The impact on tax revenues from all firms is captured by the average effect. Figure 1 confirms the argument presented above that the optimal separate accounting rules will be preferred by the union when country 1's tax rate is low. At the lowest tax rate reflected in Figure 1 (thin solid line), the average effect is negative and at the highest tax rate (thick solid line) it is positive.

## 5. Concluding Remarks

As the national economies of the world become increasingly integrated and the role of multinational firms increases, the costs associated with using any particular profit allocation method will increase. These costs can either be direct accounting and legal costs or they can be reflected in the economic distortions national profit allocation procedures create. In this essay, I have focused on the latter and have emphasized that a fundamental trade-off inherent in the choice between a separate accounting system and formula apportionment is between rent extraction, for which separate accounting has an advantage, and cost efficiency, for which formula apportionment has an advantage.

At a scientific level, Gresik (2010b) represents the first model that allows one to derive the features of optimal profit allocation methods in a setting with heterogeneous firms, private firm information, and moral hazard. Extensions of this work to include multiple factors and two-way flows of intermediate goods can be incorporated in a straightforward fashion. Adding in tax competition effects will require more substantive changes in the analysis. While more research, both theoretical and empirical, needs to be conducted, the current results can help frame discussions about the substantive differences between separate accounting and formula apportionment.

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# Profit Split, the Future of Transfer Pricing? Arm's Length Principle and Formulary Apportionment Revisited from a Theoretical and a Practical Perspective

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## Abstract

*This article compares the Profit Split Method (“PSM”), one of the transfer pricing methods for the application of the arm’s length principle, with Formulary Apportionment (“FA”) which is discussed as an alternative to the arm’s length principle as such. In the course of this article, we analyze and compare both approaches, in particular by considering compliance costs, resource allocation, and transition costs. Even though at a first glance FA might be viewed as similar to the PSM (or even more advanced), we demonstrate that there are crucial differences between both approaches. Based on our analysis, we conclude that FA is not an alternative to the application of the PSM. In contrast, we believe that the PSM will gain more and more importance in future. Therefore, we present our proposals to further improve the institutional framework for the application of the arm’s length principle in general and the PSM in particular. Our proposals will help to decrease double taxation, and it will lead to lower compliance costs for the taxpayers as well as for the tax authorities.*

## 1. Introduction

In the discussion on international taxation of cross-border activities of multinationals the following notions are discussed:

- Practically, the profit split method gains more and more importance in order to comply with the arm’s length principle (among other reasons discussed below) because it can be applied in situations even when no sufficiently comparable uncontrolled transactions are available;
- The profit split method is in some important aspects comparable to a formulary apportionment approach; and
- The arm’s length principle, and in particular the profit split method, seems in practice to be too difficult to apply. The prevalence of the arm’s length principle thus leads to significant inefficiencies for tax authorities and multinationals. Formulary apportionment is often said to provide a solution to overcome the inefficiencies caused by the arm’s length principle.

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One potentially could draw the conclusion based on the notions discussed above that in the context of international taxation of cross-border activities of multinationals switching to the formulary apportionment would provide an improvement regarding the overall economic efficiency as

- the profit split method and the formulary apportionment are broadly comparable to each other anyway;
- the profit split method in practice is the method that can be reliably applied in many situations; hence switching to the formulary apportionment would not constitute a complete change; and
- formulary apportionment is able to avoid the drawbacks of the arm's length principle.

This has also been raised during the latest hearing before the Committee on Ways and Means US House of Representatives, on July 22, 2010. For example Martin A. Sullivan, Economist and Contribution Editor Tax Analysts commented: *“The arm's length method is seriously flawed in both theory and practice. (...) Modifying the arm's length standard will not get the job done. The only credible long-term solution is the defenestration of the arm's length standard and its replacement with formulary apportionment methods.”*

In the course of this article we argue that such a conclusion is not appropriate. In contrast, in our view there exists no alternative to the arm's length principle. In particular, we will show that

- although in practice, standard transfer pricing methods are often not applicable, especially because of the lack of sufficiently comparable data, the profit split method provides an approach that is suitable to resolve the cross-border transactional situations of multinationals; and
- there are crucial differences between the profit split and the formulary apportionment approach.

Furthermore, we discuss the advantages and disadvantages of the profit split method versus the formulary apportionment with respect to

- compliance costs of all participants (taxpayer, tax administrations, courts etc.);
- the resource allocation of MNEs;
- transition costs for changing from the arm's length principle to the formulary apportionment.

From this we follow that there is no need to switch from the arm's length principle to formulary apportionment because it would most probably not increase but would instead decrease overall economic efficiency. In contrast, the profit split method as such, in particular if one takes into account the revised OECD Guidelines, is an appropriate transfer pricing method that will be applied much more in future. The reason is that it is suitable to take account of the deficiencies of other OECD transfer pricing methods and therefore provides a basis for an efficient resolution of international taxation of cross-border activities of multinationals.

However, in practice there are some obstacles regarding the application of the arm's length principle in general and the profit split method in particular. These are related to the institutional framework for multinationals and tax authorities and lead to inefficiencies in the context of international taxation of cross-border activities. These obstacles are not a result of the conceptual framework of the arm's length principle as such but result from the current institutional framework for the application of the arm's length principle / the double tax treaties by tax administrations and multinationals. In this respect, it would be crucial to improve the institutional framework in the context of international taxation of cross-border activities for multinationals and tax authorities in order to increase the overall efficiency regarding the application of the arm's length principle.

This article is structured as follows. Section 2 explains why in practice the profit split method gains more and more importance. Section 3 analyzes the concepts behind the profit split and the formulary apportionment and shows the similarities and differences. Section 4 discusses the advantages and disadvantages of the profit split method vs. the formulary apportionment by considering compliance costs, resource allocation, and transition costs. Section 5 presents different measures regarding the improvement of the institutional framework relevant in the field of international taxation of cross-border activities for multinationals and the application of the profit split method in particular. Section 6 provides a summary and the conclusions of the article.

## **2. The Gaining Importance of the Profit Split Method**

The following section discusses why the profit split method in practice gains more and more importance in order to comply with the arm's length principle.

With the revision of Chapter I – III of the OECD Guidelines, the OECD Guidelines acknowledge the increasing importance of the profit split method. Major changes in Chapter I – III of the OECD Guidelines include, among other things, that the profit split method is not any longer considered as a method of last resort, and much more guidance on the application of the profit split method, including examples, is now provided. This increasing importance of the profit split method can be understood based on a comparison of the profit split method with other OECD approved transfer pricing methods.

The profit split method is a two or multiple-sided method, whereas all other transfer pricing methods are one sided methods, i.e. it does not only determine the arm's length price or income of one taxpayer in a transaction and the income of the other taxpayer involved in the transaction results as a residual, but it determines a profit allocation for both participants / the overall group.

Furthermore, it can be the case that no sufficiently comparable third party data for a specific transaction is available. Nevertheless, based on the arm's length principle, the profits of such kind of transactions can be split with reference to how unrelated parties in a similar situation would distribute the profits between them. This is exactly achieved with the application of the profit split method. Therefore, through the application of the profit split method an arm's length approach can often be deter-

mined even if no sufficiently comparable third party data for the specific transaction is available.

According to the OECD Guidelines, the profit split method applies to situations with highly integrated and interdependent activities, especially if core value drivers – as significant IP – and risk taking are distributed over the jurisdictions where the multinational is active. As this applies to very many business models of multinationals, in particular when merger and acquisition deals occurred recently, for which in addition no direct sufficiently comparable data is available the profit split method is often the most appropriate approach to take account of complex international business models and supply-chain organization in order to comply with the arm's length principle.

In the course of the profit split method, the overall income from certain transaction flows, i.e. the system profit of certain cross-border business activities is split, instead of analyzing cross-border activities on a transaction by transaction basis. This may allow balancing off-setting effects and could provide a more reliable picture of the overall business conditions underlying the individual transactions between the related parties.

Overall, the profit split method compared to the other OECD transfer pricing methods has specific advantages, and taxpayers and tax authorities should prefer it over other OECD transfer pricing methods. The specific advantages include that<sup>1</sup>

- a profit allocation in line with arm's length principle and OECD guidelines can be derived, even in cases when no comparable uncontrolled transactions for single transactions are available;
- the profit split method can take account of complex situations when entrepreneurial functions, core value drivers of the business, and risks are spread over different entities. Thus, it can take account of complex cross-border activities and supply chains. It is therefore a more holistic approach which takes into account the overall profit of a business and it avoids double taxation because only the actual income / loss is distributed according to the arm's length principle;
- the profit split method offers a solution for highly integrated operations for which a one-sided method may not be appropriate. In the course of the globalization, driven by the employees' higher cross-cultural competence and enhanced IT systems, more and more multinationals have started implementing highly integrated business models, making it necessary to use the profit split method to comply with the arm's length principle. A common example is the financial service industry with its global trading activities or its investment banking division where fees are shared accordingly;
- world-wide integrated markets yield to tougher competition in local markets. To differentiate products from products offered by competitors, unique and valuable contributions like specific know-how and patents gain more importance. At the same time this makes it difficult to find comparable third party data. It may be the

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<sup>1</sup> Para. 2.109 OECD Guidelines (2010).

- case that reliable comparables information might be insufficient in order to use other transfer pricing methods than the profit split method;
- specially, in cases where both parties to a transaction make unique and valuable contributions the profit split method can be more appropriate than a one-sided method as e.g. the transactional net margin method. This is in particular true in the case of mergers and acquisition where often both companies involved own their own unique IP. Due to the globalization and world-wide integration, M&A activities will rather increase than decrease, making the use of the profit split method more necessary;
  - also the importance of services and marketing is increasing to gain competitive advantages in the service economy. In such cases the unique and valuable contributions are generally made by the different local entities making the profit split method the most appropriate method in most cases. This does not only relate to classical service providers, e.g. to consulting companies, but also to more traditional industries, e.g. the automotive industry. Moreover, it can be observed that products are developed together with competitors making the products as such relatively comparable. The development of the electrical motor is a recent example for this ongoing trend. Subsequent competition between the producers takes place with respect to the portfolio and quality of services that are provided in connection with the product. Often the local entities are responsible for the respective services and therefore for the unique and valuable contributions; and
  - additionally, in some cases multinationals try to achieve synergies through implementing so-called Central Entrepreneur models, including the centralization of IP. Centralization of IP is mostly done to enhance the efficiency of involved processes. It lowers the costs of transfer as well as communication and coordination, and allows a better control of the IP portfolio. In the course of the centralization, the existing local IP is often phased-out over a certain period of time where at the same time new IP is build up at the location of the Central Entrepreneur. During this transition period relevant IP is owned by several companies, once again making the use of the profit split method necessary.

Therefore, the profit split method should be the transfer pricing method of the future if the arm's length principle and the OECD Guidelines prevail.

### **3. Profit Split Method and Formulary Apportionment Compared**

In the following the concepts behind the profit split method and the formulary apportionment are described in more detail.

#### **3.1 Profit Split Method**

The OECD Guidelines state several transfer pricing methods that can be used to establish whether the conditions in the commercial or financial relations between related parties are consistent with the arm's length principle. Besides the traditional transaction methods, the OECD Guidelines mention two transactional profit methods. Traditional transaction methods require the use of prices or gross margins

agreed by independent third parties as the basis of testing the arm's length character of related party prices. Transactional profit methods test the profit results earned by related parties through the profit results earned by comparable uncontrolled third parties as the means of determining whether related party transfer pricing is consistent with arm's length principle. The mentioned transfer pricing methods fulfill the arm's length principle as they are generally based on a comparison of the conditions in a controlled and in an uncontrolled transaction.

According to the OECD Guidelines the selection of a transfer pricing method should always aim at finding the most appropriate method for a particular case. The OECD Guidelines do not longer provide a priority in selecting a transfer pricing method; however, in a case where a traditional transaction method and a transactional profit method can be applied in equally reliable manner, the application of a traditional transaction method is preferred over the application of a transactional profit method. In addition, the OECD Guidelines provide for the application of "other methods", given that the prices identified using this method satisfy the arm's length principle in accordance with the OECD Guidelines.

The focus of this article lies on the profit split method, which is especially applied in transactions where two or more of the related parties make valuable and unique contributions or the related parties commonly own significant intangible assets, whereas these intangible assets considerably impact the total group profit. In general, the profit split method allocates operating profits or losses from controlled transactions in proportion to the relative contributions made by each party in creating the combined profits or losses. Relative contributions may be determined by functions performed, risks assumed, resources employed, and costs incurred.

In order to apply the profit split method, one must first identify the relevant profit to be split between the related parties. In a second step, these combined profits are split between the related parties in an economically reasonable way that approximates the division of profits as it would occur between independent parties.<sup>2</sup>

In order to split the combined profits of a controlled transaction, the relevant transactions must be identified in advance. If accounting standards between the parties differ, this could influence the determination of the profits to be split and should also be consistently adjusted before. The total distributable profits are then generally allocated in two stages.<sup>3</sup> In the first stage, each participant gets a certain part of the profit ensuring an appropriate return for the type of activity performed. This basic return is determined on the basis of market returns achieved for similar types of activities by independent enterprises. Therefore, each participant is allocated an arm's length remuneration for its non-unique contributions in relation to the controlled transaction. In the second stage, any residual profit / loss is split. The key issue of the profit split method is how to allocate the remaining overall profit (residual). The first approach to split the residual profits is based on data from possible com-

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<sup>2</sup> Para. 2.108 OECD Guidelines (2010).

<sup>3</sup> This description relates to the so called residual profit split method (see para. 2.121 OECD Guidelines (2010)). An alternative approach is the contribution analysis.

parable uncontrolled transactions, i.e. split of profit between unrelated parties.<sup>4</sup> A second approach according to the OECD guidelines is to determine a split how unrelated parties would have split the residual profit in the respective situation.<sup>5</sup> Thus in practice, often one or more allocation keys are used that best reflect the contributions of the parties. The underlying assumption is that a split between unrelated parties would be correlated with the contribution of each party. Therefore, in practice often split-ratios are based on the value or the costs of assets or activities contributed by the parties. The use of more than one allocation key requires weighting each key. Nevertheless, the choice of the right allocation key strongly depends on the kind and circumstances of the transactions.

### 3.2 Formulary Apportionment

The formulary apportionment is not a method to determine an arm's length allocation of profits according to the OECD Guidelines and is therefore not in line with Art. 9 of the OECD Model Tax Treaty. The formulary apportionment is mainly applied by U.S. state governments and Canadian provinces for domestic taxation purposes. This approach arose in the U.S. as it seemed impossible to account separately for each income which is earned in different, but highly economically integrated states. The method behind the formulary apportionment is to use one of various formulas to apportion the total profits of a firm. The apportionment is mainly based on the location of sales, payroll, and property.<sup>6</sup> The factors can be weighted identically or differently in the formula. Furthermore, the formula can include all factors or only parts. The first formulary apportionment approach applied by the U.S. state governments was the so-called "Massachusetts formula" which used sales, payroll and property factors equally weighted.<sup>7</sup> Over time, sales were weighted more, which is interpreted as an attempt to improve the taxing's state competitive position.<sup>8</sup> In Germany only the trade tax (the so-called Gewerbesteuer) follows the formulary apportionment approach, whereas the apportionment depends on the payroll of each plant.<sup>9</sup>

In general, three steps are necessary to apply formulary apportionment: First, all subsidiaries and branches comprised in a multinational have to be determined. Second, the profits of each subsidiary are accumulated to the global profit which is allocated in the third step, according to the respective formula, to each unit subject to taxation.

The OECD Guidelines highlight that the formulary apportionment should not be confused with the profit split method.<sup>10</sup> The formulary apportionment uses a formula that is predetermined whereas the profit split method allocates the profits on a case-

<sup>4</sup> Para. 2.133 OECD Guidelines (2010).

<sup>5</sup> Para. 2.134 OECD Guidelines (2010).

<sup>6</sup> Gordon and Wilson (1986).

<sup>7</sup> See Hellerstein and McLure (2004), who provide a detailed theoretical foundation of standard formulary apportionment factors.

<sup>8</sup> See Mazerov (2001).

<sup>9</sup> See sec. 29 GewStG (Gewerbesteuergesetz).

<sup>10</sup> Para. 1.18 OECD Guidelines (2010).

by-cases basis with respect to what comparable independent enterprises would have earned in comparable circumstances. In particular, according to the OECD Guidelines, the formulary apportionment should not be confused with the use of a formula agreed upon by the tax administrations and the taxpayer after considering the individual facts and circumstances. Such formulas may result from mutual agreement procedure, advance pricing agreement, or other bilateral or multilateral determination.

### 3.3 Numerical Example

In the following we provide a simple numerical example to illustrate the differences between the profit split method and formulary apportionment. We consider a simple set-up where Company A in country a produces a widget and sells the widget to Company B in country b. Company B adopts the widget for local market purposes and sells the reworked widget in country b. The picture below summarizes the supply chain.

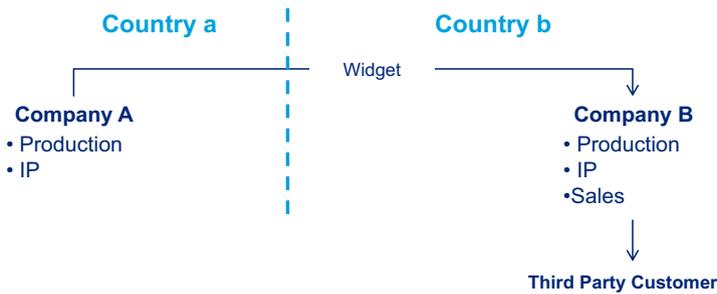


Figure 1: Simple setup

We assume that Company A uses IP for its production process with a fair market value of 900. Company B, for localization purposes, uses IP with a fair market value of 100. Both developed the respective IP on their own risks and are the sole owner of the respective IP. Further, Company A (Company B) uses assets with a market value of 100 (50) in the course of its production process (Capital Employed). The final widget is sold at a market price of 300 in country b. Pure production costs incurred amount to 200 for Company A and 50 for Company B. These production costs exclude any intercompany transfer prices.

Company A		Company B		Consolidated	
Revenue	TP	Revenue	300	Revenue	300
Costs	200	Costs	TP+50	Costs	250
<b>Profit</b>	<b>TP-200</b>	<b>Profit</b>	<b>250-TP</b>	<b>Profit</b>	<b>50</b>
<i>Capital Employed for Production: 100</i>		<i>Capital Employed for Production: 50</i>		<i>Capital Employed for Production: 150</i>	
<i>Value of IP 900</i>		<i>Value of IP 100</i>		<i>Value of IP 1.000</i>	

Figure 2: Resulting profits and losses

**Profit Split Analysis**

1) Total Profits 50

2) Routine Remuneration

For Production: 10% on Capital Employed  
For Distribution: 1% on External Revenue

Production	10	Production	5	
Distribution	0	Distribution	3	
<b>Total</b>	<b>10</b>	<b>Total</b>	<b>8</b>	<b>Total</b>

3) Residual Profit

Total 32

4) Allocation of Residual Profit based on IP Value

Total IP Value	1.000	Total IP Value	1.000
Value of IP (A)	900	Value of IP (B)	100
Share of Residual Profit	29	Share of Residual Profit	3

5) Target Profit

Production	10	Production	5
Distribution	0	Distribution	3
Residual Profit	29	Residual Profit	3
<b>Total Profit</b>	<b>39</b>	<b>Total Profit</b>	<b>11</b>

6) Resulting Arm's Length Transfer Price

TP=239

7) Resulting P/Ls

	Company A	Company B	Consolidated
Revenue	239	300	300
Costs	200	289	250
<b>Profit</b>	<b>39</b>	<b>11</b>	<b>50</b>

8) Resulting Split of Taxation Rights

Taxable Profits	39		11
<i>in %</i>	78%	<i>in %</i>	22%

**Figure 3:** Taxable profits and losses using the profit split method

For the example considered, it is assumed that an arm's length routine remuneration for the function production amounts to 10% of the capital employed. Furthermore, for the function distribution to third parties, it is assumed that a routine remuneration of 1% on third party revenue is arm's length. Market analyzes have shown that third parties allocate their residual profits proportionally to the value of the respective IP. This results in a split ratio of 90:10 of the residual profit as 90% of the relevant IP is owned by Company A.

Overall, the profit split method allocates the taxation rights of 78% of the consolidated profits to country a and 22% to country b.

In case of formulary apportionment the split of the combined profits depends on the actual formula applied. In our case if a pure sales-based formula is used<sup>11</sup>, 100% of the consolidated profits would be allocated to country b and no taxable profits would be allocated to country a. If a more sophisticated formulary apportionment is

<sup>11</sup> Such a formula is e.g. recommended by Clausen and Avi-Yonah (2007).

applied, e.g. as advocated by Avi-Yonah, Clausing and Durst (2008)<sup>12</sup>, the actual result might be also quite different compared to the profit split method’s result. As proposed by Avi-Yonah, Clausing and Durst (2008), we assume that each entity receives first a basic remuneration for its activity performed. For our numerical example we assume a mark-up of 10% on capital employed. The residual profit would then be split e.g. based on the allocation key third party sales.

**Formulary Apportionment**

1) Total Profit					50
2) Basic Remuneration 10% on Capital Employed					
Basic Remuneration	10	Basic Remuneration	5	Total	15
3) Residual Profit					35
4) Allocation of Residual Profit based on External Sales					
External Sales	0	External Sales	300		
Attributable Profit	0	Attributable Profit	35		
8) Resulting Split of Taxation Rights					
Taxable Profits	10		40		
<i>in %</i>	<i>20%</i>	<i>in %</i>	<i>80%</i>		

**Figure 4:** Taxable profits using formulary apportionment

Such an approach would result in an allocation of 20% of the consolidated profits to country a and 80% to country b.

Comparing the different approaches shows clearly that the methods can yield completely different results.

Taxable Profits	Country a	Country b
Profit Split Method	39	11
Formulary Apportionment		
Pure sales based	0	50
Capital employed/ sales based	10	40

**Figure 5:** Comparison of profits using the profit split method and formulary apportionment

## 4. Discussion of Advantages and Disadvantages Arm’s Length Principle vs. Formulary Apportionment

In the following, the advantages and disadvantages of the profit split method and the formulary apportionment are discussed. Generally, there are three main types of cost associated with the profit split method compared to the formulary apportionment:

- Pure compliance costs resulting from the fact that multinationals may have incentives to shift profits to low tax jurisdictions by using transfer prices and that tax

<sup>12</sup> Avi-Yonah, Clausing and Durst (2008).

authorities have an incentive to use their tax assessment power to maximize tax revenue. In practice these costs are primarily related to complying with transfer pricing regulations and tax audit controversy (including the resources of the tax administrations). Such compliance costs at least on the side of the companies could be potentially avoided with the application of the formulary apportionment and the elimination of intercompany transfer prices.<sup>13</sup>

- Efficiency costs with respect to the resource allocation of multinationals. Such costs may be different in the case of the profit split method compared to the formulary apportionment.
- Furthermore, the transition from one system to another system may result in substantial transition costs.

## 4.1 Compliance Costs and Profit Shifting

Before analyzing compliance costs in detail, we perform a high-level review of the relevant empirical literature on profit shifting of multinationals. There is the common notion that multinationals can easily use transfer prices under the arm's length principle to shift profits to low tax jurisdictions even though a huge amount of resources is invested in compliance work. Consequently, it is argued that the arm's length principle in general and the profit split method in particular, does not work in practice. This would provide a strong argument to switch to the formulary apportionment. However, based on our understanding of the empirical literature the finding of profit shifting under the arm's length principle is not well established. One should be careful to draw too fast conclusions based on the studies available. After having discussed the empirical evidence on profit shifting, we analyze the different kinds of compliance costs in more detail.

### 4.1.1 Empirical Studies about Profit Shifting

Based on our review of the available literature, so far no direct evidence of income shifting is present since this would require detailed information on intercompany transactions of multinationals. Most of the empirical literature presents indirect evidence, especially the early papers dealing with highly aggregated data.<sup>14</sup> One main problem with such indirect evidence is that in most of the analyses the performance and characteristics of the multinationals and subsidiaries are not directly controlled,

<sup>13</sup> Mintz and Smart (2004) state that in the case of the US there is the broad perception that interstate profit shifting practices would “presumably” not be very successful due to the formulary apportionment applied.

<sup>14</sup> See e.g. Grubert and Mutti (1991), Hines and Rice (1994), Klassen et al (1993), Harris (1993), Harris et al (1993), Collins et al (1998), Grubert (1998), Grubert and Slemrod (1998), Demirgüç-Kunt and Huizinga (2001), Bartelsman and Beetsma (2003), Grubert (2003), Desai et al (2006), Huizinga and Laeven (2008), and Weichenrieder (2009); Furthermore, for the US there are also studies using tax filings data and presenting correlations between pre-tax operating margins and the countries' tax base (Treasury Department, 2007), and between the average tax rates and the countries' shares of the business (Government Accountability Office, 2008). For a survey of the early empirical evidence see Hines (1999). A more recent survey is provided by Devereux (2006).

i.e. the unobserved firm effects.<sup>15</sup> Also many analyses can only determine correlation between variables that indicate income shifting and its possible channels, but without identifying the causal relationships.<sup>16</sup> Additionally, most of the papers were concerned with the US and evidence about other economies is only recently becoming available.<sup>17</sup>

The situation is partially improving with the increasing availability of more detailed micro-econometric data, also for other economies, that allows the researchers to account for differences not only between countries, but also between companies and industries.<sup>18</sup> E.g. Clausing (2003) is becoming increasingly cited as being one of the few papers presenting direct evidence for income shifting by using transfer pricing. He finds e.g. that a tax rate 1% lower in the country of destination is associated with intrafirm export prices that are 1.8% lower relative to non-intrafirm goods for US firms. Even more striking, Bernard, Jensen, and Schott (2008) find that related-party sales by a firm compared to arm's length sales by the same firm for the same product to the same country in the same month using the same mode of transport is on average 43% lower. However, both papers are not able to control for facts and circumstances surrounding the transactions considered. In particular, the studies cannot control for the functions carried out and risks borne by the trading parties. To ensure arm's length transfer pricing, the respective functional and risk profile must be reflected in the intercompany transfer prices used. This may obviously lead to the fact that market prices differ to intercompany prices for a similar widget if the functional and risks profiles of the trading parties are different. Also the OECD Guidelines explicitly require that the following five comparability criteria are met to directly compare market prices with intercompany prices:<sup>19</sup>

- Characteristics of the property or services;
- Functions performed and risks assumed as well as assets used;
- Contractual terms;
- Economic circumstances of the parties; and
- Business strategies pursued

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<sup>15</sup> Hines (2003) states that analysis employing aggregated data may obscure the unobserved variation across industries and firms. In a study of the determinants behind dividend payments from foreign affiliates to parent companies, Desai, Foley and Hines (2007) found that after controlling for the country and branch effects, tax rates do not influence payout ratios of foreign branches in a significant way.

<sup>16</sup> For example Desai, Foley and Hines (2004) found that foreign investments by American multinational firms are financed with significantly more debt in high tax countries than in low tax countries, reflecting the benefits of interest deductions in high tax countries. This pattern holds both for related party debt and for the much larger (in dollar volume) category of unrelated party debt, the latter of course being unaffected by any transfer price manipulation.

<sup>17</sup> Devereux (2006) and Weichenrieder (2009).

<sup>18</sup> E.g. micro-level data is now available through the database Amadeus or MIDI (German Central Bank)

<sup>19</sup> See para. 1.34 et seq. OECD Guidelines (2010)

Consequently, it is not clear to us that these studies really prove that MNEs use non-arm's length transfer prices for their intercompany trading as the studies are not able to control for these five comparability factors.

Further, one important issue is on how to measure an effective tax rate.<sup>20</sup> Most of the empirical literature considers the tax levied on corporate profit. However, some authors argue that this approach is problematic given the complexity of legal frameworks of corporate tax liabilities.<sup>21</sup> For instance, liabilities can be agreed with tax authorities many years after the period of study from which the data was obtained. Additionally, in many cases the researcher cannot observe yet the precise tax payments in any jurisdiction, or a multinational may be liable for further taxes on profits repatriated to the parent company.

Another important issue is regarding the causal relationships between the studied variables. With the availability of more detailed micro-economic data, adequate structural models that enable the formulation of sound empirical and econometric analysis for hypothesis testing are necessary. While in the past researchers were forced to test only reduced specifications and correlations due to data limitations, future econometric studies can include a more comprehensive theoretical framework that defines the interrelationships and causality issues.<sup>22</sup>

Based on our experience made in practice, we have practical evidence that multinationals are less concerned about optimizing their corporate tax rate as it may be generally assumed. First, we observe that in countries like Japan, a country with one of the highest tax rates in the world, domestic multinationals have the strong tendency to move profits to Japan due to cultural reasons. In Germany we also often observe that multinationals have a strong preference for smooth tax audits and consequently do not use possible tax saving strategies. Second, if a multinational really wants to engage in profit shifting, then this has consequences for its supply-chain organization. Consequently, business restructurings, including moving people and assets, would be required to ensure that enough substance in the low-tax jurisdiction is available. Otherwise, so-called CFC rules generally prevent MNEs from allocating profits to "postboxes" in low-tax jurisdictions. Regularly, we find that multinationals are often not ready to interfere in existing and well established processes only for tax reasons. Every change has to be supported by the employees as otherwise the implementation is normally not feasible. Substantial changes just for tax reasons are very difficult and are generally not advisable.

A point where we feel that further analyses are required is the definition of profit shifting. Obviously, shifting profits by not complying to existing tax rules is tax fraud and inappropriate profit shifting. However, the discussion begins to be more difficult in case a multinational would reallocate its risks. Generally, based on the

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<sup>20</sup> Stöwhase (2005), Devereux (2006) and Volkering and De Haan (2001) provide a survey of the conceptual and practical problems when calculating tax rates.

<sup>21</sup> Stöwhase (2005) and Devereux (2006).

<sup>22</sup> For instance see the emerging literature and working papers using European and German data: Baghadasarayn et al. (2010), Buettner et al. (2009), Overesch and Schreiber (2008), Dischinger (2007), Buettner and Wamser (2007), and Overesch (2006).

arm's length principle, an entity that bears more risks should on average also earn a higher profit, *ceteris paribus*. Is this something that should be classified as "profit shifting" even though the multinational is in full compliance with the regulations? Does it make a difference if the risk is moved for economic reasons, e.g. economies of scale due to a central risk management system? Is achieving tax savings an appropriate economic reason?

Overall, we conclude that the existing evidence on profit shifting should be interpreted with caution. If profit shifting was easily possible, we would not observe a fierce tax competition between the different jurisdictions. James R. Hines summarizes this point in a neat way in his recent testimony before the Committee on Ways and Means to United States House of Representatives on July 22, 2010: *"This revenue loss [from inappropriate transfer pricing] is obviously not complete, as we and other countries still collect substantial tax revenue from multinational firms; and the evidence that tax rates significantly influence international investment patterns also implies that taxpayers are unable to manipulate transfer prices to allocate taxable income between countries at will. If it were otherwise – if multinational firms were able to earn money in one place and adjust transfer prices to report all of the income to have been earned elsewhere – then there would be no reason to concentrate productive investments in low tax parts of the world. Since there is ample and convincing evidence that tax rates significantly influence investment patterns, it follows that taxpayers must be significantly limited in their abilities to reallocate income for tax purposes."*

Based on the finding that profit shifting is definitely limited through the respective regulations, we discuss compliance costs which directly result from regulations, in more detail.

#### 4.1.2 Compliance Costs

Compliance costs comprise the expenditure of time or money in complying with the arm's length principle or the formulary apportionment.

With respect to the arm's length principle, compliance costs can include the taxpayers' resources spend to:

- determine arm's length prices for intercompany transactions, in particular if a profit split method is applied as this is a rather complex method;
- comply with the local transfer pricing documentation regulations;
- enforce transfer pricing tax audits comply with the obligation to cooperate with the respective tax authorities; and
- resolve double-taxation by mutual agreement procedure or litigation.

For the tax authorities respective costs are incurred in:

- the course of tax audits to review the transfer pricing documentation prepared and to double-check the intercompany transfer prices applied;
- the negotiation of mutual agreement procedures or advanced pricing agreements with foreign tax authorities; and
- judicial costs in case courts are involved.

Empirically, the importance of transfer pricing and related appropriate compliance work is confirmed by a recent Deloitte Survey on the income tax audit experiences of German inbound investors.<sup>23</sup> On average, the study shows that income tax audits resulted in (normalized) additional taxes of about 50% of the relevant group's average German income tax expense per year. The survey finds that transfer pricing is the most important issue in tax audits and the significance of transfer pricing will continue to grow. Inbound investors report that tax auditors challenged the arm's length pricing in 75% of all tax audits. Income adjustments were even performed by tax authorities based on non-compliance with formal requirements (e.g. absence of written contracts, insufficient documentation, implementation of year-end adjustments, etc.).

Economically, compliance costs are generally triggered through asymmetric information between the taxpayer and the tax authorities. It could be assumed that the amount of asymmetric information is higher under the profit split method compared to the formulary apportionment. Consequently, one could conclude that the respective compliance costs are higher under the arm's length principle. However, the OECD Guidelines discuss that in fact the formulary apportionment may present intolerable compliance costs and data requirements. This is the case because information would have to be gathered about the entire MNE group and not only with respect to the individual cross-border transactions considered. Furthermore, this information has to be presented in each jurisdiction. If currencies and tax accounting rules differ in the jurisdictions involved, then the information must be made available based on several frameworks. In particular, the costs of formulary apportionment are further increased if not all countries apply the same formula or agree on the way the components are measured. Also practical experience demonstrates the problems with formulary apportionment. In Germany, the so called trade tax is allocated to the different local communities based on the sum of labour costs. However, even this simple rule creates significant difficulties in practice. For examples the question arises how labour costs should be defined, so whether to include temporary employees, or how to deal with industries where labour costs do not relate to value added in the local jurisdiction, so e.g. windenergy parks.

To the best of our knowledge there are no empirical studies focusing on the difference in compliance costs between the arm's length principle and formulary apportionment. Existing studies focusing on compliance costs conclude that cross border activities increase compliance costs significantly compared to national activities. For example Blumenthal and Slemrod (1995) present survey evidence from a sample of large companies with assets above \$1 billion and located in the US. The companies were asked regarding the fraction of the total compliance cost of the federal corporate income tax that was due to foreign source income. They estimate that 39.2 percent of the total compliance cost of federal taxes is due to foreign source income. The authors argue that such percentage is disproportionately high relative to the companies' foreign activities, given that in comparison the fraction of their assets abroad is of only 21.1 percent, sales abroad 24.1 percent, and employment abroad

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<sup>23</sup> Deloitte (2010).

17.7 percent. Furthermore, in regression analysis the results show a statistically significant relationship between the variables measuring foreign-presence with the increase in compliance costs in the US. They estimate that shifting employment abroad in a way that raises the ratio of foreign assets to company assets by 10 percent will also raise the compliance costs by 6.5 percent.<sup>24</sup> Slemrod and Venkateshs (2002) provide evidence from survey data of medium-sized businesses in the US. Their regression analysis estimate that being multinational active is statistically significantly related with reporting higher internal compliance costs, in relation to those companies not being internationally involved. Moreover, the addition of activities for each new foreign country is also associated with increasing these costs.<sup>25</sup> The Commission of the European Community estimated that the compliance costs for companies are between 2 to 4% of the tax revenues for large companies, but given economies of scale this leads to even higher costs for smaller companies.<sup>26</sup>

Overall, this illustrates that compliance costs are a crucial factor. However, no clear assessment seems to be possible. In particular, it seems to be not appropriate to prefer the formulary apportionment over the profit split method based on the facts available. This is certainly an interesting area for further research, in particular with respect to empirical work.

## 4.2 Resource Allocation of Multinationals

In the following it is analyzed whether the arm's length principle in general, and the profit split method in particular, create artificial tax incentives compared to the formulary apportionment. In particular, this is done with respect to resource allocation of multinationals which might lead to overall economic inefficiencies, i.e. welfare losses. The profit split method and the formulary apportionment allocate the right of taxation to the different countries. Given these "profit allocation rules" it may be the case that multinationals perform investment decisions which are individually rational but not from an overall economic perspective because they maximize their after-tax profits, but decrease overall social welfare.

The economic tax literature so far only provides a few analyses of the role of profit allocation rules for the firms' choices of organizational forms.<sup>27</sup> However, these analysis often take into account only a reduced form of profit allocation rules, and most of the literature is concerned about tax competition between the different jurisdictions and less about inefficiencies triggered through multinationals' investment choices.<sup>28</sup>

Research work performed by Keuschnigg and Devereux is one notable exemption. Keuschnigg and Devereux (2009) analyze a model with financing constraints. They assume that independent third-parties as well as subsidiaries of multinationals

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<sup>24</sup> Blumenthal and Slemrod (1995).

<sup>25</sup> Slemrod and Venkatesh(2002).

<sup>26</sup> Commission of the European Communities (2001).

<sup>27</sup> For a discussion of the existing literature please refer to Keuschnigg and Devereux (2009), and Klein and Schmidtke (2009).

<sup>28</sup> See e.g. Bucovetsky and Haufler (2008).

have limited financing possibilities, depending on their cash-flow. In the absence of any “profit allocation rules” they show that using non-arm’s length prices compared to arm’s length prices may actually increase social welfare. The rationale is that non-arm’s length prices allow multinationals leaving more profits at the level of the subsidiary. This increases the subsidiaries cash-flow and as a consequence, their external financing abilities. More financing ability results in higher investments. This can have a positive social welfare effect as investments are welfare increasing, given the set-up of the model. Based on their model, it could be the case that formulary apportionment results in higher social welfare as it may yield less inefficient decisions of multinationals compared to the arm’s length principle.

It has to be highlighted that Keuschnigg and Devereux (2009) should be viewed as an improvement compared to the other existing contributions by explicitly modeling market prices as they are observed in comparable outsourcing relationships among independent entities, and comparing these prices to those which are optimal for multinationals. However, the findings of Keuschnigg and Devereux (2009) heavily rely on the assumption that the financing ability of subsidiaries is limited in a similar way as it is limited for stand-alone entities, i.e. entities which are not part of a multinational. In practice we often observe that multinationals are able to overcome this obstacle by providing intercompany financing and / or financial guarantees to facilitate external financing.

Based on a different framework developed by Klein and Schmidtke (2009) it can be shown that the profit split method, which per definition should ensure arm’s length profits, actually results in social welfare maximizing investment decisions of multinationals. This is the case even though multinationals maximize after-tax profits and social welfare generally is more concerned about pre-tax profits.<sup>29</sup> Profit allocation rules which are not in line with the arm’s length principle, as e.g. the formulary apportionment, can make it individually rational for a multinational to choose a non-welfare maximizing organizational structure.

Based on the Klein and Schmidtke (2009) framework, two potential distortions can be identified which may be triggered through suboptimal profit allocation rules.

- A company may decide to not outsource activities to an independent third party in a foreign country even though this would be social welfare enhancing, e.g. due to location savings.
- Given outsourcing, a company may choose the non social welfare maximizing organizational form, e.g. to trade via internal markets as a multinational instead of dealing with uncontrolled third parties on external markets.

In the course of their analysis it is assumed that the decision to outsource activities to a foreign jurisdiction results in a trade-off between realizing location savings vs. incurring additional principle agent costs. Furthermore, it is assumed that the decision to outsource to a related party compared to an unrelated party yields in a trade-off between efficiency vs. profit shifting opportunities.

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<sup>29</sup> The model used by Klein and Schmidtke (2009) is generally based on the model framework as e.g. also applied by Raimondos-Møller and Scharf (2002).

The following picture summarizes in a non-technical way the respective model framework:

### Model Framework

#### Arm's Length Principle and Welfare Maximization

- Welfare: Maximize pre-tax profits
  - MNE: Maximize after-tax profits
- } Incentives are not aligned

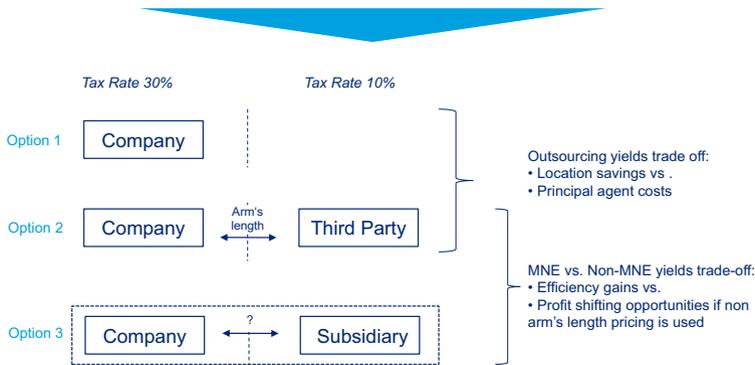


Figure 6: Model framework

Given the model framework developed, it can be shown that the profit split method ensures that a multinational chooses a welfare maximizing organizational structure. In contrast, approaches that are not based on the arm's length principle as e.g. the formulary apportionment could make it individually rational for the multinational to choose a non-welfare maximizing organizational structure.

The intuition is as follows: Assume that the Company can choose between two third parties (A and B) under Option 2 (Outsourcing to an unrelated party). Assume furthermore that A is more efficient than B. Generally, Company will contract with the more efficient third party, namely A. This will also maximize welfare per assumption.

Assume that Company now can choose between Option 2 and Option 3. Assume furthermore that Third Party is more efficient than Subsidiary. Under the profit split method, so given arm's length pricing, Company will choose Option 2 (see discussion above). This also maximizes welfare. If formulary apportionment is used, i.e. non-arm's length pricing, then it can be the case that it is individually rational for the Company to choose Option 3 as the after-tax profits under Option 3 are higher than under Option 2. However, this would not be social welfare maximizing. Overall, based on this kind of straight forward argumentation the formula apportionment may result in a suboptimal allocation of resources of a multinational compared to the profit split method based on the underlying assumption that equilibrium prices in markets generally maximize social welfare.

Additionally, it can be shown that not only the organizational form of multinationals may be negatively affected by inappropriate profit allocation rules but also

the decision which legal entities should be consolidated for tax purposes. Buettner, Riedel and Runkel (2008) develop a theoretical model that explains the choice of multinationals under formulary apportionment whether or not to consolidate affiliated firms and test empirically their predictions. They identify the following trade-off multinationals are faced with if they do not consolidate related parties: On the one hand additional costs may occur through having a lower degree of economic and financial integration, but on the other hand non-consolidation may have the benefit of using profit-shifting opportunities.<sup>30</sup>

### **4.3 Transition Costs for Changing from the Arm's Length Principle to the Formulary Apportionment**

It is generally acknowledged that introducing a formulary apportionment would entail huge institutional and transition costs.<sup>31</sup>

First, a formulary apportionment system that avoids double-taxation would require a high degree of legal uniformity which would have its own costs. This does not only relate to the allocation factors. Also the determination of a consistent base that includes all profits of a multinational would have to be based on a common, world-wide system. In contrast, for the profit split method, only the relevant profit of a specific cross-border transaction between related entities has to be considered and measured consistently. Even on EU level it appears to be very difficult to agree on a common tax base as the ongoing work on the Common Consolidated Corporate Tax Base demonstrates. The world-wide change from the existing tax accounting systems to a new system would involve huge transition costs, in particular since existing accounting standards as IFRS have to be amended to be eligible for taxation purposes.<sup>32</sup> Also all countries would have to agree to a common formula which would require immense coordination costs between the different countries. How difficult it is to change a system can be seen in Germany with respect to the trade tax ("Gewerbesteuer"), for example. Almost all tax reform proposals uniformly recommend changing the German trade tax as it does not fit into the existing system of taxation. However, since the tax income is received by the local communities, a reform would obviously leave some communities as winners and others as losers. For this reason it was not possible so far to reform the German trade tax. Given the fact that even within Germany no agreement is possible, we ask ourselves how this should work in a global context?

Second, transition costs with respect to international affairs and their underlying legal framework have to be considered. Generally, it appears to be difficult for bilateral treaties based on existing rules to co-exist with bilateral treaties adopting a formulary apportionment approach. Transition costs would include renegotiating and changing most of the existing double taxation treaties. Most probably, a transition period where both, the existing system and the formulary apportionment, will co-

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<sup>30</sup> Buettner, Riedel and Runkel (2008).

<sup>31</sup> See for a further discussion e.g. Roin (2007).

<sup>32</sup> Freedman and Macdonald (2007).

exist cannot be avoided. It is not clear how taxes should be levied during such a transition period and how over- or under-taxation can be avoided.<sup>33</sup>

The issue gets even more severe as formulary apportionment has to include every member of a multinational as otherwise the multinational must retain a separate entity accounting for the interface between that part of the group subject to global formulary apportionment and the rest of the multinational. If this is the case, then introducing the formulary apportionment would be questionable as such since the compliance burden of multinationals would probably actually increase. Furthermore, in the course of a transition also other rules, e.g. customs and VAT rules, which rely on arm's length prices and prices for single transactions, would have to be changed too.<sup>34</sup>

The OECD Guidelines conclude that the transition to the formulary apportionment system would include enormous political and administrative complexity. They expect that this would require a level of international cooperation which should be regarded as unrealistic in the field of international taxation.<sup>35</sup> In contrast to that, the improvement of the institutional framework for the application of the arm's length principle is always based on a common understanding how taxation rights are allocated between the different jurisdictions. The OECD Guidelines represent a consensus among the different OECD member countries and are generally followed in domestic transfer pricing regulations, also of non-member countries. Further, any improvements of the arm's length principle generally do not require a change of existing double-tax treaties as the improvements only relate to the application of the arm's length principle as such, and most double-tax treaties include Art. 9 of the OECD Model Tax Treaty.

#### 4.4 Conclusion

Based on our view, a change from the international accepted arm's length principle to formulary apportionment would only make sense if a change

- has substantial advantages;
- is realistic in the sense that the formulary apportionment is something that can be used in practice; and
- only involves manageable transition costs.

Based on our analysis we do not see any substantial advantages of the formulary apportionment and we do not believe that it can be implemented on a global level. In addition, it would involve significant transition costs. Thus, there seems to be no reason why one should move from the arm's length principle to formulary apportionment.<sup>36</sup>

<sup>33</sup> Para. 320 OECD (2004).

<sup>34</sup> Para. 1.31 OECD Guidelines (2010).

<sup>35</sup> Para. 1.24 OECD Guidelines (2010).

<sup>36</sup> Also, if one further takes into account effects from tax competition between the different jurisdictions under the arm's length principle or formulary apportionment, so far the literature does not provide clear insights why formulary apportionment should be advantageous over the arm's length principle; See e.g. Eichner and Runkel (forthcoming).

## 5. How to Improve the Institutional Framework for the Application of the Arm's Length Principle

Instead of changing the system, we would rather recommend improving the institutional framework to strengthen the system. As indicated above compliance costs related to the application of the arm's length principle for multinationals as well as tax authorities are often high in practice. This does not only relate to compliance in preparation of tax audits, e.g. fulfillment of documentation requirements and to tax audit controversy which often ends in burdensome discussions between multinationals and tax authorities and significant double taxation. It also relates to resolving cases of double taxation in mutual agreement procedures between the involved tax authorities or to avoid such cases through advanced pricing agreements. Rather than trying to solve the problems by introducing the formulary apportionment, the existing system of applying the arm's length principle and the profit split method should be improved.

The objective would be to enhance the efficiency of resolving transfer pricing dispute under the arm's length principle, consequently reducing compliance and controversy costs for multinationals and tax authorities. From an economic viewpoint, the international institutional framework relevant for the taxation of multinationals under the arm's length principle should be further improved in order to enable a smoother resolution of transfer pricing controversy.

In the process of setting up a transfer pricing approach by multinationals and auditing such approach by the local tax authority, the parties involved in this process follow their own objectives, i.e. multinationals maximize after-tax profits and local tax authorities try to maximize their tax return. The result often is a burdensome tax audit process which might end in a controversy. When stepping one step back and looking at the process of defending and challenging the transfer pricing approach as such, the parties would probably agree that it would be beneficial for all parties involved if in advance there were clear rules / institutions that helped to avoid such a resource binding process. In this respect, the following potential measures to further improve the institutional framework for the application of the arm's length principle and to resolve cases of controversy and double taxation should be put forward:

- Increase Possibility of Simultaneous Audits

Often tax audits are not synchronized between the different jurisdictions. This results in situations where audit periods, which were already analyzed in detail and closed, have to be considered once again because tax authorities in a different jurisdiction came to the conclusion that the transfer prices applied were not appropriate. This is highly inefficient as the taxpayer and the tax authorities have to restart the analysis and have to go into all the details once again. If tax audits are performed simultaneously, the taxpayer could provide the same documents to both tax authorities. Both tax authorities would have the same level of information and could also align their assessment in advance.

- Mandatory Information before an Adjustment

Today, tax authorities of the different jurisdictions do not coordinate their actions. Rather, each tax authority builds its own opinion independently from the view of

the other tax authority. In case a profit adjustment is performed, the taxpayer first has to start a burdensome mutual agreement procedure before the different tax authorities start to exchange information and opinions. It would be an improvement if tax authorities have to inform the corresponding tax authority in advance if a profit adjustment is intended. The other tax authority could provide its assessment of the case and the taxpayer and the local tax authority could take this assessment into account when determining the next steps. Such a system would help to reduce uncertainty and facilitate international coordination.

- Further Introduction of Binding Arbitration Clauses in the Double Tax Treaties  
Binding arbitration clauses facilitate a more rapid solution of mutual agreement procedures and help to avoid that mutual agreement procedures take years or never end without a resolution of the case. Thus, such proceeding helps to enhance the overall efficiency in favor of taxpayers but also of tax authorities because the negotiation process is speeded up. Positive examples are the EU arbitration convention and the double tax treaty US/Germany. In practice, the EU arbitration convention has led to more cases brought to competent authority, but the overall efficiency of the proceedings has enhanced and finally not very many cases enter the arbitration phase but are resolved during the first stage.
- Obligation to resolve Mutual Agreement Procedures based on Transfer Pricing Methods

In the course of mutual agreement procedures taxpayers are not directly involved in the negotiation between the tax authorities. Based on our practical experiences, the mutual agreement procedures seem often to be solved arbitrarily. It would be beneficial for taxpayers and local tax authorities if there is an obligation for the parties in a mutual agreement procedure to find solutions based on transfer pricing methods which are then communicated to the taxpayer and the local tax authorities. Instead in most cases only a negotiation result is communicated which often gives the parties no implication for the future transfer pricing. It would be a major step forward if the result of a mutual agreement procedure provides the taxpayer and the local tax authorities with some guidance on how to apply a certain transfer pricing approach, e.g. a the profit split, in future to comply with the arm's length principle.

- Enhance the use of Advanced Pricing Agreements  
Advanced pricing agreements are the possibility to get certainty of an acceptable profit allocation in advance. They help avoiding burdensome tax audits or even mutual agreement proceedings. Thus, advanced pricing agreements are in principle a good way to enhance efficiency of the cross-border taxation of multinationals. However, although their number has dramatically increased during the last years, conducting an advanced pricing agreement usually is still a lengthy and sometimes also burdensome undertaking. For example, US duration of proceeding and agreement takes on average 45 months. Thus, it would be required to increase the efficiency and to decrease the duration of advanced pricing agreements proceedings, e.g. by dedicating more specialized resources to the respective authorities. This is in particular relevant for complex transactions which are often dealt with application of the profit split method.

- Introduce Specialized Courts to Deal with Transfer Pricing Issues

Interestingly, if tax auditors do not agree with the transfer prices applied by a multinational and perform profit adjustments to levy additional taxes, taxpayers refuse to use the court system but apply for mutual agreement procedures to eliminate double-taxation. Based on our experience this is mainly triggered by the fact that courts seem to decide arbitrarily about transfer pricing cases. Transfer pricing is in most cases less controversy with respect to the interpretation or application of specific tax law but more about the assessment of the economic facts and circumstances. Consequently, it may be helpful to have a specialized court system with experienced judges who understand economic theory and have a sound knowledge about the relevant industry and its specifics.

- Have Specialized Experts in Mutual Agreement Procedures and Increase Resources Available

Generally, we observe a quite high backlog of unresolved mutual agreement procedures. Germany has currently about 700 open procedures and the number is increasing each year. Once again, it would be required that highly specialized experts take care of such mutual agreement procedures to avoid unnecessary and inefficient discussions between the different tax jurisdictions. Furthermore, more resources have to be provided to improve the processes.

- Provide Clear Guidelines and Make use of International Coordination

There should be international coordination on clear guidance regarding the application of the arm's length principle and the transfer pricing methods. Clearly, the OECD is the most relevant international body in this respect which has established a very good basis. The most recent example is the revision of the OECD Guidelines which provide a good progress in the right direction. Another example is the Joint Transfer Pricing Forum of the European Commission. However, to further enhance the efficiency of the taxation of cross-border transactions, it is important that these bodies of international coordination not only intensify their effort to provide clear guidance for taxpayers and tax authorities. It is even more important that the tax authorities represented in these bodies also implement the agreed standards in their jurisdictions, or at least that they do not contradict these standards through their own regulations and administrative guidance. A prominent example is certainly the concept of the hypothetical arm's length test, introduced in the German tax law in the course of the corporate tax reform in 2008. With this hypothetical arm's length test, Germany, as one of the most important countries of the OECD, has introduced a transfer pricing method in its tax law which is not even mentioned in the OECD Guidelines.

- Establish Safe Havens:

To enhance the certainty for taxpayers and tax authorities and thus to increase the overall efficiency of the cross-border taxation of multinationals it would be beneficial to introduce more internationally coordinated safe havens. One example is the European Joint Transfer Pricing Forum's established or planned guidance on benchmarking studies, the distinction between shareholder vs. non-shareholder cost and ranges for the profit markup in management services. It would be beneficial to have similar guidance with respect to the profit split method, e.g. regard-

ing safe havens for profit mark-ups in certain routine functions and / or the acceptable bases for a split of the residual profit.

## 6. Conclusion

In this article we argued that the profit split method, as one general accepted method to implement the arm's length principle, will continuously gain importance in future. This is mainly triggered by the fact that intercompany transactions of multinationals are more and more integrated. Moreover, it might be increasingly difficult to find third party data that is sufficiently comparable to the relevant cross-border intercompany transactions. The profit split method provides a solution because the method is able to determine arm's length profit allocations even without direct transactional third party data.

Formulary apportionment, which could in theory be an alternative way to agree on a consistent allocation of tax rights to the different jurisdictions, is not an appropriate alternative to the profit split method or the arm's length principle in general. The separate entity approach, and so the profit split method, does not result in inappropriate or unacceptable profit shifting. In particular, compliance costs can be higher under the formulary apportionment. On the contrary, applying formulary apportionment may provide incentives for suboptimal investment decisions of multinationals. This is mainly triggered by the fact that formulary apportionment may provide opportunities to multinationals to use tax differentials between countries which are not available in case of market prices. Furthermore, a change to formulary apportionment would result in unacceptable high transition costs. Overall, formulary apportionment would be closer to a kind of planned economy whereas the arm's length principle is directly related to the outcome of the market. We do not see why a system that relates to a planned economy should be superior given the good experience made with a market economy and its provision of the right incentives.

The existing separate entity approach should not be changed but improved by strengthening the respective institutions. This mainly relates to introduce simultaneous tax audits, to have mandatory information requirements, to increase the number of double tax treaties with binding arbitration clauses, to provide guidance to the taxpayers with respect to the results of mutual agreement procedures, to have specialized experts in mutual agreement procedures, to enhance advanced pricing agreements, to introduce specialized courts for transfer pricing, to improve international coordination, and to establish safe havens.

Our conclusions are fully in line with the prevailing opinion on OECD level, and we strongly support the assessment as laid out in the OECD Guidelines:

*“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. Experience under the arm's length principle has become sufficiently broad and sophisticated to establish a substantial body of common understanding among the business community and tax administrations. This shared understanding is of great practical value in achieving the objectives of securing the appropriate tax base in each jurisdiction and avoiding double*

*taxation. This experience should be drawn on to elaborate the arm's length principle further, to refine its operation, and to improve its administration by providing clearer guidance to taxpayers and more timely examinations. In sum, OECD member countries continue to support strongly the arm's length principle. In fact, no legitimate or realistic alternative to the arm's length principle has emerged. Global formulary apportionment, sometimes mentioned as a possible alternative, would not be acceptable in theory, implementation, or practice.*<sup>37</sup>

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<sup>37</sup> Para. 1.15 OECD Guidelines (2010).

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# In Favor of Formulary Apportionment

## A Comment on Kroppen/Dawid/Schmidtke: “Profit Split, the Future of Transfer Pricing? Arm’s Length Principle and Formulary Apportionment Revisited from a Theoretical and a Practical Perspective”

Marco Runkel

### Abstract

*In this comment I critically discuss the points made by Kroppen, Dawid and Schmidtke in order to argue in favor of separate entity accounting over formulary apportionment. Moreover, I direct the attention to the tax competition issue which is largely ignored by Kroppen, Dawid and Schmidtke, but which is central to the comparison between separate entity accounting and formulary apportionment. I will conclude that, in light of the literature on the two tax principles, one may well come to the opposite conclusion than Kroppen, Dawid and Schmidtke: there are a lot of arguments that formulary apportionment is superior to separate entity accounting.*

### 1. Introduction

Multinational firms can basically be taxed according to two principles. The first principle is separate entity accounting under which each affiliate of a multinational firm is taxed separately by its host country. Intra-firm trade then requires the use of transfer pricing in order to determine the price which the delivering affiliate charges to the receiving affiliate. According to OECD guidelines, transfer pricing has to follow the arm’s length principle which can be implemented by several methods. One of these methods is the profit split method that first identifies the profit associated with the intra-firm transaction under consideration, then assigns a part of the profit to the involved affiliates such that each affiliate earns an appropriate return and finally splits the residual profit according to the split that would have been chosen by unrelated parties.

The alternative to separate entity accounting is formulary apportionment. This principle is not transaction based and, thus, basically avoids the transfer pricing problem. Formulary apportionment first consolidates the taxable income of all affiliates to the global taxable income of the multinational. It then apportions the consolidated income to the affiliates according to a certain formula. The formula aims at reflecting the relative activities of the affiliates within the multinational enterprise and, therefore, usually employs some indicators of assets, labor and sales as apportionment factors. Finally, each country taxes the share of the consolidated income which the formula assigns to the hosted affiliate.

Separate entity accounting in combination with the arm's length principle is the prevailing taxation principle among OECD countries. However, several countries like the U.S., Canada, Germany and Switzerland use formulary apportionment on the local level in order to tax income of firms which operate in several jurisdictions. The comparison between the two taxation principles has always been the subject of controversial discussions among politicians and researchers. This discussion has gained renewed interest since the European Commission proposed to replace the current separate accounting principle by formulary apportionment within the borders of the European Union. The article of Kroppen, Dawid and Schmidtke (henceforth KDS) contributes to this debate by comparing formulary apportionment with the profit split method applied under separate entity accounting.

Their general conclusion is that separate entity accounting with the profit split method is superior to formulary apportionment. This conclusion mainly builds on four arguments:

- (1) The evidence on profit shifting under separate entity accounting is not convincing. Hence, it is not clear whether the arm's length principle is really impaired by profit shifting, as stated by the European Commission in its formulary apportionment proposal.
- (2) Not only separate entity accounting causes substantial compliance costs for tax payers and tax authorities, but also does formulary apportionment. Thus, it is not clear whether the introduction of formulary apportionment in Europe will reduce compliance costs.
- (3) The introduction of formulary apportionment will cause substantial transition costs to tax payers and tax authorities. Such costs are avoided when the current system of separate entity accounting is maintained.
- (4) Formulary apportionment distorts the investment decision of multinational enterprises and, thus, causes efficiency costs. These costs are avoided under separate entity accounting.

KDS therefore argue in favor of maintaining separate entity accounting and improving the institutional setting of the profit split method, since this method is basically capable to solve the transfer pricing issue in a way consistent with the arm's length principle.

The paper of KDS addresses an important and highly policy relevant topic. It is well and clearly written and contains some interesting statements and conclusions. However, the statements are controversial and, thus, the conclusions should be drawn with more caution. In fact, in this comment I will critically discuss the above arguments of KDS. Moreover, I will direct the attention to the tax competition issue which is largely ignored by KDS, but which is central to the comparison between separate entity accounting and formulary apportionment. I will conclude that, in light of the literature on the two tax principles, one may well come to the opposite conclusion than KDS: there are a lot of arguments that formulary apportionment is superior to separate entity accounting.

## 2. Discussion of Profit Shifting

In their first point, KDS acknowledge that a lot of studies provide evidence on profit shifting under separate entity accounting. But they then argue that this evidence is not convincing and should therefore be viewed with caution. Their main argument is that there is almost no direct evidence on profit shifting and that most studies use aggregated data and, thus, cannot control for firm characteristics which are important in transfer pricing of multinationals.

The criticism that there is no direct evidence on profit shifting is too excessive. Profit shifting is by definition an unobservable activity, similar to tax evasion or the shadow economy. Hence, if we would like to have direct evidence in the narrower sense we have to ask firms for their motives in transfer pricing, and firms have to honestly answer this question. This cannot be expected in practice. Instead, the directness of the evidence on profit shifting is not a binary variable in the sense that we either have direct evidence or not. It is a matter of degree and the cited articles of Clausing (2003) and Bernard, Jensen and Schott (2006) have a rather high degree of directness. In particular, Bernard, Jensen and Schott (2006) exactly do what the arm's length principle requires. They impose a fine-meshed categorization of products and then compare transfer prices with prices charged by unrelated parties. Showing that both types of prices deviate on average clearly indicates profit shifting.

The criticism that empirical studies on profit shifting use aggregated data and do not control for firm characteristics is not comprehensible to me. As KDS themselves mention, databases like Amadeus and MiDi provide micro firm-level data. But these data are not only available, they have already intensively been used to provide empirical evidence on profit shifting. One example is the cited article of Weichenrieder (2009), other examples are Dharmapala and Riedel (2010), Dischinger and Riedel (2010) and the articles cited therein. Moreover, most of these studies take into account firm fixed effects. Such effects absorb the influence of firm characteristics which KDS correctly mention to be important. The same is true for the article of Clausing (2003) who incorporates in her regression industry dummies, which are less accurate than firm fixed effects, but basically work into the same direction. Finally, Bernard, Jensen and Schott (2006) take into account product fixed effects that may even do a better job than firm fixed effects. Hence, firm-level data and firm characteristics are well taken into account in the literature providing evidence on profit shifting.

Beside their criticism of the previous literature, KDS provide some arguments against profit shifting based on anecdotal evidence. First, they refer to their own experiences with Japanese customers. However, it is well known in the taxation literature that the case of Japan is always an outlier and, thus, cannot be used to deny profit shifting in general (e.g. Gresik, 2001). Second, KDS argue that profit shifting requires substantial investment in low-tax countries and that their experiences with German customers do not indicate such investment. The empirical literature again speaks against the generalization of this observation. For example, the much-cited article of Grubert and Slemrod (1998) shows that U.S. multinationals have a strong incentive to invest in Puerto Rico in order to improve profit shifting opportunities.

Another example is the recent contribution of Dischinger and Riedel (2011) who provide evidence that European multinationals ease profit shifting by locating intangible assets in low-tax countries. Third, following an argument of James R. Hines, KDS argue that if profit shifting was easily possible we would not observe tax competition and a concentration of investment in low-tax countries. Despite the fact that this argument contradicts the previous one, we can again use Grubert and Slemrod (1998) and Dischinger and Riedel (2011) to argue that *because of – and not despite of –* profit shifting, firms invest in low-tax countries.

To sum up, in contrast to KDS we have to conclude that the previous literature provides clear evidence on profit shifting by multinational firms. This will still be true when the use of the profit split method is intensified, as proposed by KDS, since this method also follows separate entity accounting and the arm's length principle. In order to avoid misunderstandings, it should be noted that profit shifting is not necessarily an illegal activity, as opposed to tax evasion and the shadow economy. Multinationals simply use legal loopholes provided by tax law, and it is their right and even their duty to shareholders to do this. However, as I will argue in more detail below, even legal profit shifting may be detrimental for the taxing countries and, thus, governments have the duty to their residents to avoid profit shifting.

### 3. Discussion of Compliance and Transition Costs

KDS acknowledge that separate entity accounting and the arm's length principle cause substantial compliance costs for tax payers and tax authorities. They motivate this statement by a study of their own company. But they then speculate that also formulary apportionment will be associated with huge compliance costs and, thus, it is not clear whether a tax reform as the one proposed by the European Commission will really decrease compliance costs.

I cannot seriously argue against (but also not in favor of) this statement, simply because there is no reliable study estimating concealment costs under formulary apportionment. However, the extent of these compliance costs certainly depends on the institutional setting of formulary apportionment, and it is very likely that institutions exist that ensure substantially lower compliance costs than under separate entity accounting. The current formulary apportionment system in the U.S. is not of this type, since each state uses its own apportionment formula and, more or less, its own tax base definition. But formulary apportionment under the German local business tax (“Gewerbesteuer”) is supposed to be associated with rather low compliance costs. This tax applies a common tax base definition and a common (payroll only) apportionment formula. Hence, firms operating in several German communities only have to find out the statutory tax rates imposed by local governments. This is a very easy and cheap task. The argument of KDS that it is not clear how labor costs should be defined and what to do with firms having only small labor costs is not convincing. These are important and perhaps difficult questions. But once they are clarified, what most of them are in the German system, they do not imply any compliance costs for tax payers and tax authorities.<sup>1</sup> Beside this German experience, another important argument is that, even for complex formulary apportionment sys-

tems like the one in the U.S. and in contrast to separate entity accounting, there are no studies deploring concealment costs. One reason may be that concealment costs simply do not represent a crucial problem under formulary apportionment.

Next to concealment costs, KDS argue that the introduction of formulary apportionment in the European Union will cause substantial transition costs. That might be true, but again no empirical estimates of such costs are available. Moreover, transition costs are by definition only temporary and they have to be compared with the potential benefits of formulary apportionment. Such benefits accrue year by year over a longer time period. For example, if the yearly benefits accrue over a very long time, then the highest level of transition costs which renders formulary apportionment still superior equals the yearly benefits divided by a suitable discount rate. Taking this discount rate to be 4%, for example, transition costs can be 25 times as large as the yearly benefits. This is a quite generous value for transition costs. In addition, KDS view the difficulties of policy coordination as a substantial part of the transition costs associated with the introduction of formulary apportionment. I agree that policy coordination is difficult to attain, in particular since there will be loser and winner countries. However, this is a purely positive argument and cannot be used as a normative argument against the introduction of formulary apportionment. Put differently, it is possible that the winners compensate the losers, so all countries benefit from the reform and transition costs associated with difficult policy coordination largely vanish.<sup>2</sup>

To sum up, I agree with KDS that there is potential for further research regarding compliance and transition costs under different taxation principles. However, my above arguments suggest that these costs are supposed to be lower under a suitable designed formulary apportionment system than under separate entity accounting.

#### 4. Discussion of Tax Distortions of Investment

The final argument of KDS is that formulary apportionment distorts investment decisions of multinational enterprises, while separate entity accounting with the arm's length principle induces efficient investment. I have several objections against this argument.

First, KDS make things just too easy when blaming the Keuschnigg and Devereux (2009) article for too restrictive assumptions, while treating the paper of Klein and Schmidtke (2009) as a rather general approach. Any theoretical analysis has to abstract from important features and this is certainly true for the Keuschnigg and Devereux (2009) paper. It is also true, however, for the Klein and Schmidtke (2009) analysis. One obvious candidate for a restrictive assumption in Klein and Schmidtke (2009) is the objective function. While this function measures efficiency by pre-tax profits of firms, the most commonly used efficiency criterion is welfare,

<sup>1</sup> This is not to say that the payroll only formula in the German system is the best formula feasible. However, the argument applies to other apportionment formulas as well.

<sup>2</sup> It should also be noted that the improvement of the institutional setting of the profit split method under the arm's length principle, which KDS proposes as an alternative to introducing formulary apportionment, is impaired by policy coordination problems as well.

which is influenced by but not identical to pre-tax profits. This is not to say that the Klein and Schmidtke (2009) paper is useless. However, it is at least as restrictive as most theoretical studies and, thus, cannot be used as the sole answer to a comprehensive question like the efficiency of investment under different taxation principles.

Second, the results of Buettner, Riedel and Runkel (2011) are misinterpreted by KDS. In this article, we really show that formulary apportionment gives firms the incentive to distort their ownership structure. However, a closer look reveals that the results actually make an argument against separate entity accounting. More precisely, in almost all formulary apportionment systems the definition of a corporate group gives firms some discretion regarding the set of affiliates that are consolidated. If a firm decides not to consolidate an affiliate, this affiliate is taxed according to separate entity accounting. Firms therefore effectively have the choice between separate entity accounting (no consolidation) and formulary apportionment (consolidation). We then show theoretically that firms choose the no consolidation option if tax savings from profit shifting are larger than those from factor misallocation under formulary apportionment. As the empirical part of the analysis confirms this no consolidation incentive, we can conclude that separate entity accounting tends to offer better opportunities for tax burden minimization (via profit shifting) than formulary apportionment. Put differently, the analysis reveals that the group definition is crucial under formulary apportionment and that an imprecise specification of this definition may undermine the intended goal of abolishing profit shifting. The paper implicitly shows, however, that profit shifting under separate entity accounting still tends to be the more severe problem.

Third, and most important, I agree that formulary apportionment induces multinationals to choose an inefficient level of investment. However, KDS ignore a number of studies that theoretically or empirically prove a distortion of investment not only under formulary apportionment, but also under separate entity accounting. More precisely, papers like e.g. Pinto (2007), Pethig and Wagener (2007) and Eichner and Runkel (2008) show that under formulary apportionment investment is distorted by a formula effect. Firms have an incentive to overinvest (underinvest) in low-tax (high-tax) countries in order to increase (decrease) the share of consolidated income that the formula assigns to low-tax (high-tax) countries. In addition, formulary apportionment distorts investment by a tax base effect, i.e. an increase in one country's tax rate raises the average tax rate and gives multinationals the incentive to reduce the consolidated tax base by lowering production inputs. However, investment is also distorted under separate entity accounting because profit shifting is eased if the size of affiliates in low-tax countries increases. Hence, multinationals have an incentive to overinvest in low-tax countries in order to improve their profit shifting opportunities. This incentive is identified, for example, in the theoretical papers of Eggert and Schjelderup (2003), Sørensen (2004) and Nielsen, Raimondos-Møller and Schjelderup (2010). It is exactly the same effect which the above mentioned papers of Grubert and Slemrod (1998) and Dischinger and Riedel (2011) prove empirically.

To sum up, the previous empirically and theoretical literature shows that investment is distorted not only under formulary apportionment, but also under separate entity accounting. Even more important, in the next section I will argue that the distortion tends to be more severe under separate entity accounting than under formulary apportionment.

## 5. The Missing Argument: Tax Competition

In their discussion of tax distortions, KDS overlooked a number of studies since they state that a large part of the previous literature is concerned with tax competition and not with the distortionary effects of corporate taxation on investment. This view is misleading because any tax competition analysis also contains an analysis of tax distortions. Tax competition studies are even more comprehensive since they proceed in two steps. The first step investigates the effects of taxation on the firms' decisions. This represents the tax distortion analysis. Building on the insights of the first step, the second step analyzes how governments set their tax instruments in order to optimize their objective function, taking into account the effects on the firms' behavior. Hence, tax competition studies are central to the whole discussion and, in addition, provide information on the tax distortions of the firms' decision.<sup>3</sup>

What is the basic working of a tax competition analysis? The idea is that tax competition can be interpreted as a non-cooperative game between governments. Each government sets its tax instruments in order to maximize its objective function, which is usually equal to the welfare of residents. In so doing, the government takes into account the effects of taxation on the firms' behavior (e.g. investment, labor demand, sales, profit shifting etc.), but it takes as given the tax instruments set by other governments. An equilibrium of this game is attained if all governments mutually give their best response (i.e. the best choice of tax instruments) to the tax instruments chosen by the other governments. The central question is whether the equilibrium tax instruments are efficient. This question is answered by identifying policy externalities, i.e. the effect of one country's tax instrument (e.g. tax rate) on the objective function (e.g. welfare) of other countries. Since the externalities are by definition external to the decision of the individual government and the individual government therefore does not take into account the full benefits (costs) of its policy choice, a positive (negative) sign of an externality points to inefficiently low (high) tax instruments. The decisive point is that each policy externality usually goes back to a distortion of the firms' behavior. Thus, any tax competition analysis mirrors the analysis of tax distortions.

Applying this general idea to the comparison between separate entity accounting and formulary apportionment, the literature identifies a basic tradeoff. Under separate entity accounting, the profit shifting incentive of multinationals translates into a profit shifting externality (PE). The government of a country does not take into account that a decrease in its tax rate *ceteris paribus* induces multinationals to intensify profit shifting to this country and thereby reduces the tax base, tax revenues and

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<sup>3</sup> In fact, all references cited in the previous section are tax competition studies.

welfare in other countries. Hence, the correlation between the tax rate in one country and welfare in other countries is positive, implying a positive sign of PE and inefficiently low tax rates under separate entity accounting. Under formulary apportionment, two externalities arise. First, the formula effect mentioned in the previous section causes a positive formula externality (FE). The government of a country ignores that a fall in its tax rate *ceteris paribus* induces multinationals to reallocate investment in order to increase (decrease) the share of consolidated income taxed in the tax-reducing country (other countries). This reallocation worsens the tax base, tax revenues and welfare in other countries. Second, the above mentioned tax base effect is responsible for a negative tax base externality (TE). If a country reduces its tax rate, it does not take into account the corresponding fall in the average tax rate and the incentive of multinationals to raise production by increasing factor demand. This effect leads to a larger consolidated tax base and, thus, higher tax revenues and welfare in all countries. Under rather mild conditions, it can be shown that the sum of FE and TE is positive, so tax rates under formulary apportionment are inefficiently low, as under separate entity accounting.

Hence, when replacing separate entity accounting by formulary apportionment we replace one type of externalities (PE) by the other type of externalities (FE+TE). This tradeoff was first identified in the early working paper version of Nielsen, Raimondos-Møller and Schjelderup (2010) and it is present in many further articles. The decisive question is under which taxation principle the distortion is more severe. As shifting paper profits is much easier and cheaper than reallocating real production inputs like capital or labor, it seems plausible that the profit shifting externality is larger than the sum of the formula and tax base externalities. The much-cited contribution of Mintz and Smart (2004) provides empirical evidence on this hypothesis by showing that under the provincial corporate income tax in Canada the profitability of firms which are subject to separate entity accounting reacts more sensitive to changes in tax rate differentials than the profitability of firms taxed according to formulary apportionment. This strongly indicates that the tax distortion and, thus, inefficient undertaxation is more pronounced under separate entity accounting than under formulary apportionment.

Moreover, in discussing the basic tradeoff, I abstracted from tax distortions of investment under separate entity accounting. If we take into account such distortions, it is clear that we get a further investment externality (IE). For example, in Eichner and Runkel (2011) it is shown that, once the whole analysis is conducted in a general equilibrium framework, an investment externality occurs even if the extent of profit shifting does not depend on the size of affiliates in low-tax countries. The individual government does not take into account that a tax rate reduction increases investment in its own country and reduces investment, tax revenues and welfare in other countries. This investment externality IE augments the profit shifting externality PE and, thus, further aggravates inefficient undertaxation under separate entity accounting. Moreover, we prove that under empirically relevant values of the model parameters the superiority of formulary apportionment over separate entity accounting does no longer depend on the extent of profit shifting, i.e. it holds even if there

is no profit shifting at all. The reason is that IE under separate entity accounting is already larger than FE+TE under formulary apportionment, independent of PE.<sup>4</sup>

## 6. Concluding Remarks

In this comment I have argued that, based on a thorough survey of the previous theoretical and empirical literature, we cannot conclude that separate entity accounting is preferable to formulary apportionment. In contrast to the discussion of KDS, I have shown that (a) there is clear evidence on profit shifting under separate entity accounting, (b) concealment and transitions costs are expected to be lower under formulary apportionment than under separate entity accounting and (c) formulary apportionment is less distortive with respect to investment than separate entity accounting. Moreover, tax competition is central to the comparison of both taxation principles and also makes the point for formulary apportionment. While I have discussed all these points with reference to separate entity accounting in general, it is clear that the arguments also hold for the profit split method, which KDS advocate. This method still operates under separate entity accounting and, thus, is subject to the same objections.

To sum up, formulary apportionment may be an attractive alternative to separate entity accounting. Of course, such a conclusion is never clear-cut. There are still arguments in favor of separate entity accounting, others than those mentioned by KDS. An example is the idea that profit shifting may be welfare-enhancing for high-tax countries, since it allows the governments of these countries to tax discriminate between multinational and national firms (e.g. Hong and Smart, 2010). Thus, the title which I choose for my comment may be too exaggerated. However, it cannot be denied that the literature clearly indicates several crucial advantages of formulary apportionment over separate entity accounting. From my point of view, it is therefore appreciated that the European Commission (2010) incorporates the formulary apportionment proposal into its official work program. This process may yield further information on the relative merits of both taxation principles, so in the end a sensible and unbiased decision can be made.

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<sup>4</sup> It should also be mentioned that the literature identifies other important factors like the water's edge (Riedel and Runkel, 2007) or investment in the form of mergers and acquisitions (Becker and Runkel, 2010) which further improve the beneficial role of formula apportionment vis-à-vis separate entity accounting.

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