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TRANSFER PRICING: PRICING OF PRIMARY PRODUCTS BETWEEN RELATED ENTITIES, COST SHARING AND PROVISION OF SERVICES*

1. In their publication "Guidelines for tax treaties between developed and developing countries" (ST/ESA/14) of 1974, the Group of Experts commented "... transfer pricing is an issue of primary importance, both to developed and to developing countries, in connection with the proper international treatment of multinational corporations and their complex network of subsidiaries and branches".

2. The intervening 20 years have done nothing to call that assessment into question. And the Group has judged it timely to address the matter of guidelines once more with the twofold objective of taking into account the considerable amount of study that the member States of the Organisation for Economic Cooperation and Development (OECD) have devoted to the issue over the years and of sensitizing developing countries in particular to the latest thinking and to new ways in which the old question can arise. In particular the Group puts stress on the importance of establishing double taxation conventions for the contribution they can make through exchange of information (art. 26) to finding appropriate solutions to both old and new problems of transfer pricing. As one representative commented, "The starting point ... has been that transfer pricing problems should be dealt with in an international context. Difficulties in this field can ... not be resolved unilaterally, without causing double taxation." Annex I sets out in an aide-memoire a list of the practical methods that are in use for valuation purposes.

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* Working paper prepared by the Steering Committee of the Group, on the basis of discussions at its meeting held from 5 to 7 June 1995 in New York.

A. Pricing of primary products between related entities

3. One of the most tangible manifestations of the internationalization of economies is the creation of multinational enterprises, sometimes of considerable size, which bring together directly or indirectly associated enterprises and answer a need for rational economic behaviour and a coherent approach by markets. Such international groups thus have a tendency to become true entities from the economic standpoint.

4. Tax authorities may have a natural inclination to consider only those entities or those parts of a multinational enterprise that are located in their territory and to want to deal with them in isolation, without taking into account the fact that they are part of a larger group which may have its own interests. This approach is natural and legitimate as long as borders exist between States and the payment of taxes in one State rather than another is therefore of some consequence. It may require the group to disregard economic logic and to focus instead on whether their internal transactions are in compliance with the tax regulations of the States in which they are established.

5. This is the basis for a common abuse of transfer pricing, growing out of the fact that prices can be agreed among members of a group of associated enterprises, something which would not have occurred if the enterprises were unrelated or if related enterprises maintained arm’s length prices.

6. The prices charged in respect of transactions of all kinds between connected companies in a multinational group (transfer prices) will not necessarily represent the result of market forces but, for a host of reasons, may diverge from those which would have been agreed between unrelated parties engaged in the same, or similar, transactions under the same, or similar, conditions. For example, the prices charged for raw materials or semi-finished products, or for the sale or licensing of patents and know-how, or for establishment costs, may be set below "market" levels to assist a subsidiary in achieving optimal production levels, effect market entry or overcome tariff barriers. The use of transfer pricing by multinationals will impact on the allocation between countries of their overall profits, and prices can be manipulated to minimize or avoid tax by diverting profits into tax havens, or to low tax rate countries, or to countries where unutilized losses are stored. The prices used therefore will not necessarily produce a figure of profit or loss in a particular jurisdiction which is considered appropriate by that tax authority.

Some domestic law approaches

7. In the course of discussion, two participants noted that the domestic tax legislation in their respective countries contained provisions whereby profits or losses could be adjusted to reflect an arm’s length price. This was the price that might have been expected if the parties to the transaction had been independent persons dealing with each other in a normal commercial manner, unaffected by any special relationship between them. For example, in the case of one developed country, the principal provision stipulated that (with respect to associated persons) if the actual price for which goods or services were sold was not considered to be an arm’s length price, then the computation of income, profits and losses for tax purposes might be adjusted as if the transaction had

taken place on an arm’s length basis. A further provision enabled the tax authority to obtain information in relation to specific transactions. The legislation defined the transactions governed by the legislation to include letting and hiring of property, grants and transfers of rights, interests or licences and the giving of business facilities of whatever kind. Loan interest, patent royalties, management fees and payments for services were deemed thus to be within the scope of the legislation as well as payments for goods. Contributions by a subsidiary towards costs incurred by a parent company were similarly covered.

8. By contrast, other participants explained that the domestic law contained no provisions explicitly directed at transfer pricing in terms. Nevertheless, they were enabled to take action to counter it under general provisions underlying the overall approach to the application of tax law.

9. One participant noted that in his country the major principle was expressed in an article of a tax act which stated: "Profit is the amount of the total benefits that are derived from a business, under whatever name and in whatever form"; that was connected with another article which read: "In determining profit, the following may not be deducted: direct and indirect distributions of profit, regardless under what name and in what form they have been made". The provision enabled the revenue authorities and the courts to adjust reported taxable income of corporations, if they found that transactions with related persons contained an element of distribution of profit. The system was very flexible: there were no detailed rules, which were often very difficult to comply with or to enforce. The country’s view was that standard rules could not do justice to the factual situation. The main guidance for the tax inspectors were the OECD reports on transfer pricing.

10. The representative of another country noted that, mainly owing to the fact that it still had a classic system of taxing the profits earned by corporate enterprises and distributed to their shareholders (under which distributed profits were doubly taxed) there existed a large body of case law on this point. Shareholders were in fact often inclined to minimize taxes by artificially increasing the remuneration for personal functions and the interest rate on loans they had granted to the company, or by borrowing funds from the company at too low an interest rate or by using the equipment of the company (flats, cars, planes, etc.) on privileged terms.

11. For about 30 years, the relevant juridical fact which entitled tax authorities to adjust taxable profits had been the so-called hidden or disguised profit distribution. Such a distribution depended on three conditions:

(a) The value of the reciprocal performances (goods or services against cash or a claim) was not balanced;

(b) The beneficiary was the shareholder (parent company) or any other person directly or indirectly controlled by the same shareholder;

(c) The discrepancy between the value of the goods sold or the services performed and the remuneration received was recognizable by the executives involved at the time the transaction took place.

12. The country concerned, Switzerland, noted that these principles of domestic tax law had been applied by the High Court in four decisions given on transfer pricing across the national border. Those concerned, in one case, the resale price method; in two cases, the application of the cost-plus method; and in one case, the application of general principles of the separate entity approach. The major points of all four cases are summarized in annex II.

Approach of the United Nations and OECD Models

13. The OECD Model Double Taxation Convention of 1977 and the United Nations Model Double Taxation Convention of 1980 treat the subject of transfer pricing in identical terms in their article 9, "Associated enterprises". The commentaries on this article annexed to the model conventions develop the same arguments in the same terms. The intent of the commentaries is to define the situation of "parent and subsidiary companies and companies under common control", but they do not go into the details of application to a given type of product or service.

14. Paragraph 1 of article 9 gives a competent authority the possibility of adjusting transfer prices if they are not in conformity with the arm’s length principle. Paragraph 2 deals with the corresponding adjustment by the other competent authority and states that the competent authorities shall if necessary consult each other. This, however, gives no guarantee to taxpayers that double taxation will not occur, because there is no obligation for the competent authorities to reach agreement.

Some detailed studies

15. Questions regarding the details of the application of the arm’s length approach to a given type of product or service have been the subject of lengthy examination by the OECD Committee on Fiscal Affairs throughout the years.

16. The main document is "Transfer prices and multinational enterprises" (1979). That report elaborated on the broad principles set out in the OECD Model Tax Convention and set out guidelines for establishing transfer prices consistent with the arm’s length standard. It provided that the transfer price charged in a transaction between associated enterprises (the "controlled transaction") should be the price that would have been charged by independent enterprises engaged in the same or similar transactions (the "uncontrolled transaction") under the same or similar circumstances in the open market.

17. The 1979 report was supplemented in 1984 by a report entitled "Three taxation issues" which considered, successively, the ways in which a multinational enterprise may be relieved from "economic double taxation" when transfer prices are adjusted by tax authorities; transfer pricing in the particular sector of banking; and issues related to the allocation of management and service costs for tax purposes.

18. The experts noted that events had moved on, and that once again the Committee on Fiscal Affairs had the issue of transfer pricing under scrutiny and that a further report, which would update the 1979 report and respond to developments since 1979, was in preparation. The Group welcomed that

development unreservedly, noting that it was a common experience that transfer pricing cases were becoming more complex and difficult. This reflected a growing complexity in the real world of business. Multinational enterprise groups themselves were becoming increasingly integrated, there was an accelerated globalization of the world economy, trade barriers were being reduced and there had been an observable rise in intra-group transactions involving intangible property. Those new developments had led to difficulties in applying the arm's length standard and led to a demand for its relevance and appropriateness to be re-evaluated.

19. The Group looked forward to the appearance of the new report, but in the meantime had taken the opportunity to update its own contribution to the debate by focusing on the aspects that were especially relevant as between developed and developing countries.

Interests of developing and developed countries distinguished

20. The participants identified three particular areas as being of overriding concern to developing countries: they were the three identified in the title, namely primary products (as opposed to finished goods), cost-sharing arrangements and the provision of services. There was a common linking theme: many developing countries saw themselves as involved in an unequal contest with multinational enterprises (as compared, for example, to tax administrations of developed countries) because they were deficient in the basic information they needed in order to fight a case. The Group looked for some practical solutions.

Primary products

21. The Group considered first some problems posed in the sphere of extractive industries such as copper, nickel, bauxite and aluminum. While it was accepted that some indication of a world market price might be established for these commodities traded on recognized metal exchanges, even this information had to be identified and assembled, which could be a laborious activity. And when it was available, it went only part of the way to a solution in a given case. For one thing, a single price could not be apt in a situation where it was possible to trade in wholly raw material or in a whole range of partly processed material. The bauxite example was a case in point. No one primary producing country was likely to be able to arm itself with sufficient information to argue a complete range of cases. And the question arose of whether some research institutions might not need to be established, perhaps at a regional level to compile data which could then be made available to all subscribing States in the region.

22. A further example examined was that of tropical hardwoods, where for a number of years there had been some difficulty in establishing a properly external comparable market price. This could and did lead to a State fixing a minimum export price for the purpose of domestic control, which was itself lower than it should have been, with the result that transfer pricing manipulation was, in effect, created by the Government's own action in determining a price in error.

B. Cost-sharing arrangements

23. Developing countries perceive themselves to be particularly at-risk in respect of payments of royalties and technical fees. Determining an appropriate transfer price for different types of goods and services can sometimes be difficult, but perhaps one of the most complex areas of transfer pricing arises when intellectual property is owned and developed by one company in the group but the benefits of such property accrue to other group companies as well. The Group recognized that cost-sharing arrangements could be very helpful in this respect. In general, it might be expected that the costs incurred in developing intellectual property under such an arrangement would be apportioned on the basis of the benefits that each participant in the arrangement could be expected to receive from the exploitation of such property. The Group noted that some tax authorities had formal rules governing cost-sharing arrangements. Others preferred to look at each arrangement on the basis of its own facts and circumstances.

C. Provision of services

24. Here the Group considered that the central principle was that costs incurred to benefit associated enterprises should be borne by those enterprises. The general rule to be followed was that prices performed between associated enterprises should be those which would be paid between unrelated parties. Unrelated parties would trade with each other under the proviso that they could profit from their transactions. Therefore a charge for the services, including a profit element, would in general be appropriate. If open market prices for the services rendered could not be found, the most common way to determine the price to be charged was to apply a cost-plus approach, i.e., the price for the services consisted of the costs plus an appropriate profit mark-up, the mark-up being dependent on the entrepreneurial risks involved for the provider of the services.

25. The developing countries considered that, while they were comfortable with that exposition of the theory, they felt themselves to be, once again, severely disadvantaged by their relative lack of access to relevant information to challenge whatever figure the multinational enterprises cared to show in the accounts for tax purposes.

26. One developing country went so far as to propose the creation of a multilateral international clearing-house for information: but the view of a majority of the Group was that it was most important that the existing bilateral provision for information exchange in the double taxation conventions should be made to operate as effectively as possible. If each tax authority were to tax an equitable share of profit, economic double taxation were to be eliminated and international tax avoidance by means of non-arm’s-length transfer pricing challenged, it was essential that administrations acted in cooperation rather than on a unilateral basis. In the absence of an international consensus on how to deal with transfer pricing there could be increased uncertainty for business and a consequent disruption of international trade. The Group thought that there was a case for the extended use of simultaneous examinations as a means of obtaining information on the activities of multinational groups, and necessary

for determining appropriate transfer prices and to eliminate loss of revenue earnings from abusive transfer pricing practices. The Group also remained committed to improving the full range of competent authority procedures in order to reach agreements that would eliminate economic double taxation.

D. The Arbitration Convention

27. The Group took note of a new development. In 1990, members of the European Community (EC) signed a multilateral Convention on the Elimination of Double Taxation in Connection with the Adjustment of Profits of Associated Enterprises - the so-called "Arbitration Convention". Once all signatories had ratified, the Convention would come into operation and would seek to prevent economic double taxation arising when transfer pricing adjustments were made in one member State while the other member State involved did not make a corresponding adjustment. The Convention would seek to achieve this by giving a company a right of appeal to the competent authority, if the company believed that the taxing authority had not observed the "arm's-length" standard. The relevant competent authority might then resolve the case by mutual agreement or, if agreement could not be reached, the Convention required the competent authorities to set up an Advisory Commission which would reach a decision on how to eliminate the double taxation. Unless they came to their own agreement, the States concerned were obliged to follow that opinion. The Group further noted that provision for binding arbitration had been included in certain recent bilateral Double Taxation Conventions. But in the absence of any experience of arbitration in practice, the Group deferred expressing an opinion on its value.

Annex I

THE ARM'S LENGTH PRINCIPLE: SOME PRACTICAL METHODS OF TRANSFER PRICING

A. Comparable uncontrolled prices

Making a judgement whether a particular transfer price conforms to the arm's length principle would ideally require direct reference to prices in comparable transactions between enterprises independent of each other or between the group and unrelated parties. This method is frequently referred to as the "comparable uncontrolled price" method and in principle it is the most appropriate to use and in theory the easiest. In practice, however, it often happens that such evidence is not available, or it is impracticable to collect it together, or there is argument about whether the prices quoted are comparable or not. Other methods may therefore need to be used to obtain an arm's length price.

B. Cost-plus and resale methods

There will be many cases where no useful evidence of uncontrolled transactions will be available because, for example, the goods or services etc. which are supplied are so special to the group that there is no open market in them and they are not supplied to independent enterprises. This may be particularly the case for example for semi-finished products or in relation to transfers of technology. In other cases the transactions within the group may not be satisfactorily comparable with those between the group and independent third parties, for example, because they take place at a different stage in the chain of production or distribution or because the independent third party is too small a customer to claim the discounts for volume which an entity within the group might be big enough to achieve if it were independent. In such circumstances it will often be necessary, in order to establish an arm's length price, to use either the cost-plus method or the resale method, the cost-plus method starting from the cost of providing the goods or services etc. and adding whatever cost and profit mark-up is appropriate, and the resale price method starting from the final selling price and subtracting the cost and an appropriate profit mark-up.

C. Other methods

The complexities of real life business situations may put many conceptual and practical difficulties in the way of the application of the methods referred to above. A mixture of these methods, or other methods still, may sometimes therefore have to be used. Any method which is used will involve problems of judgement and the evaluation of evidence and it has to be recognized that the object of using it is to produce a figure which is acceptable for practical purposes. Experience shows that the difficulties can in general be satisfactorily dealt with and acceptable prices agreed.

D. The so-called "global" methods

Proposals for radical reformulations of the approach to intra-group transfer pricing which would move away from the arm’s length approach towards so-called global or direct methods of profit allocation, or towards fixing transfer prices by reference to predetermined formulae for allocating profits between affiliates, are not endorsed in this report. The use of such alternatives to the arm’s length principle is incompatible in fact with articles 7 and 9 of the OECD Model Double Taxation Convention. Such methods would necessarily be arbitrary, tending to disregard market conditions as well as the particular circumstances of the individual enterprises and tending to ignore the management’s own allocation of resources, thus producing an allocation of profits which may bear no sound relationship to the economic facts and inherently running the risk of allocating profits to an entity that is in truth making losses (or possibly the contrary). A number of such methods are sometimes advocated, allocating profits in some cases in proportion to their respective turnovers or to their respective labour forces, or by some formula taking account of several such criteria. They are all however to some degree arbitrary. For example, it does not follow that profit is uniformly related to cost at all stages in an integrated production and marketing process. Indeed the problem of allocating costs could well be no easier than in using the cost-plus method to arrive at arm’s length price. Nor does it follow that labour costs are the same for the same labour in different countries, or that profits are necessarily related to any simple combination of such factors. To allocate profits by such methods in a way that reduced the arbitrariness of the results to a negligible degree would necessitate a complex analysis of the different functions of the various associated enterprises and a sophisticated weighing up of the different risks and profit opportunities in the various stages of manufacturing, transportation, marketing and so on. Nor would the information necessary for such an assessment be readily available or, in many cases, available at all. The need would be for full information about the total activities of the whole multinational enterprise. While the widest range of such information may be available to the tax authorities in the country of the parent company, in a group even those tax authorities will be limited to some extent in the information which they can compile. The tax authorities of the country in which a subsidiary is situated will on the other hand be in no position to acquire even this amount of information without imposing on the enterprise itself a possibly intolerable administrative burden, or a similar burden on the tax authorities of the parent company’s country if they seek to get the information by way of exchange of information provisions under double taxation agreements. Nor can it be generally assumed that the tax authorities of the country of the subsidiary should in any case be entitled to quite such a wide range of information about the group’s world-wide activities. In practice moreover the information may simply not be available to those authorities. Even if the information were available, however, the varied activities of any multinational enterprise and the varied circumstances and situations in which they are carried on must make it impracticable for the tax authorities of the country in which one subsidiary is situated to judge in any satisfactory manner the profitability of any of the other parts of the group situated elsewhere. Moreover, problems would still arise in the comparison of figures produced in different countries by different accounting methods and different legal requirements. Another major disadvantage of any attempt to use such global methods of profit allocation as an alternative to the arm's length principle is that their uncoordinated use by the tax authorities of several countries would involve the danger that, overall, the enterprise affected would suffer double taxation of its profits. This is not to say, however, that in seeking to arrive at the arm's length price in a range of transactions, some regard to the total profits of the relevant enterprise may not be helpful, as a check on the assessment of the arm's length price, or in specific bilateral situations where other methods give rise to serious difficulties and the two countries concerned are able to adopt a common approach and the necessary information can be made available.

E. Minor adjustments and substitution of methods

The starting-point for scrutinizing transfer prices would frequently be the appearance of a discrepancy between the profits returned by an associated enterprise and those which might be expected to be made by comparable enterprises in the uncontrolled situation. Since the assessment of an arm's length price depends very often on careful judgement and the resolution of many, perhaps conflicting, considerations by negotiation between the tax authorities and the enterprise concerned, it follows that if the prices actually paid can be substantiated by acceptable evidence as being arm's length prices, there would be no justification for seeking to make merely minor or marginal adjustments to them for tax purposes. Similarly a tax authority should hesitate to disturb without good reason a pricing arrangement reasonably and consistently operated between associated enterprises if it is also reasonably and consistently operated in comparable dealings with independent parties. Moreover, as a general principle, tax authorities should base their search for an arm's length price on actual transactions and should not substitute hypothetical transactions for them, thus seeming to substitute their own commercial judgement for that of the enterprise at the time when the transactions were concluded (though there may be some circumstances where the form of transaction has effectively to be ignored).

F. Safe havens

At this point it may be helpful to consider whether limits of tolerance could be formulated in advance by tax authorities and made known to enterprises by what are sometimes known as safe haven rules, indicating that prices falling within certain ranges would be accepted without question. The report makes no recommendation on this topic. While such an approach may be useful to both taxpayers and tax authorities within a particular country in minimizing disputes over the determination of a proper arm's length price, such safe havens are likely to be arbitrary since they will rarely fit exactly the varying circumstances even of enterprises in the same trade or business. The minimization of this arbitrariness would be difficult and would involve a considerable expenditure of skilled labour in collecting, collating and continuously revising a pool of information about prices and pricing developments. Another point is that safe havens in one country may create difficulties in other countries and further problems would arise if it were a question of seeking to fix a safe haven range of prices acceptable to a number of countries. In any event, it would be necessary to revise periodically the range of prices or rates of interest to reflect changes in market conditions. Moreover, the general use of safe haven ranges for tax purposes could affect the prices charged in the open market. More important perhaps in practice they could open an undesirable scope for tax avoidance.

Annex II

SWITZERLAND: SOME HIGH COURT DECISIONS

A 1947 decision concerned the Swiss permanent establishment of a foreign company of the watch industry. Although the production was sold to independent wholesale dealers operating in the country of the head office, all goods were billed at cost to a related company of the same country acting as an intermediary. Since in the relevant commercial years export prices for watches were officially fixed (war economy) and no export permission was granted if the official prices were not paid by the final wholesale import dealers, the entire difference between the at-cost price and the official price was at first sight considered as a disguised transfer of profits. This appeared to be self-evident since the related intermediary did in fact receive from the final wholesale import dealers the official Swiss export price. The adjustment was, however, reduced by 10 per cent of the actual final turnover to remunerate the functions of the intermediary. (Unfortunately, it is not clear what the real functions of the intermediary were. This was most probably the first time where the resale price method had been applied by the country of production.)

A 1973 decision concerned the Swiss permanent establishment of a foreign press news corporation. The taxpayer handed in, for taxation purposes, the balance sheet and profit and loss account of the whole company. The overall result was negative and there was no suitable indication to appraise the permanent establishment's receipts. The tax authority applied therefore the instruction of 1960 and taxed 10 per cent of the administrative and other expenses incurred by the Swiss permanent establishment. Arguments of the taxpayer in order to obtain a set-off adjustment for numerous items of free-of-charge news received by the company were not accepted, because in a cost plus taxation concept this would not have had the result expected by the taxpayer. Furthermore nothing proved that the respective receipts were connected with the permanent establishment's functions.

A 1979 decision concerned a Swiss company acting as an international agent for the account of its 14 shareholders, all of them being wholesale import merchants of sports' articles in their respective countries. The taxpayer's policy was to charge such amounts as to cover all administrative and other general expenses without realizing any profit. The tax authorities considered that the taxpayer acted as a service company and applied the instruction of 1959. Therefore, a net profit of 10 per cent on all expenses incurred by the Swiss company was taxed. The taxpayer opposed this measurement of the taxable profit and claimed a mark-up on the much lower amount of salaries alone or even just a fair remuneration of the company's capital stock. The taxpayer suggested also the alternative of setting-off, against the original adjustment, the value of all services received free of charge from the shareholders in relation to its marketing and other commercial functions.

It was considered that in a system which worked on a riskless cost-sharing basis there was no reason to calculate the assessment basis by reference to costs that were not incurred by the Swiss taxpayer. The other claims of the taxpayer were also rejected since in practice the mere sum of the salaries has up to now never been taken as an assessment basis. The remuneration of the capital stock was rejected too, as it was unsuitable to measure the actual value of the functions performed. (It may seem surprising that the value of the transactions involved was not taken as a basis for calculating the agent's reward.)

Another 1979 decision concerned a permanent establishment of a foreign company. The Swiss permanent establishment had taken over all assets of a related Swiss company to continue the former commercial activity of that related company. Its balance sheet showed, however, an allotted capital, granted by the foreign head office, which had supposedly been entirely financed by interest-bearing advances coming from the parent company. It was not clear whether the foreign head office had more than purely formal functions. Since the Swiss permanent establishment paid to its head office a 5 per cent interest on the allotted capital, the tax authorities considered that such an interest was incompatible with general principles of taxation. Thus the interest on allotted capital was taxed as profit. The taxpayer did not contest the adjustment but required the deduction of an even higher amount to take into account the whole interest and various legal charges incurred by the head office for the benefit of this sole permanent establishment. Since the information on the direct connection between the activity in Switzerland and the charges incurred in the country of the head office was doubtful, the tax authorities refused the supplementary deductions claimed by the taxpayer.
