TRANSFER PRICING: ALTERNATIVE METHODS OF TAXATION OF MULTINATIONALS
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TAX ADMINISTRATION IN SUB-SAHARAN COUNTRIES
TRANSFER PRICING ISSUES

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1. Modern transfer pricing guidelines, following the arms length principle, were initiated by the United States in the 1960s and then adopted by OECD member countries.
2. Not long after adoption by the OECD, non-OECD countries turned to the UN for assistance with transfer pricing and also double tax agreements believing that the OECD rules in both areas were not necessarily in their best interests.
3. For most of my sixty year career, I worked primarily with OECD member countries and their multi-nationals
4. About two-years ago, I began working in a sub-Saharan African country (SSAC) with respect to transfer pricing and other tax issues, and I realized several major differences between the OECD countries and my African client with respect to resolving transfer pricing problems:
    a. The OECD countries have extremely large and complicated economic systems as opposed to most SSAC.
    b. There are major capital flows in and out of the OECD countries while capital flows into the SSAC.
    c. The major investors in the SSAC economies are neither citizens nor residents of the SSAC countries.
    d. Possibly most importantly, the SSAC countries lack the administrative resources to deal effectively with foreign MNCs with respect to transfer pricing issues while the OECD countries with their huge resources have similar problems—all to the advantage of the MNC.
5. In the SSAC in general:
    a. The home based economic activity is relatively small involving retail stores, farms, minor manufacturing and the like, certainly as compared with a typical OECD country
    b. The largest economic activity is often extraction of natural resources by foreign-based companies. The SSAC usually lacks the resources including skills and capital to exploit such assets.
    c. The major source of revenue in the SSAC countries is often from the natural resource industry and together with other large players; possibly in telecommunications and goods distribution are breeding grounds for transfer pricing manipulation.

6. Accordingly, while transfer pricing may be a problem in the OECD countries,[1] as a share of revenue the issue can have a relatively greater impact on government revenues in the SSACs.
7. The arms length method has been the guiding principle from time immemorial and remains flawed but the best test yet devised. The application of the test including guidelines and administration need continual adjustment particularly as they impact the developing world which is what I wish to discuss. Formulary apportionment, a system to be discussed here, is not only impossible of administration but at least in some forms, including its use in the United States would be devastating to the SSAC
8. Let us look at the situation in the SSAC as compared to OECD members with respect to transfer pricing issues. On the plus side:
    a. In the natural resource area, a major source of revenue, the number of taxpayers is generally small, furthermore in many cases indices are available which can assist in estimating arms length sales prices.
    b. In many cases the natural resources are mined and exported with little if any processing in country—this simplifies transfer pricing issues
    c. In many cases double tax issues are not involved as the investments are made through a tax haven or sometimes a chain of tax havens
    d. Relatively few industries generate the transfer pricing issues compared with hundreds of different situations in OECD countries. The most common are:
        i. Natural resources
        ii. Telecommunications
        iii. Goods Distributors
    e. Many foreign investments require approval or detailed concession agreements which can contain provisions which ease the administration of transfer pricing issues.
    f. Technical assistance available from ATAF, IMF, AfDB, IBRD, OECD, governmental sources, such as the US Treasury's Revenue Advisory Program, Office of Technical Assistance, and Finland's Ministry of Foreign Affairs, as demonstrated by this conference as well as other regional and international organizations, and NGOs such as the International Senior Lawyers Project.
9. On the negative side are the following:
    a. As previously noted lack of experienced staff
    b. Lack of budgetary resources to staff properly tax administration and obtain equipment, lack of trained economists, data bases and the like
    c. Much of the information needed to pursue transfer pricing cases lies outside the SSAC and is often unavailable to the tax inspector

10. Suggestions for tax policy and administration in SSAC. The following suggestions may require legislation but some may be done by regulatory means.

[1] Martin A. Sullivan, "Transfer Pricing Costs U.S. at Least $28 Billion," *Tax Notes,* Mar.22, 2010

Comment [s1]: I agree with this as stated with respect to administration. The biggest issue in this are that I have not formed a view on is whether the agreement should have separate substantive tax provisions. I would say "no", except the stabilization clauses screw everything up. My current thinking is that stabilization clauses should not be allowed to apply to taxation and that taxation should be under the applicable domestic law as it may be changed from time to time.

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a. Adopt arms length principle and apply OECD/UN transfer pricing guidelines with adjustments as appropriate as discussed below:
   i. Do not permit cost-sharing[2i]
   ii. Do not permit contractual "risk" allocation and deductibility of payments with related parties that are based on purported allocation of risks within the controlled group
   iii. Look closely at supposed "comparables" if questionable about comparability or if broad range, move quickly to profit split or other alternative.
   iv. Instead of *permitting* allocation of income by revenue service when related party transactions are not at arms length, provide
      1. All transactions *must be* at arms length
      2. Transactions with related parties are *presumed not to be* at arms length (so taxpayer has burden to establish that they are at arm's length with documentation)
      3. Substantial penalties will be incurred when adjustments are required.

b. Train staff—take advantage of all opportunities. Focus on large case audits with most revenue potential. A few successful audits could account for major benefits.

c. Impose reasonable withholding taxes which will equate sufficiently to normal income tax on all income payments (except payments for sales of property) to minimize need to verify arms length nature of service fees.

d. Taxpayers are required to provide full information with respect to all related party transactions certified by appropriate high ranking personnel and on a continuing basis

e. Taxpayers must provide full information with respect to all shareholders/owners through the complete chain until a publicly held company is reached and even in such cases full details as to any party owning more than 5% of such a company

f. Taxpayers are to disclose on tax returns all related party transactions and how arms length price was determined. Taxpayers must furnish all documentation filed with any taxing authority with regard to any transactions or products involved in the host country activities.

g. Tough thin capitalization rules

h. Include appropriate safe harbors as well as presumptions with respect to low-risk related party transactions

i. Taxpayers must provide copies of any advance pricing agreements entered into by any member of the chain of ownership that relates to products or services also produced or rendered by taxpayer in the host country.

Comment [s2]: This can be done by regulation. Should discourage any statutory authorization of cost sharing.

Comment [s3]: The transfer pricing effects of risk sharing go well beyond deductible payments (unless you assume one-way direction which I would not in every case).

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[2] [2]The OECD released a new paper on intangibles just last week, and I have not had the chance to study it sufficiently to include it in this presentation and decided not to discuss out of date issues. This latest draft was prepared by OECD CFA Working Party 6 in which 9 non-OECD member countries participated.

j. Taxpayers must provide all data properly certified by knowledgeable senior officials at the level of the controlling person ("up-stream certification").
k. Investors and their parent companies should not be allowed to claim agreements are not available or have been classified as "Confidential."
l. SSACs must strictly adhere to the secrecy afforded tax information.
m. Severe penalties will apply to failure to provide or providing inaccurate information and unauthorized disclosure of information.
n. Encourage use of APAs with respect to the larger taxpayers by making such APAs advantageous to the investor and to the revenue. Consideration should be given not only to providing for negotiation of APAs in concession and licensing agreements but actually setting forth agreed means of determining at least some data relevant to determining royalties and income.
o. Limit the scope of any required stabilization agreements so as not to include tax issues.
p. Provide appropriate guidance through regulations and other assistance but tailor the guidance to the needs of the country's taxpayers and the tax administrators which should result in much more simplified guidelines than provided by the OECD and its member countries.
q. Adopt appropriate general anti-avoidance rules (GAAR)..

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Comment [s4]: Having said this, I am skeptical of basis for confidentiality of corporate (non-personal) tax information.

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Comment [s5]: I think this comment should be limited to concession agreements, where the government has some leverage.

I am skeptical of the use of APAs that are voluntary to taxpayers. I think the history is that the taxpayers get more than the tax authorities.

Comment [s6]: YES!

Comment [s7]: YES.

11. Double Tax Agreements
    a. DTAs generally provide little benefit to SSACs outside of administrative assistance and competent authority
    b. dispute resolution as the international models including the UN model generally are based on reducing source based taxation.
    c. The SSACs will have little if any income sourced in the putative treaty country and such provisions even if limited serve to reduce much needed SSAC revenue.
    d. In today's world most major countries except for the US exempt much foreign income from source or provide a foreign tax credit unilaterally. Much of the foreign investment is run through tax haven countries so there is no genuine threat of double taxation.
12. Tax Information Exchange Agreements
    a. TIEAs were introduced to cover situations in which a full-blown DTA was not appropriate or available.
    b. Recently, the Multilateral Convention on Mutual Administrative Assistance in Tax Matters has been opened to non-OECD member countries and can be a valuable transfer pricing administration tool.
    c. Alternatively, bilateral TIEAs are also appropriate.
    d. SSACs should strive through whatever is the best means, to be able to obtain information particularly with respect to the residence countries of its major investors.
13. Concession and License Agreements
    a. Such agreements should not be used for the purpose of creating new tax or mineral "laws," by modifying existing laws.

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b. As previously suggested, stabilization agreements should be kept to a minimum and in any case should exclude tax laws.
c. The agreements can be used for the purpose of assuring information with respect to the chain of companies which often exist to make the investment as well as other companies in the group and to assure continued access to such information during the life of such agreements.

14. Investors and Host Governments
    a. There needs to be mutual obligations to comply with the spirit and intent of the relevant agreements
    b. The investors need to publish information regarding transactions on a project by project basis
    c. The SSAC and the investor must provide each other with a corruption free environment and cooperative and knowledgeable counterparts
15. NGOs should continue to provide their constituents with knowledgeable documented studies exemplified by the SABMiller study by ActionAid. Such studies and resulting publications need to carefully distinguish between lawful minimization of taxes and tax evasion. That is not to say that there should not be disclosures to encourage all governments to close tax loopholes and prevent untoward tax minimization. Furthermore, in many cases inept tax administration by a host government or lack of good governance and corruption contributes to the minimization of tax revenues. In many cases tax evasion requires two to tango.
16. In examining the role of the OECD with respect to transfer pricing we should look at what it is doing at the present time and for at least the last several years during which it has increased its commitment and resources to the developing world. OECD created the Task Force on Tax and Development, and the Global Forum on Transfer Pricing whose first meeting included 90 countries. OECD's work on risk assessment for determining what audits to pursue and what issues to focus on, documentation, home office expenses, and safe harbors, are particularly helpful to the developing world.

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Deleted: [i] My work to date has not involved intangible property to any large extent and I will leave these difficult problems to others.