Transfer Pricing and Double Tax: Rethinking Conventional Wisdom

By Michael C. Durst


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In this article, Durst reexamines the common belief that greater use of preestablished transfer pricing methods, such as fixed margin or formulary methods, will lead to more harmful double taxation than occurs under systems that rely on case-by-case, ad hoc pricing methods. Durst's analysis suggests that preestablished methods likely would result in less, not more, harmful double taxation, even if different countries adopt conflicting preestablished methods (such as conflicting apportionment formulas). He briefly discusses implications of that conclusion for tax policymaking. He is grateful for comments received on prior drafts. The opinions expressed in this article are his own.

Introduction

Debates over transfer pricing policies often center on whether tax laws should require that taxpayers use ad hoc or preestablished transfer pricing methods. Under the ad hoc approach, taxpayers must devise individualized transfer pricing methods that are intended to conform to all the relevant facts and circumstances of their related-party transactions. Most transfer pricing regulations worldwide use ad hoc methods. The OECD transfer pricing guidelines, the U.S. regulations under section 482, and similar rules in other countries all generally require that taxpayers take the ad hoc approach.

Ad hoc methods have the advantage, at least in principle, of providing a relatively accurate measure of the taxpayer's net income. However, the taxpayer faces uncertainty regarding whether one or more tax authorities will challenge the method that the taxpayer has designed.

Under a system of preestablished methods, the tax authority sets forth relatively simple (some would say simplistic) pricing methods that are intended to track the taxpayer's net income only roughly, but which the taxpayer can use without fear of second-guessing by the tax authority. Well-known examples of systems relying on preestablished methods include the formulary system used by U.S. states and Canadian provinces and the fixed-margin approach used by Brazil. It also has been proposed for use among countries in the European Union.

This article examines the long-standing argument that because different countries would inevitably adopt conflicting methods under a preestablished system, such a system would lead to an increased incidence of harmful double taxation. Defenders of ad hoc transfer pricing systems routinely make that argument; it serves as a centerpiece of the denunciation of formulary methods in paragraph 1.22 of the OECD's transfer pricing guidelines.[1] On the basis of that argument, ad hoc systems are perceived as more conducive than preestablished methods to the encouragement of international business investment.

An assessment of that argument, however, from the standpoint of an investor considering the establishment of a new cross-border business venture suggests that this conventional viewpoint is not only mistaken, but diametrically so. This is the case for two reasons: (i) the subjective nature of ad hoc transfer pricing methods means that different countries' results will conflict with one another at least

[1]Paragraph 1.22 of the OECD's transfer pricing guidelines provides:

> The most significant concern with global formulary apportionment is the difficulty of implementing the system in a manner that both protects against double taxation and ensures single taxation. To achieve this would require substantial international coordination and consensus on the predetermined formulae to be used and on the composition of the group in question. For example, to avoid double taxation there would have to be common agreement to adopt the approach in the first instance, followed by agreement on the measurement of the global tax base of [a multinational enterprise] group, on the use of a common accounting system, on the factors that should be used to apportion the tax base among different jurisdictions (including nonmember countries), and on how to measure and weight those factors. Reaching such agreement would be time-consuming and extremely difficult. It is far from clear that countries would be willing to agree to a universal formula.

as often as under preestablished methods; and (ii) preestablished methods do a better job than ad hoc methods of protecting taxpayers against uncertainty of effective tax rates, so that preestablished methods generally should provide a more encouraging environment for international investment and trade. The following portions of this article explain the different investment environments provided by ad hoc and preestablished methods and illustrate the difference in a numerical example.

Ad Hoc vs. Preestablished Methods

A starting point in the analysis is to recognize that in terms of the frequency of conflicts between the transfer pricing assessments made by different countries regarding the same facts, ad hoc transfer pricing methods almost certainly result in double taxation at least as frequently as do preestablished methods, even when the formulas or other preestablished methods faced by taxpayers in different jurisdictions are to some extent inconsistent. Ad hoc transfer pricing rules give both taxpayers and tax administrations wide scope for exercising judgment in devising transfer pricing methods on a case-by-case basis. The OECD guidelines even state that transfer pricing is ''not an exact science,''[2] and the most that typically can be hoped for is not a single but instead a range of results, all of which might be seen as correct.[3] Given the wide degree of subjectivity that is acceptable in applying ad hoc methods, it is almost certain that two different tax authorities seeking independently to devise ad hoc methods for the same set of transactions will come up with inconsistent results.

Moreover, and more importantly, ad hoc transfer pricing methods pose special difficulties not only because of the high probability that different countries will use inconsistent methods and reach different results under the same set of facts, but also because the taxpayer has no way of predicting the manner and extent to which the two countries' approaches will differ. As a result, taxpayers under ad hoc transfer pricing regimes face a high degree of *uncertainty* as to the combined tax burden they are likely to face from a cross-border activity.[4]

When a multinational business group is considering whether to commit to a new investment, a key consideration typically is whether the anticipated rate of after-tax income will equal or exceed the group's threshold rate. In a system of ad hoc transfer pricing methods, however, the potential investor in a cross-border business cannot predict with reasonable certainty what proportion of the total income from an anticipated business venture each country will seek to tax. Instead, the best it can hope is to predict the arm's-length range of results each country might reach in its own transfer pricing analysis — and those ranges can be astonishingly broad.[5] The taxpayer therefore cannot predict with a high degree of confidence the overall effective rate at which the cross-border business activities which the taxpayer might conduct will be taxed. That uncertainty can be expected to discourage business investment, as well as international trade and economic growth.

The situation under preestablished pricing methods is not as problematic for the taxpayer. Under preestablished methods, double taxation is not likely to arise every time different countries apply their methods to the same facts — instead, it is likely to arise only when the formulas or other methodologies used by the different countries are inconsistent. This will be the case often, but not as often as double taxation arises under ad hoc transfer pricing methods. And very importantly, to the extent that double taxation will be present, the taxpayer *knows in advance* the extent to which it is likely to occur. The taxpayer therefore can predict the effects of any double taxation on its overall tax rate and can confidently make the decision whether or not to invest.[6]

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[2]OECD guidelines paragraph 1.13.

[3]Paragraph 3.55 of the OECD guidelines provides:
In some cases it will be possible to apply the arm's length principle to arrive at a single figure (*e.g.*, price or margin) that is the most reliable to establish whether the conditions of a transaction are arm's length. However, because transfer pricing is not an exact science, there will also be many occasions when the application of the most appropriate method or methods produces a range of figures all of which are relatively equally reliable. In these cases, differences in the figures that comprise the range may be caused by the fact that in general the application of the arm's length principle only produces an approximation of conditions that would have been established between independent enterprises. It is also possible that the different points in a range represent the fact that independent enterprises engaged in comparable transactions under comparable circumstances may not establish exactly the same price for the transaction.

[4]For prior discussion of this phenomenon, see Michael C. Durst, ''Untangling Double Taxation in Transfer Pricing Policymaking,'' *Tax Notes*, Mar. 26, 2012, p. 1689, *Doc 2012-4066*, or *2012 TNT 58-10*.

[5]*See* Durst, ''Pragmatic Transfer Pricing for Developing Countries,'' *Tax Notes*, Jan. 9, 2012, p. 243, *Doc 2011-25096*, or *2012 TNT 5-11*.

[6]Under preestablished transfer pricing methods, the presence of potential double taxation has the same economic effect as an increase in the statutory tax rates of one or both of the countries that are involved, announced to the taxpayer in advance of the investment decision. The taxpayer has an opportunity to avoid this tax increase, thereby allowing the taxpayer to avoid an economically undesirable investment.

Double taxation is economically harmful if the potential business investor cannot foresee it — that is, if the possibility of double taxation subjects an investor to economic uncertainty. If double taxation can be predicted in advance, it amounts in effect to a foreseeable increase in the taxpayer's prospective effective tax rate, which the taxpayer can take into account in making his investment decisions. The analysis in the OECD transfer pricing guidelines neglects to take that important business consideration into account. The guidelines therefore reach the wrong conclusion concerning the relative effects of double taxation under different kinds of transfer pricing methods.

I offer below a numerical example to illustrate the differences between the operation of ad hoc and preestablished transfer pricing methods in the context of an international investment decision. Before moving to that example, however, and particularly because of the emotional heat that sometimes surrounds any discussion relating to formulary apportionment or other preestablished transfer pricing methods, it will be useful to try to put the argument made in this article in a public policy perspective.

First, I don't purport in this article even remotely to settle the longstanding debate between the desirability of "arm's-length" versus "formulary" transfer pricing regimes. The article attempts only to re-examine the "harmful double taxation" argument against formulary and other preestablished methods, as put forth in paragraph 1.22 of the OECD guidelines. Additional arguments exist on both sides of the debate between preestablished and ad hoc methods, and those arguments must be considered in making overall policy conclusions.

Second, it should be understood that no comparison of the relative merits of preestablished and ad hoc methods can ever fully dispose of the transfer pricing policy problem, if only because there is no such thing in practice as a purely preestablished or ad hoc transfer pricing system. Ad hoc systems typically allow in practice for many safe harbors, often for recurring kinds of transactions, and can offer taxpayers the opportunity to enter into advance pricing agreements, which can effectively convert ad hoc into preestablished methods. Similarly, preestablished rules, such as those in formulary and fixed-margin systems, typically allow both the taxpayer and the tax authority substantial discretion when the preestablished methods don't appear to fit.[7] Therefore, even if there were clear reasons to support either preestablished or ad hoc transfer pricing systems, the practical result would still be a set of hybrid systems.

Nevertheless, the belief that preestablished methods would exacerbate harmful double taxation is deeply seated and undoubtedly has influenced policymaking over the years. A reexamination of that belief might therefore lead to a more effective set of global transfer pricing rules.

An Example

Assume the following:

1. Parentco is resident for tax purposes in Country A, which imposes corporate income tax at a rate of 35 percent.

2. Parentco is considering establishing an operating subsidiary in either Country B, which imposes corporate income tax at a rate of 18 percent, or Country C, which imposes corporate income tax at a rate of 20 percent. Parentco anticipates that it and an affiliate in either Country B or Country C will jointly operate a new line of business that will include research and development, manufacturing, advertising, and distribution activities, all of which will be conducted in both Country A and either Country B or Country C — whichever is selected for the new venture. Apart from income tax considerations, countries B and C are equally attractive locations for Parentco's envisioned investment.

3. Based on an analysis of its threshold after-tax rate of return, Parentco believes that in order for the envisioned venture to be adequately profitable on an after-tax basis, income from the venture can be subject to an effective income tax rate of no more than 24 percent.

4. Parentco anticipates that 45 percent of the sales from the envisioned venture will occur in Country A and that the remaining 55 percent will occur in either Country B or Country C, depending on which country is chosen for the venture. Parentco also anticipates that 50 percent of the operating expenses of the venture will be incurred in Country A, and 50 percent in Country B or Country C.

5. Countries A, B, and C all operate under a system of ad hoc transfer pricing methods similar to the system described in the OECD transfer pricing guidelines. Based on its own economic analysis, Parentco determines that the proper transfer pricing method is a residual profit-split method under which 50 percent of the income from the envisioned

[7] *See, e.g.*, section 18 of the Uniform Division of Income for Tax Purposes Act, under which taxpayers and state tax authorities can reach agreement on alternative apportionment methods.

business activities will be taxable in Country A, and 50 percent in either Country B or Country C.

6. Because all three countries operate under an ad hoc transfer pricing regime, Parentco cannot be certain that countries A, B, and C will agree with its assessment regarding the proper transfer pricing method for the new venture. Instead (absent an APA, which is assumed in this example not to be available), Parentco must try to estimate a range of possible transfer pricing positions that each country might assert. Based on its understanding of the past practices of the revenue authorities in countries A, B, and C, Parentco estimates that each country is likely to assert that between 40 and 60 percent of the aggregate income from the proposed venture is to be taxed in its jurisdiction, with the likelihood of a particular position approximately uniform throughout that range.

7. Parentco therefore anticipates that if it chooses to make its new investment in Country B, the effective tax rate on income from the venture might range from a low of 22.8 percent ((0.4 x 0.3) + (0.6 x 0.18)) to a high of 25.2 percent ((0.6 x 0.3) + (0.4 x 0.18)). Similarly, Parentco anticipates that if it chooses to make the new investment in Country C, the effective tax rate on income from the venture might range from a low of 24 percent ((0.4 x 0.3) + (0.6 x 0.2)) to a high of 26 percent ((0.6 x 0.3) + (0.4 x 0.2)). These results are summarized in Table 1.

Table 1. 'Ad Hoc' Scenario

	Country A	Country B	Country C
Nominal tax rate	30%	18%	20%
Range of possible combined effective rates if investment made in Country B or C	___	22.8%-25.2%	24%-26%

The results show, not surprisingly, that Country B, with its 18 percent rate, is likely to provide a more hospitable environment for Parentco's proposed investment than Country C, with its higher rate. That is not the key observation, however. Even if lower-tax Country B is chosen for the investment, Parentco faces uncertainty regarding whether its effective tax rate will be low enough to justify the envisioned investment. Depending on how much weight Parentco assigns to that uncertainty in making its investment decision, Parentco might choose not to make the investment. Thus, the use of ad hoc transfer pricing regimes by countries A, B, and C would end up imposing a restraint on international investment.

The uncertainty faced by Parentco might be alleviated if the countries involved have tax treaties with one another so that competent authority negotiations might result in Country A on one hand, and either Country B or Country C on the other, applying consistent transfer pricing methods. However, even if competent authority negotiations are available (and they often are not) and costless to the taxpayer (which they never are), the taxpayer still faces uncertainty, because it cannot predict how the competent authority negotiations will turn out. If Country A "wins" the negotiations, income from the venture might be taxed at a rate of more than 24 percent. The availability of competent authority relief, therefore, is not a cure for the business uncertainty inherent in ad hoc transfer pricing systems.

Consider now the same facts as above, but modified as follows:

1. Instead of applying ad hoc transfer pricing methods, countries A, B, and C all employ preestablished transfer pricing methods, although the methods employed are to some extent inconsistent. In particular, Country A taxes within its jurisdiction a percentage of the total global income derived from a cross-border activity equal to 0.5 times the percentage of the total sales from the activity that are made in Country A, plus 0.5 times the percentage of the total operating expenses from the activity that are incurred in Country A. Countries B and C each tax within their jurisdictions a percentage of the total global income from a cross-border activity equal to 0.6 times the percentage of the total sales from the activity that are made in Country B or C (as the case may be), plus 0.4 times the percentage of the total operating expenses from the activity that are incurred in the country.

2. Taking into account the distribution of sales and operating expenses provided above, if Parentco makes its investment in Country B, it will face an effective tax rate of 23.79 percent, or 30 x ((0.5 x 0.45) + (0.5 x 0.5)) + 18 x ((0.6 x 0.55) + (0.4 x 0.5)), on income from the anticipated activities. If Parentco makes its investment in Country C, it will face an effective tax rate of 24.85 percent, or 30 x ((0.5 x 0.45) + (0.5 x 0.5)) + 20 x ((0.6 x 0.55) + (0.4 x 0.5)).

Table 2. 'Preestablished' Scenario			
	Country A	**Country B**	**Country C**
Nominal tax rate	30%	18%	20%
Percentage of sales in country	45%	55%	55%
Percentage of operating expense in country	50%	50%	50%
Method	0.5 x PCTsales + 0.5 x PCTopex	0.6 x PCTsales + 0.4 x PCTopex	0.6 x PCTsales + 0.4 x PCTopex
Effective tax rate if Country B or C is chosen for investment	___	23.79%	24.85%

The implications for Parentco are clear: Because the different jurisdictions have set forth their transfer pricing methods in advance, Parentco can be reasonably sure that if it makes the envisioned investment in Country B, it will face an acceptable overall effective tax rate on income from the venture. (If Parentco chooses to make the investment in Country C, however, the overall rate that it faces will be excessive.) Parentco is more likely to proceed with the investment under the preestablished transfer pricing regime than under the ad hoc regime (and Parentco will make the investment in Country B, not Country C). The use of preestablished methods, even though the methods used by the different countries in the example differ to some extent, has provided an environment that is more conducive to international investment.

A caution is required in interpreting the example: The example assumes perfect ability of the countries concerned to measure the taxpayers' sales and operating expenses in their jurisdictions. In practice, the measurement of those amounts is imprecise so that taxpayers face some degree of uncertainty even under preestablished methods. The overall conclusion, however, remains clear: To the extent that transfer pricing methods can be made known to taxpayers (or agreed between taxpayers and the revenue authority) in advance, taxpayers are likely to face less uncertainty regarding effective tax rates (and hence their after-tax incomes), and trade and investment are likely to improve. Preestablished transfer pricing methods therefore appear less prone to harmful double taxation than are ad hoc methods, even if different countries use conflicting preestablished methods.

It is worth noting that in the example, because of the inconsistency between the preestablished methods used by countries A and B, some double taxation does exist. Specifically, because Country B weights sales at 55 percent and Country A weights them at 50 percent, together they can be seen as using 105 percent of the taxpayers' combined sales in computing their taxes. But because that double taxation is known in advance, Parentco can take it into account in making its investment decision. In contrast, under an ad hoc approach, Parentco does not know whether double taxation is likely to occur, and that uncertainty can inhibit the company from undertaking its proposed business activity.

Implications

Although the argument offered here cannot by itself resolve the debate between ad hoc and preestablished transfer pricing methods, it does suggest that historical criticism of preestablished methods has failed to distinguish between double taxation that can and cannot be anticipated and therefore incorporated into taxpayers' business decisions. If policymakers are to choose effectively between ad hoc and preestablished transfer pricing regimes, the conventional wisdom must to be altered so as to incorporate a better appreciation of the effects of uncertainty on business investment. Under a corrected analysis which gives due regard to the problem of investment uncertainty, preestablishing transfer pricing methods, including formulary methods, are likely to appear more desirable on economic grounds than many have perceived them in the past.

Some additional policy recommendations also seem warranted:

1. Advance pricing agreements (APAs) can convert ad hoc methods into a preestablished methodology, thereby mitigating taxpayer uncertainty. Accordingly, to the extent that countries retain regimes of ad hoc transfer pricing methods, they should facilitate the availability of APAs and, in particular, attempt to process APA requests quickly enough to provide reliable answers to taxpayers in advance of the need to make investment commitments. Speeding up the APA process (admittedly a difficult exercise) could provide benefits in terms of promoting trade and investment, as long as ad hoc transfer pricing methods remain the dominant rule worldwide. It is doubtful that enough situations could feasibly be covered by APAs, which usually must be issued on a case-by-case basis, to alleviate the bulk of the problems associated with uncertainty under ad hoc transfer pricing methods. Nevertheless, APAs should be able to make a positive contribution, particularly regarding large international investments.

2. Greater use of safe harbors, as recommended by some, including OECD Working Party 6, can provide substantial net benefits by reducing taxpayer uncertainty in many situations.[8] The adoption of safe harbors around the world should be accelerated.

3. The traditional argument that under formulary systems, differences among countries' formulas would lead to more harmful double taxation than arises under current transfer pricing rules appears to be without logical support. There may well be valid economic arguments against formulary regimes, but harmful double taxation does not seem to be one of them. In the interest of sound policymaking, this persistent but mistaken argument should be removed from the OECD guidelines and retired from the international debate.

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[8]*See supra* note 6.