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TRANSFER PRICING: WILL THE OECD ADJUST TO REALITY?

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The BNA Transfer Pricing Report had an article, "The Arm's Length Principle and Developing Economies (Vol.20, No.12, October 20, 2011) ("OECD Staff Report"), written by the current head of the Transfer Pricing Unit in the OECD's Center for Tax Policy and Administration (CTPA) and two previous CTPA officers. The OECD Staff Report defended the OECD's arm's length principle described in the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations of July 2010 ("OECD Guidelines"), in particular for developing countries. [1]

In reply to the OECD Staff Report, this article will discuss how the OECD Guidelines are faulty in theory and practice, and that the OECD Guidelines are generally unworkable. Further, this article will analyze the comments in the OECD Staff Report about the following topics: (1) the OECD's assertion of the "sound theoretical basis" of the OECD Guidelines; (2) the OECD's emphasis on the need for a consistent global transfer pricing system, and the OECD's assertion that such "consistent global transfer pricing system" must be based on the OECD's Guidelines; (3) the OECD's rejection of a fixed margin system with minimum income requirements, such as the Brazilian transfer pricing system; (4) the application of the OECD Guidelines to developing countries, and the role of the United Nations. This article is a follow-up of an article "Challenging the Status Quo: The Case for Combined Reporting" by Prof. Michael McIntyre, of Wayne State University Law School and Senior Adviser of the Tax Justice Network (the "McIntyre Article"). [2] The McIntyre Article challenges assertions in the OECD Staff Report about formulary apportionment and combined reporting.

Is There A "Sound Theoretical Basis" of the OECD's Arm's – Length Principle?

The OECD Staff Report (p. 495) begins by quoting the OECD Guidelines (paragraphs 1.14-15), that "the arm's length principle is <u>sound in theory</u> .....:"

> The view of OECD member countries continues to be that the arm's length principle should govern the evaluation of transfer prices among associated enterprises. The arm's length principle is <u>sound in theory</u> since it provides the closest approximation of the workings of the open market in cases where property is transferred or services are rendered between associated enterprises. While it may not always be straightforward to apply in practice, it does generally produce appropriate levels of income between members of MNE groups… A move away from the arm's length principle would abandon the <u>sound theoretical basis</u>

[1] The two previous CTPA officers, Mary Bennett and Caroline Silberztein, are currently partners of Baker & McKenzie.

[2] BNA Transfer Pricing Report, Vol. 20, No. 22, March 22, 2012.

> described above, and threaten the international consensus thereby substantially increasing the risk of double taxation…OECD member countries continue to support strongly the arm's length principle. (Emphasis added).

However, the OECD Staff Report does not detail nor describe such "sound theoretical basis."

The main weakness of the OECD Guidelines is that there is no such "sound theoretical basis." According to Michael Durst, who from 1994 to 1997 served as Director of the U.S. Internal Revenue Service's Advanced Pricing Agreement (APA) Program, there is "a gaping conceptual hole at the heart" of the OECD Guidelines: [3]

> The basic tenet of arm's-length transfer pricing – the availability of "uncontrolled comparables" for transactions between commonly controlled parties – is based on a fundamental misunderstanding of practical economics. Multinationals groups form because in some industries and markets, it is economically infeasible to operate nonintegrated business. For example, in large markets, it is not feasible for manufactures and distributors to be separately owned. That means that for transactions between members of multinational groups – precisely the transactions for which transfer pricing rules are important – the uncontrolled comparables on which the current rules try to depend seldom if ever exist. There is, therefore, a gaping conceptual hole at the heart of the OECD transfer pricing guidelines, as well as the national rules of the United States [in the U.S. Internal Revenue Code] and many other countries. (Emphasis added).

Durst continues:

> The inescapable problem, however, is that the failure of the arm's-length system is not rooted merely in the particular way the system is implemented. The problem lies in the assumption, on which the entire system is based, that the tax results of multinational groups can be evaluated as if they were aggregations of unrelated independent companies transacting with one another at arm's length. Until that view is finally abandoned and replaced by one that is more attuned to practical realities, the international corporate tax system will remain unadministrable.

Michael Durst has written further about the theory underlying the OECD's arm's-length principle, and stated that "the OECD approach to transfer pricing, both theoretically, and empirically, falls apart:"

[3] "It's Not Just Academic: The OECD Should Reevaluate Transfer Pricing Laws," Tax Notes, January 18, 2010, pages 247-256, and Durst, "The Two Worlds of Transfer Pricing Policymaking," Tax Notes, January 24, 2011, pp. 443-444. See also Michael Durst, "OECD Guidelines: Causes and Consequences," presentation at the Max Planck Institute, December 11, 2010, 24 pages, in particular pages 2 and 3.

………. In proposed revisions [which were finalized] to the OECD's transfer pricing guidelines, the [OECD] Committee on Fiscal Affairs repeats generalizations concerning the arm's-length standard that simply cannot be supported by any fair evaluation of real-life experience. Thus, in a model of understatement, the Committee claims (OECD Guidelines, paragraph 1.11): "A practical difficulty in applying the arm's length principle is that associated enterprises may engage in transactions that independent enterprises would not undertake." This would suggest that generally, members of multinational groups function pretty much as would independent enterprises transacting with one another arm's length, and that departures from this comfortable situation are exceptions rather than the rule. The reality, however, is just the opposite: Multinational groups exist precisely because it is impossible to conduct their business other than under common control; members of multinational groups will rarely, if ever, transact business with each other similarly to unrelated parties acting at arm's length. Similarly, the proposed revisions would repeat the statement from the existing guidelines: "the arm's length principle has….been found to work effectively in the vast majority of cases" [revised paragraph 1.9]. While in political environments such as the OECD, people sometimes find themselves saying things they later find they cannot support, it is inconceivable to me that any fair observer of transfer pricing practice over the past 20 years could believe this statement to be correct. [4]

Durst has further stated about paragraph 1.9 in the OECD Guidelines: "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." Durst comments: "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."

Durst has an additional comment about paragraph 1.9 of the OECD Guidelines:

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

[4] "It's Not Just Academic: The OECD Should Reevaluate Transfer Pricing Law," Tax Analysts, January 18, 2010, pages 247-256. See also, Durst, "OECD Guidelines: Causes and Consequences, footnotes 3, above, and page 4.

> 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.[5]

Michael Durst has in effect implied that the OECD's arm's-length standard exists precisely because it is unenforceable and that is why business lobbyists, in the United States and other countries, have supported it so energetically.

The "flaws in both theory and practice" in the OECD's arm's-length standard were also emphasized by economist Martin Sullivan, Ph.D., at a hearing on "Transfer Pricing Issues in the Global Economy" before the Committee on Ways and Means of the U.S. House of Representative on July 22, 2010:

> This [OECD] standard gives primacy to the often futile search for comparable unrelated-party transactions in the hope of using those transactions to determine the terms for related-party transactions. The arm's-length method is seriously flawed in both theory and practice. The theoretical problem is that because of synergies within a large corporations—what economists call "economies of scope"—the economic relationship between entities within a corporate group are not the same as those between [unrelated] parties. The practical problem is the lack of truly comparable unrelated transactions that can be used to apply the arm's-length method to related party transactions. As manufacturing and the importance of national borders shrink, cross-border transfers of valuable intellectual property within a single multinational are becoming increasingly common. Unfortunately, this is the type of transfer pricing issue that poses the greatest challenge to the arm's-length method. The simple reason is that intangibles by their nature are unique, and so it is always difficult, and frequently impossible, to identify transactions between unrelated parties involving the transfer of comparable intangible assets. Administering the arm's-length method without comparables is like playing hockey without a puck. This standard gives primacy to the often futile search for comparable unrelated-party transactions in the hope of using those transactions to determine the terms for related-party transactions.

Reuven Avi-Yonah, Professor of Law and Director of the, International Tax LLM, at the University of Michigan, and Ilan Benshalom, Assistant Professor, Hebrew University of Jerusalem, criticize the theoretical basis of the OECD's arm's-length standard ("ALS"), emphasizing that the increasing centralization of management by multinationals has made the arm's-length principle outdated and that the central assumption of the arm's-length principle defies reality: "At the heart of the ALS [Arm's-

[5] Michael Durst, "OECD Guidelines: Causes and Consequences," page 5.

Length Standard] system, with its reliance on estimated “arm’s length” prices is the assumption that each affiliated company within the group transacts with the other members of the group in the same way that it would transfer if the members were unrelated. That central assumption defies reality, and it is not surprising that a system of “arm’s length” pricing cannot yield sensible results.[6]

Reuven Avi-Yonah and Ilan Benshalom emphasize the fallacy at the central core of the OECD’s arm’s-length system, and why such system is historically outdated:

> Finally, it is important to note that the problems with the current system derive not from rules at its periphery, but instead from a fallacy that lies at the system’s central core: namely, the belief that transactions among unrelated parties can be found that are sufficiently comparable to transactions among members of multinational groups that they can be used as meaningful benchmarks for tax compliance and enforcement. For example, if one wants to determine the “arm’s length” level of profitability of a U.S. distribution subsidiary of a foreign manufacturer of automobiles, one identifies one or more independent U.S. distributors of automobiles operating in economically, similar circumstances and uses the income of the independent distributor or distributors to benchmark the income of the U.S. subsidiary.
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> Such an approach might well have made sense eighty years ago, when the legislative language underlying today’s arm’s length standard for income tax purposes was first developed. At that time, although multinational groups existed, available transportation and communications technology did not permit centralized management of geographically dispersed groups. Therefore, members of multination groups functioned largely as independent entities, and benchmarking their incomes or transactions based on uncontrolled comparables probably made good sense.
>
> That situation changed, however, with the technological changes precipitated by the Second World War. Today, it is possible to exercise close managerial control over multinational groups, and these groups develop in all industries and geographic markets segments in which the efficiencies of common control pose significant economic advantages. Moreover, in those industries and markets where common control poses advantages, it is typically economically infeasible to remain in the market using a non-commonly controlled structure (for example, by maintaining distributors that are economically independent of manufacturers). Therefore, in those markets in which transfer pricing issues arise – it is unlikely that reasonably close “uncontrolled

6 Reuven Avi-Yonah and Ilan Benshalom, “Formulary Apportionment-Myths and Prospects,” University of Michigan Law School Public Law and Legal Theory Working Paper Series, Empirical Legal Studies Center, Paper 28, 2010.

> comparables" can be found. For example, to my knowledge, there are no independently owned distributors of mass-market automobiles in the United States, all of the distributors are owned by their manufactures.
>
> The same is true of virtually every other industry that is conducted on a large global scale. In sum, no matter how assiduously one performs "functional analyses" designed to identify "uncontrolled comparables" that are reasonable similar to members of multinationals group, one is rarely going to find them. Certainly such comparables will not be – and have not been – found with sufficient regularity to serve as the basis for a workable transfer pricing system. If the transfer pricing rules are to be made tolerably administrable, policymakers around the world will need to restate them on a basis other than that reliance on uncontrolled comparables. [7]

The problems with the OECD Guidelines, in the case of multinational banks and other multinational entities, is also discussed in detail in "Taxation of Multinational Banks: Using Formulary Apportionment to Reflect Economic Reality." [8] Sadiq notes that: "The need for comparables is also a fundamental flaw in the application of the arm's-length standard. Economic interdependence of vertically integrated multinational entities, such as multinational banks, also often means that there are no comparable transactions. Even where comparable transactions do exist the level of vertical integration may mean that the comparable prices do not reflect the contributions by the component parts of the entity. The continued globalization and integration of multinational entities mean that the problem of determining comparables will only worsen."

The Results of Implementing the OECD Guidelines

Prof. Avi-Yonah emphasizes the results of the current system, which assumes the availability of useful comparables when they are very unlikely to be found: [9]

> (i) Companies and the government spend extraordinary sums each year on efforts at compliance and enforcement, largely through the preparation of "contemporaneous documentation" by taxpayers and attempts at comprehensives examinations by the IRS involving some of the Service's most experienced and skilled personnel.

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[7] See footnote 6.

[8] Kerrie Sadiq, Journal of International Taxation, May, 2011.

[9] Reuven Avi-Yonah and Kimberly A. Clausing, "Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment," The Hamilton Project, The Brookings Institution, 2007, and Reuven Avi-Yonah "Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation," The John M. Olin Center for Law & Economics Working Paper Series, University of Michigan Law School, Paper 102, 2009.

(ii) Despite the expense of compliance and enforcement, companies and the IRS typically are dramatically far apart in their determinations of arm's length pricing. Controversies routinely involve hundred of millions of dollars and are resolved at amounts that resemble neither the government's nor the taxpayer's positions, thereby casting grave doubt on the conceptual soundness of the underlying rules.

(iii) The inability to predict whether their positions will be sustained leaves companies and their investors with large areas of uncertainty in their financial statements.

(iv) The absence of clear standards for compliance, coupled with the ability under the arm's length standard to apportion income to low-tax countries through legal arrangements governing the shifting of intangibles and (more recently) the bearing of risk, make it impossible for governments to predict with reasonable accuracy their actual amount of corporate tax revenue.

(v) The fact that neither taxpayers nor enforcement authorities typically have clear standards for judging compliance means that issues involving very large amounts – billions of dollars – of federal revenue are resolved in examination, settled in Appeals, resolved in negotiations under tax treaties with foreign governments, negotiated through advance pricing agreements, or settled by attorneys out of court after examination. In most cases, federal privacy laws required that this decision-making occur outside the public eye. In the author's experience, those in this process have served their roles with both integrity and skill. Nevertheless, the resolution of issues involving such large amounts of money, without the benefit of clearly discernable decision –making standards and public scrutiny, is not healthy for the tax system.

(vi) A related problem is that the uncertain results under current transfer pricing law degrade the quality of tax practice on the parts of both taxpayer and government representatives, regardless of the high standards of practice that both sides seek to maintain. Both sides are tempted to state, as "starting points" for what is expected to be extended negotiation, positions that strain the edges of what most would consider reasonable. The resulting atmosphere contributes to a lessening of the publicly perceived credibility of both corporations and the government – a development that is seriously damaging to what will always remain a largely mixed economic system.

H. David Rosenbloom, formerly International Tax Counsel and Director of the Office of International Tax Affairs at the U.S. Treasury Department, from 1977 to 1981, and now a partner in Caplan and Drysdale and Director of the International Tax Program at New York University Law School, has been quoted as follows: "H. David Rosenbloom called the arm's-length system as it operates today fundamentally unworkable. Nevertheless–citing treaty obligations and problems of international coordination–he had to admit we are "stuck with it." But he does not believe there must be a dichotomy between the arm's-length and formulary methods. He suggested a "midway position" whereby the IRS would presume a formulary assignment of profits but taxpayers would be allowed to rebut the presumption with reference to arm's-length principles. Rosenbloom pointed out that this could be a variant of the Brazilian system, adopted in 1997, that relies heavily on formulary methods and fixed-markup sale harbors. Brazil's approach is not compliant with the OECD's arm's-length standard." [10]

<u>The OECD Guidelines and "Appropriate Levels of Income between Members of the MNE Group?"</u>

The OECD Staff Report cites paragraph 1.14-15 of the OECD Guidelines (quoted above) which states:

> While [the arm's-length principle] may not always be straightforward to apply in practice, it does generally produce appropriate levels of income between members of MNE groups.

That statement has been challenged even by senior tax officials in the U. S. Department of the Treasury. On July 22, 2010, Stephen E. Shay, then Deputy Assistant Secretary (International Tax Affairs), U.S. Department of the Treasury, testified before the U.S. House Committee on Ways and Means. Shay stating, in summary:

> " I will focus my testimony today on [US] Treasury's analysis of the available data relating to the issue of whether profits are being shifted abroad out of the United States for tax purposes through the mechanism of related party transactions or, as the mechanism is more commonly known in the tax policy community, through transfer pricing. We conclude, based on our analysis of available data, that there is evidence of substantial income shifting through transfer pricing."

Durst comments about "appropriate levels of income between members of MNE groups:"

> It is not surprising, then, that real-life transfer pricing examinations, no matter how well conducted, eventually dissolve in confusion and controversy. Anyone who has participated in a transfer pricing controversy, whether from the standpoint of the taxpayer or the government, can see vividly that the system does not achieve its intended result of a reasonably clear measure of company's taxable income

[10] Martin A. Sullivan, "Combining Arm's-Length and Formulary Principles," Tax Notes, January 25, 2010, page 314.

according to clearly articulated, and hence practically enforceable, standards. [11]

Income Shifting to Low Tax and No Tax Jurisdictions

The OECD Staff Report (p. 496) states that “it is a also undoubtedly the case that some multinational companies appear to report more income in low-tax jurisdictions and tax havens than can be economically justified, to the detriment of both developed countries with higher tax rates.” This is an understatement. This issue of income shifting to low tax /no tax jurisdictions by U.S. multinationals is emphasized by Reuven Avi-Yonah and Kimberly A. Clausing, [12] and also by Michael Durst.

The issue of U.S. multinationals shifting income to low tax/no tax jurisdictions was discussed by Martin Sullivan in his congressional testimony to the U. S. House Ways and Means Committee, on July 22, 2010:

> My testimony will address the magnitude of the transfer pricing problem, its detrimental impact on the economy, and the need for congressional action to overhaul rules for apportioning profits of global business. In addition to anecdotal evidence from practitioners, and the revelations from court cases, economic data from a variety of sources indicate inappropriate profit shifting occurring on a large scale. By inappropriate” I mean the perfectly legal but economically indefensible assignment of profits to subsidiaries in low-tax jurisdictions.
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> The table [below] presents the latest data on the profitability of affiliates of U.S. multinational corporations in five low-tax countries. In all these jurisdictions the average effective tax rate of U.S. affiliates was below 10 percent. Although these are all small jurisdictions (with their economies equal to only about 5 percent of the European economy) they together account for 24 percent of foreign profits of U.S. multinationals. There is no perfect way to measure profitability, but by almost every measure these five tax havens have extraordinarily high rates of profit. These figures strongly suggest U. S. multinationals are readily able to shift profits into tax havens and thereby significantly reduce taxes properly owed to the United States and other industrialized nations.

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[11] Durst, “OECD Guidelines: Causes and Consequences,” pages 14-15; Durst, “Congress: Fix Transfer Pricing and Protect U.S. Competitiveness,” Tax Notes, July 26,2010, pages 401-404; Durst, “It’s Not Just Academic: The OECD Should Reevaluate Transfer Pricing Laws,” Tax Analysts, January 18,2010, pages 247-256; Durst, “The Two Worlds of Transfer Pricing Policymaking,” Tax Notes, January 24, 2011, page 444; and Durst, “The Urgency–and Challenges–of International Reform,’ Tax Notes, June 20,2011, pages 1277-1279.

[12] “Reforming Corporate Taxation in a Global Economy: A Proposed to Adopt Formulary Apportionment,” The Hamilton Project, The Brookings Institution, June 2007, paragraphs 2.1 and 2.2.2.

Profits and Profitability of Foreign Affiliates of U.S. Multinationals in 2007						
	Before-tax Profits (millions)	Effective Tax Rate	Profit as % of Sales	Profit as % of Property	Profit as a % Employee Compensation	Profit per Employee
Bermuda	$ 16,213	2.6%	21%	272%	7174%	$ 5,404,333
Singapore	$ 14,624	7.4%	6%	125%	277%	$ 115,422
Ireland	$ 45,403	7.7%	20%	170%	724%	$ 488,730
Switzerland	$ 18,195	9.1%	7%	164%	228%	$ 219,217
Cayman Islands	$ 7,414	9.4%	24%	218%	2415%	$ 1,123,333
Five Tax Haven Total	**$ 101,849**	**7.2%**	**12.2%**	**173%**	**508%**	**$ 326,230**
Worldwide Total	**$ 430,186**	**29.6%**	**9%**	**44%**	**101%**	**$ 42,947**
Source: Author's calculations using latest data from the Bureau of Economic Analysis of the U.S. Department of Commerce. The BEA data does not include banks and other financial businesses.						

Income shifting by U. S. based multinationals has been detailed in a report (six case studies) by the U.S. Joint Committee on Taxation, "Present Law and Background Related to Possible Income Shifting and Transfer Pricing, "July 20, 2010, and a report by the United States Government Accountability Office ("GAO"), "International Taxation: Large U.S. Corporations and Federal Contractors with Subsidiaries in Jurisdictions Listed as Tax Havens or Financial Privacy Jurisdictions" states (page 1): "….the [US] Department of the Treasury has found that some U.S. corporations have aggressively set transfer prices to move income to offshore jurisdictions to avoid U.S. taxes." [13]

Prof. Michael McIntyre has commented on income shifting, in his article, "Challenging the Status Quo: The Case for Combined Reporting;"

> The [OECD Staff Report] asserts that a core principle of its transfer pricing rules focuses on "the importance of minimizing or eliminating double taxation." If the goal is simply to eliminate double taxation, then the OECD can claim success. That goal, however, is rather unambitious. A far more worthy goal would be to make multinational enterprises report something close to the income they actually earn in each country in which they operate. The OECD's arm's-length approach does not come close to achieving that goal, as is clear from the trillions of dollars that multinational enterprises have deflected to tax havens over the years. In contrast, a combined reporting system with formulary apportionment is designed specifically to achieve that goal. The OECD knows better than most the difficulties that must be overcome to get consensus on any significant principle of international taxation. As a result, it gives a high, almost mystical value to any consensus it has achieved. That the OECD would cling fiercely to the arm's-length principle is understandable. The time has come, however, to start to let go. The arm's-length method

[13] GAO-09-157, December 2008. That GAO Report cites the following U.S. Treasury Report (November 2007): "Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties."

> simply is not working, and 50 years of tinkering and major revisions have revealed that it cannot be made to work. It offers little more than a general framework for negotiations-negotiations in which the multinational enterprises hold the upper hand. The arm's-length method is numbingly complex and so expensive that it provides a royal living to thousand of accountants, economists, and lawyers. It has facilitated the shifting of trillions of dollars to offshore tax havens. The time has come to seek an alternative. [14]

The Impact on Developing Countries of Mispriced Trade

The negative impact on developing countries of mispriced trade is extremely significant. A study by Eurodad, "Exposing the Lost Billions: How Financial Transparency by Multinationals on A Country by Country Basis Can Aid Development" (November 2011), ("Eurodad Report "), states (page 10):

> In 2009 illicit financial flows from developing countries are estimated at some US$1.3 trillion [annually], according to [Global Financial Integrity]. ["Illicit Financial Flows From Developing Countries, 2000-2009," January 2011]. The same research shows that more than 50% of these flows are related to mispriced trade.

Other studies have emphasized the volume of mispriced trade and other illicit flows from developing countries:

(1) Christian Aid has estimated that developing countries lose about US$160 billion annually as a result of trade mispricing (only from trade in goods, not including trade in services). [15]

(2) Global Financial Integrity (Washington DC) has estimated that the average tax revenue loss to all developing countries due to trade mispricing was between US $98 billion and US$106 billion annually during the years 2002 through 2006. This figure represents an average loss of about 4.4 percent of the entire developing world's government revenue. [16] The Hollingshead report [17] refers to the 2008 Christian Aid Report: "These findings –US $98 to US $ 106 billion of lost tax revenue annually] are lower than, but still consistent with, the estimates of the [2008] Christian Aid Report, which was US $160 billion per year. As noted earlier [18] the Christian Aid figure is higher because it includes an estimate of "same invoice faking, which is not captured by the

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[14] BNA Transfer Pricing Report, Vol. 20, No. 22, March 22, 2012

[15] Christian Aid, "Death and Taxes: The True Toll of Tax Dodging," May 2008). ("2008 Christian Aid Report"). See also the Eurodad Report, page 35.

[16] Ann Hollingshead, "The Implied Tax Revenue Loss from Trade Mispricing," Global Financial Integrity, February 2010.

[17] Page 15.

[18] Pages 6 and 14 of the Hollingshead Report

model used in this [GFI] paper" [which is based only on reinvoicing: import overinvoicing or export underinvoicing]. Further, the Hollingshead paper indicates that the annual amount of lost tax revenue of developing countries increased substantially from 2002 (about US $65 billion) to 2006 (about US$130 billion).

Neither 2008 Christian Aid Report nor the Global Financial Integrity report covers trade in services or intangibles.

(3) Christian Aid, "False Profits: Robbing the Poor to Keep the Rich Tax-Free," March 2009 ("2009 Christian Aid Report"). This report stated that "Between 2005 and 2007, the total amount of capital flow from bilateral trade mispricing into the EU and the US alone from non-EU countries is estimated conservatively at more than [US$1.1 trillion]….If tax was levied on this capital at current rates, non-EU countries would have raised [US$365 billion between 2005 and 2007, or US $122 billion per year." [19]

Further, case studies of specific situations illustrate transfer mispricing by certain multinational shifting income out of developing countries into low tax / no tax jurisdictions:

(a) "Conning the Congo," [20]
(b) "Calling Time: Why SABMiller Should Stop Dodging Taxes in Africa," [21]

(c) "The Banana Trade: "Bananas to UK via the Channel Islands? It Pays For Tax Reasons," [22]

(d) The Mopani Copper Mine in Zambia, owned by Glancore AG (the majority shareholder), and First Quantum. [23]

See also the discussion in the Eurodad Report [24] of Exxon's ownership and operation of the Compania Minera Disputada de las Condes copper mine in Chile.

The attitude of the OECD towards illicit funds flows from developing countries is highlighted by the comments of Jeffrey Owens in the BNA Developing Country Article, Transfer Pricing Report, "Practicioners Critique OECD Transfer Pricing Report (October 20, 2011, p.471):

> "Jeffrey Owens, director of the OECD's Center for Tax Policy and Administration (CTPA), [until January 31, 2012] said that estimates of illicit fund

[19] Page 5.
[20] Greenpeace International, July 2008, The Danzer Group.

[21] ActionAid, November 2010.
[22] Felicity Lawrence The Guardian, November 6, 2007, pages 6 and 7; and Eurodad Report, page 16.
[23] Eurodad Report, pages 29-30.

[24] Page 14

flows and tax revenues lost to evasion vary widely. It's clear that these flows are significant, and it's clear they probably have increased over the last decades, but nobody can put an exact figure on it. If we could measure it exactly, we would be able to tax it, he said."

Clearly, it is not necessary to "measure exactly" the amount of illicit financial flows from developing countries, including as a result of transfer mispricing, in order to start confronting such tax evasion.

OECD Not Confronting Tax Havens and Regimes That Constitute Harmful Tax Practices

What has the OECD done to confront this issue of shifting of profits to low tax/no tax jurisdictions? In its seminal report, "Harmful Tax Competition: An Emerging Global Issue" (OECD, 1998) ("1998 OECD Harmful Tax Competition Report"), the OECD called upon its Committee on Fiscal Affairs ("Committee") to focus on the application of the OECD Guidelines to tax havens and regimes constituting harmful tax competition: and called upon the Committee to develop procedural rules to confront the issue of income shifting to tax havens and harmful tax regimes:

> **Application of transfer pricing rules and guidelines**
>
> 166. Measures that constitute harmful tax competition often result in significant income being attributed to a foreign entity which performs few, if any, real activities. The application of transfer pricing rules, which typically start from an analysis of true functions performed by each part of a group of associated enterprises, does, in that respect, constitute a useful counteracting measure.
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> 167. It may be appropriate, however, that the Committee develop procedural rules that would address the specific circumstances of tax havens and regimes that constitute harmful tax practices Rules effecting a reversal of onus of proof in certain cases …. would fall in that category. One action that could be taken in that respect would be for the Committee to supplement its transfer pricing guidelines [the OECD Guidelines] with more guidance on the application of the [OECD] Guidelines in relation to tax havens and regimes constituting harmful tax competition.

The OECD Guidelines revised in July 2010, twelve years after the 1998 OECD Harmful Tax Competition Report cited above was issued, do not specifically address the issue of transfer pricing and attribution of income to tax havens and regimes constituting harmful tax competition. [25]

[25] See the very brief reference to this major issue in the OECD Guidelines, paragraph 4.117.

Brazil has focused on the issue of the shifting of income from Brazil to low tax/no tax jurisdictions, whether or not the foreign counterparty is related. Brazil's transfer pricing rules apply to transactions between Brazilian entities and (1) related foreign entities; (2) related or unrelated foreign entities located in jurisdictions classified by the Brazilian Government as tax havens; and (3) related or unrelated entities located in any jurisdiction which is not a low tax/no tax jurisdiction but which provides to the respective transaction a "privileged fiscal regime," as listed by the Brazilian Government. The OECD Staff Report criticizes the Brazilian transfer pricing rules.

Country-by-Country Reporting

The OECD has not endorsed country-by-country reporting. ("CbC Reporting"). CbC Reporting would require the disclosure by multinationals enterprises of information that would facilitate the audit of multinational enterprises, including for purposes of determining whether through transfer mispricing such multinational enterprises have shifted income to low tax / no tax jurisdictions. [26] See also the Eurodad Report. Indeed, as CbC Reporting would provide information that would significantly help determine whether multinational corporations were complying with the OECD Guidelines, it is difficult to understand why the OECD has not required nor endorsed CBC Reporting. The proposed U.S. "Stop Tax Haven Abuse Act" [27] would require country-by-country reporting for listed companies. Jeffrey Owens is quoted in the BNA Developing Country Article as stating: "Country-by-country reporting is not as important as ensuring that developing countries have the information they need to correctly tax multinationals." Owens misses the point. Country-by-country reporting would provide that information. The major accounting auditing firms also have not endorsed CbC Reporting and in several meetings have explicitly opposed it.

Mary Bennett is also quoted in the BNA Transfer Pricing Report Article: "Lead Report: As Country-by-Country Reporting Efforts Gain Momentum, Practicioners Discuss Potential Effect on Transfer Pricing Practice" [28]

> Mary C. Bennett, formerly of the OECD and now with Baker & McKenzie in Washington, D.C., spoke specifically of the country-by-country reporting requirement in House and Senate bills, saying "there should be grounds for concern anytime one sees a proposal which raises so many complex issues of implementation with so little apparent potential to achieve its stated objectives."

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[26] "Practicioners Critique OECD Transfer Pricing Approach in Light of Developing Countries' Needs, Resources," BNA Transfer Pricing Report, October 20, 2011 page 474. ("BNA Developing Country Article"). For a study of CbC reporting, see "Country-by-Country Reporting: The Concept and Benefits," Richard Murphy CFA, Tax Research LLP, May 2011.
[27] Section 201
[28] December 15, 2011, pages 631-633.

The issues raised by Ms. Bennett in that article can be resolved in the legislative process and by regulations. The significant potential of such country-by-country reporting legislation in challenging the implementation of the OECD's arm's-length standard explains why the private service sector (law firms, economic consulting firms, and auditing firms which provide transfer pricing services to multinationals) is opposing CbC so energetically. Similarly, the OECD is presumably reluctant to favor such information disclosure presumably because CbC would permit civil society to review the income that multinational corporations were reporting to each jurisdiction under the OECD Guidelines and whether such allocation is generally reasonable.

Michael Durst has commented about the opposition by many business representatives to country-by country reporting:

> 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 <u>any</u> income apportionment that seeks to rely not on searches for comparables, but instead depends on measures of observable business activity, violates international norms. 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 intangible-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 contacts. Through what have come to be referred to as "restructurings," companies based in many countries have use intragroup contracts to shift business risks of many different kinds of 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. [29]

<u>Double Taxation versus Double Non-Taxation</u>

[29] Durst, "OECD Guidelines: Causes and Consequences," pages 14-15.

In the section entitled “A Consistent Global Transfer Pricing System”, the OECD Staff Report states (page 496) that “The core principles espoused by the OECD in the area of taxation focus on the importance of minimizing or eliminating double taxation.” That section focuses almost exclusively on possible double taxation which is a clear indication that the OECD and the OECD Guidelines pay relatively little attention to double non-taxation. The McIntyre Article in its conclusion refers to this. [30]

The OECD Guidelines refers in several places to “the primary importance of avoiding “double taxation” (for example, paragraphs 4, 5,7,10, 12, 1.15, 1.22, 1.24, and 1.25), and the OECD Staff Report also refers to “double taxation” (page 496). But The OECD Guidelines barely refer to double non-taxation (See paragraph 1.24). Recently the OECD has been using the term “double exemption,” which is a narrower concept than “double non-taxation.” It seems that “double exemption” is a narrower concept than “double non-taxation.” “Double exemption” seems to cover the situation in which income is explicitly exempt from tax in two jurisdictions. On the other hand, “double non-taxation” is more clearly the situation in which in effect income is not taxed in two jurisdictions. That is, there could be many situations in which there is double non-taxation but not “double exemption.” Therefore it seems that the OECD by focusing on the term “double exemption,” is focusing on narrower fact situations. For example, (1) the comments by Marlies de Ruiter, Head of the Tax Treaty, Transfer Pricing and Financial Transaction Division of the OECD’s Centre for Tax Policy and Administration, at the March 14, 2012 meeting on transfer pricing at the United Nations in New York sponsored by the UN Financing for Development Office; (2) the presentation by Pascal Saint-Amans at the March 15, 2012 meeting of ECOSOC, the Economic and Social Council of the United Nations in New York; and (3) the OECD Press Release on March 28, 2012.

The OECD Staff Report and Minimum Income Requirements: Fixed Margins and Safe Harbors

The OECD Guidelines [31] discuss the definition and concept of safe harbors and the possible use of safe harbors. The OECD Guidelines [32] concludes that “the use of safe harbors is not recommended.” However, the OECD Staff Report [33] indicates that “[OECD] Working Party no. 6 announced, and has sought and obtained public comment on, an important new project related to the administrative aspects of transfer pricing…..Consideration of simplifying safe harbors for common transfer pricing

[30] Pages 8 and 9
[31] Chapter IV, paragraph E, 4.93 through 4.122.
[32] Paragraph 4.122
[33] Page 502

problems is an important part of this undertaking." (March 9, 2011). [34] The evidences that even the OECD recognized that its OECD Guidelines are not sufficient.

Part of this shift in approach by the OECD may result from increased engagement with developing countries through its informal Task Force on Tax and Development. The recognition that many developing countries have neither the capacity data nor expertise to conduct traditional transfer pricing methods suggests that the OECD will need to simplify its Guidelines in order to engage non-OECD countries as it hopes to do. Civil society organizations such as ActionAid, Christian Aid and Tax Justice Network, through their involvement in the transfer pricing subgroup of the informal Task Force, have consistently pushed this position.

The OECD has traditionally been opposed to the fixed margin method of calculating transfer prices – the argument presented is that this is inconsistent with the international consensus on use of the OECD Guidelines and can lead to double taxation.

There are however, some benefits to this approach over that identified in the OECD guidelines. One of the key constraints identified, particularly in a developing country context is that of a lack of data on comparables through which to administrate the CUP (Comparable Uncontrolled Prices), method as noted in the OECD Staff Report: "… the arm's length principle can sometimes be difficult to apply. The identification of perfectly comparable unrelated-party transactions on which transfer pricing determinations can be based often is not possible."

At a United Nations meeting on transfer pricing at the United Nations (7-8 June 2011), the Brazilian Member to the UN Committee of Experts on International Cooperation in Tax Matters (the "UN Tax Committee"), shared the experience of his country in applying fixed margins. As highlighted in the formal notes from that meeting:

> "This would eliminate the need to find comparables and constitute a simple and low-cost system for both taxpayers and authorities, without the need to hire outside advisors on these issues…It would address different methodologies for simple resale versus sales based on imported inputs, as well as consideration of resale price (best for imports) and cost plus (best for export operations). The Secretariat and others noted that it was important that any ranges were grounded

[34] See also "The OECD Transfer Pricing Agenda," BNA Transfer Pricing International Journal, 2012, Joseph L. Andrus, paragraph II A., "Safe Harbor Provisions". Before the OECD changes its policy on safe harbors, Michael Durst wrote in "OECD Guidelines" Causes and Consequences" (page 10) (See footnote 3, above): " Why would 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 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 spectre had to be exorcised from the Guidelines. Today, the economies of many countries continue to suffer the resulting costs."

> in real conditions if they were to be contended as an expression of the "arm's length principle."[35]

The Brazilian approach is instructive and is detailed in one article in the BNA Transfer Pricing Report [36]

> Brazilian transfer pricing regulations aim to achieve the arm's length standard by making use of a series of safe harbors and fixed formulae which are made available to the taxpayer for import and export transactions. They provide an objective method which allow the taxpayer to mathematically prove and determine what his transfer pricing benchmark is, without having to go through a search for comparables. The system allows a company to make use of its own data for the identification of appropriate prices. This is important in a developing country context, where markets tend to be concentrated with only a reduced number of players, and firms might not be able to access other companies' product's prices. Crucially, however, Brazil has developed a system which in itself is endowed with juridical certainty – something which the OECD guidelines do not provide.
>
> The Brazilian approach to safe harbors and fixed margins is an attractive alternative for developing countries as a means for administrative simplification it allows for the mobilisation of some revenue while reducing administrative burdens of firms and tax administrations However, the safe harbor system should be reviewed periodically to make sure that it is sufficiently flexible and up-to-date and produces sufficient revenue.

The OECD Staff Report criticizes the use of "Minimum Income Requirements," in effect fixed margins. However, the reasoning in the OECD Staff Report is faulty.

First, the OECD Staff Report states that minimum income systems provide for arbitrary formulas of income allocations rather than an examination of all of the specific functions, risks, assets and economic contributions of individual entities within a multinational group. However, because of the difficulty of finding comparables under the OECD Guidelines, the complexity of implementing the OECD Guidelines, and the broad range of results possible under the OECD Guidelines, the OECD Guidelines have been criticized for producing arbitrary results.

Second, the OECD Staff Report states that the tax results under a minimum income system, based on the ease of administration, can be either too high or too low. However, for developing countries, the choice (especially during an interim period) is

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[35] Report by the Secretariat on: Informal Meeting on Practical Transfer Pricing Issues for Developing Countries 7 to 8 June 2011, UN Headquarters New York, http://www.un.org/esa/ffd/tax/2011_TP/2011_TP-Report_Meeting7-8June.pdf

[36] Tatiana Falcao, "Brazil's Approach to Transfer Pricing: A Viable Alternative to the Status Quo?" Vol.20, No.20, February 23, 2012.

clear between (a) a minimum income system which produces approximate results, is easily administered, and generates tax revenue and (b) the OECD Guidelines which are unenforceable, even by many developed countries.

Third, the OECD Staff Report criticizes the minimum income system even during an initial period:

> A country adopting such a system may give up substantial tax revenue by setting minimum income thresholds at levels the weakest performers can afford, while more profitable enterprises reap a windfall. Even as a temporary approach to be applied while the developing economy builds its tax capacity, the question of how much tax revenue the country is forgoing in the interest of administrative simplicity will always be present.

However, the OECD Staff Report assumes that if a developing country initially adopt and implement the OECD Guidelines (rather than a minimum income system), and during a temporary period the tax revenue of the developing country under the OECD Guidelines would be greater than under a minimum income system. The reasoning in the OECD Staff Report is faulty, because developing countries (and many developed countries) do not have the administrative capacity to adopt and effectively implement the OECD Guidelines, especially during an initial period.

Fourth, the OECD Staff Report states:

> If one were to seek to reduce this perceived unfairness by moving in the direction of less arbitrariness, perhaps by establishing income thresholds on an industry basis or on a more limited geographic market basis, the degree of administrative simplicity declines rapidly. The need to monitor the performance of various industries, to monitor the geographic variations in profitability, and to adjust minimum income targets for dozens of other variables is itself far from a simple exercise. Moreover, the potential for political pressure special interest advocacy, and corruption in such a system is extremely high

This statement is problematic for several reasons. The OECD Staff Report does not explain why the administrative simplicity "declines rapidly." Also, each country (including developing countries) has the sovereign right to make such decision about the appropriate balance of administrative simplicity and "arbitrariness." Further, the OECD Staff Report fails to recognize that under the OECD Guidelines, which provide uncertainty and greater administrative discretion, including the APA (Advanced Pricing Agreement) system, the potential for "political pressure, special interest advocacy, and corruption" still exists and may be even greater than under a minimum income system which has less administrative discretion.

Fifth, the OECD Staff Report states that

> Moreover, it should be recognized that the tax result under a minimum income system can be either too high or too low. A distribution business that develops valuable local intangibles may find that the returns on those intangibles are not taxed because the business is swept into the same category as providers of more routine service

The OECD Guidelines, even if comparables are available, normally results in a very wide range of comparables, and therefore the OECD Guidelines normally produce a quite inexact result. Further, under a minimum income system, it is easy to treat "local intangibles" differently from other activities/assets such as import or export transactions. On what basis does the OECD Staff Report find that intangibles will be "swept" into another category?

Sixth, the OECD Staff Report states that "where minimum income rulings are available, and are granted without fall consideration of all relevant facts and circumstances, multinationals may be able to take inconsistent positions in different countries regarding the amount of income attributable to various jurisdictions. In some situations such inconsistent allocations can lead to large portions of a company's income not being subjected to tax in any jurisdiction." However, as indicated above, the OECD Guidelines have not confronted the shifting of income by multinational corporations to low tax / no tax jurisdictions which results in many situation in non-taxation of such income. Further, multinationals may in any case take inconsistent positions in different jurisdictions whether or not under the OECD Guidelines. Also, if a country decides to adopt a minimum income system, it has the sovereign right to do so and in such case, it presumably has decided it is not concerned about what occurs outside of that country's jurisdiction.

Hybrid Methods [37]

Echoing many other contributions to the transfer pricing debate, the OECD Staff Report frames the role of the formulary apportionment model within the debate as a system to be considered as a wholesale alternative to transfer pricing. In practice, the use of a formulary approach based on factors of production is already standard within transfer pricing methodologies, including within the OECD Guidelines. A helpful description is provided in an article on the Brazilian approach written in 2009 by two tax lawyers, at the time partners at a prominent Brazilian firm:

> In terms of policy for income allocation, it is possible to identify the comparable uncontrolled price (CUP) method that fully expresses the arm's length standard at one side. The other traditional transactional methods are placed to its right. At the opposite side there is the typical formulary apportionment method that states the unitary business principle derived from the theory of integration. This method

[37] Martin Hearson contributed some of the analysis for this section

allocates profits on a consolidated basis according to factors of production. In between there is a variety of methods which may be closer to one of the sides according to their characteristics. The formulary profit-based methods are examples of hybrid methods based on factors of production and close to the so-called formulary apportionment method. [38]

The OECD Guidelines [39] provide for two transactional profit methods: the profit split method and the transactional net margin method. The former examines the contribution of each partner in the transaction, and the Guidelines [40] note that, "one strength of the profit split method is that it generally does not rely directly on closely comparable transactions, and it can therefore be used in cases where no such transactions between independent enterprises can be identified." This is the situation in which revenue authorities in developing countries find themselves, as the OECD Staff Report observes.

The OECD Guidelines suggest a number of ways of approximating the Arm's Length Price using a profit split, including one that effectively splits profits in the ratio of the capital investment made in the transaction by the two trading partners, noting that the list given is "not exhaustive" [41] Developing countries could therefore consider creative and efficient ways to use the profit split method to determine the Arm's Length Price, without deviating substantially from the OECD Guidelines.

The transactional net margin method, as described in the OECD Guidelines [42], "examines the net profit margin relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer realizes from a controlled transaction." This is, then, an approach that combines a degree of formulary apportionment with the comparability approach of the OECD guidelines. The OECD Guidelines [43] note that only one of the associated enterprises need be assessed, a relevant consideration for revenue officials in developing countries, who tell us that they frequently face difficulties obtaining sufficient information on transaction partners overseas to comprehensively examine transfer pricing methodologies.

The OECD Staff Report concludes with a hope that, "a continuously improving system of transfer pricing principles, rules, and practices will be developed and that those rules and principles will be suitable for application in both developed and developing economies." Such an approach should surely include consideration of "hybrid" methods, which entail the use of elements of the formulary approach within the profit split method, as suggested by several commentators. Michael Durst, for example, makes the following suggestion in regard to developing countries:

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[38] Luiz Felipe Ferraz and Alexandre de S Almeida of Demarest e Almeida Advogados, "Questions Raised over Brazil's Transfer Pricing Rules," TP Week, November 26, 2009.
http://www.tpweek.com/Article/2347196/Questions-raised-over-Brazils-transfer-pricing-rules.html

[39] Chapter III, Paragraphs 3.2-3.57
[40] Paragraph 3.6.
[41] Paragraph 3.23.
[42] Paragraph 3.26.
[43] Paragraph 3.28.

> The OECD and national governments should continue exploring the extent to which greater reliance on profit-split methods can ease both compliance and enforcement within the context of an arm's-length system. To be effective, however, a profit-split method should incorporate elements that opponents will label as formulary. In particular, to be effective, a profit-split based method (i) will need to forgo reliance on comparables data, which are not available in sufficient quality or quantity to be useful; (ii) to permit effective enforcement, will need to involve some uniformity of apportionment keys among taxpayers, rather than permitting each taxpayer to decide on its own profit-split method; and (iii) will need to be prescribed for use whenever significant intangible property or other opportunities for enjoying economic rents appears to be present, rather than being included on a list of methods that a taxpayer might elect. [44]

Prof. Reuven Avi-Yonah has similarly proposed that the residual profit in the Profit Split Method be determined using formulary apportionment: "One needs to realize that if there are no comparables (by definition) and the residual results from the relationship between the parties and would disappear if they were unrelated, then the ALS is meaningless and any allocation is arbitrary. Under these circumstances the key is to adopt the formula that is most likely to achieve consensus…. Thus, I would propose that in hard transfer pricing cases, in which no comparables can be found beyond the return on routine functions, the OECD endorse using the traditional three factor state formula to allocate the residual under the Profit Split Method."

The UN Tax Committee has already stated its intention to consider creative approaches to transfer pricing that may include formulary elements. Alexander Trepelkov, Director of the United Nations Financing for Development Office, which hosts the secretariat of the UN Tax Committee, suggested at a meeting of the OECD's informal task force on tax and development, in April 2011, that the UN approach to transfer pricing would "learn from other approaches, such as "fixed margins" (Brazil), safe harbors, and even formulary apportionment to make arm's-length pricing more workable for both governments and taxpayers, yet still be identifiable as an arm's-length pricing approach."

Article 7, paragraph 4 of the OECD Model Income Tax Treaty explicitly permitted a method of apportioning total profits of an enterprise: [45]

> 4. Insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 [of Article7] shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however,

[44] Michael Durst, "The Two Worlds of Transfer Pricing Policymaking," Tax Notes, January 24, 2011, page 446.

[45] See the Commentary on that paragraph 4 of Article 7, and the discussion in Clausing and Avi-Yonah, "Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment."

> be such that the result shall be in accordance with the principles contained in this Article.

The OECD deleted that provision from the OECD Model Income Tax Treaty in 2010.

The OECD and the United Nations

Mary Bennett is quoted in the BNA Developing Country Article:

> "Bennett said that the effectiveness of the arm's-length principle has been illustrated through several different methods under the [OECD] transfer pricing guidelines. In fact, she said, these methods have been accepted by the United Nations for applying the arm's-length principle under the UN model [income tax treaty]."

That statement is somewhat misleading and must be clarified.

First, of the twenty-five members of the United Nations Committee of Experts in International Cooperation in Tax Matters ("UN Tax Committee"), for the 2009-2012 period, twelve members are from OECD countries and have been nominated by their respective OECD governments. That is, 48 percent (12/25) of the members of the UN Tax Committee, have been nominated by member governments and are generally tax officials working for those governments. The members of the UN Tax Committee are chosen by the Secretary General of the United Nations, who hi8mself is from an OECD country. With 48 percent of the members of the UN Tax Committee from OECD member countries, and its Chairman who is a senior tax official in an OECD member country, the OECD has had in effect operational control of the UN Tax Committee. But the OECD member countries only constitute about 18 percent (34/193) of the member countries of the United Nations. Why then should 48 percent of the members of the UN Tax Committee be designated by OECD member countries, especially as the ECOSOC resolution specifying the functions of the UN Tax Committee stated explicitly that it should pay "special attention to developing countries with economies in transition?"

Second, the apparent basis of the aforementioned statement by Ms. Bennett is paragraph A.3 of the Commentary under Article 9, Associated Enterprises, of the UN Model Double Taxation Convention between Developed and Developing Countries ("UN Model Tax Treaty") (which was drafted in 1999 by the former Group of Experts in the UN Model Tax Treaty published in 2001), which provides as follows:

> 3. With regard to transfer pricing of goods, technology, trademarks and services between associated enterprises and the methodologies which may be applied for determining correct prices where transfer have been

> made on other than arm's length terms, the Contracting States will follow the OECD principles which are set out in the OECD Transfer Pricing Guidelines. These conclusions represent internationally agreed principles and the Group of Experts recommend that the guidelines should be followed for the application of arm's length principle which underlies the article.

However, at the October 2011 meeting of the UN Tax Committee, the members of the UN Tax Committee from three major emerging countries, China, India and Brazil (which together represent about forty percent of the world's population) expressed reservations about that Commentary. The UN Tax Committee had the following comments about this:

> The views expressed by the former Group of Experts have not yet been considered fully by the Committee of Experts, as indicated in the Records of its annual sessions.
>
> Inclusion in Record of the Meeting on Article 9 (3)
>
> When paragraph 3 of the Commentary on Article 9 was discussed, it was agreed to retain the existing paragraph which endorses the arm's length principle in determining transfer pricing issues and which recognizes the role of the OECD Transfer Pricing Guidelines in developing the arm's length principle. Most Members considered these views still remain appropriate. Some members of the Committee raised concerns about the appropriateness of the views of the former Group of Experts as set out in paragraph 3 and whether they are too broadly stated. In particular, the recommendation that countries follow the OECD Guidelines may need to note that these are only for guidance in applying the arm's length principle. Three members (Mr. Valadao, [of Brazil], Mr. Liao [of China], and Mrs. Kapur [of India], noted that they hold reservations on the views expressed by the former Group of Experts as stated in paragraph 3 of the Commentary. It was agreed to consider these issues further without prejudging the outcome of such consideration.

The Government of India has strongly challenged the transfer pricing project of the UN Tax Committee, and the role of the OECD in trying to impose its OECD Guidelines on non-OECD countries.

At a meeting of ECOSOC (The Economic and Social Council of the United Nations) on March 15, 2012 in New York, the institutional status of the UN Tax Committee—whether the UN Tax Committee would be upgraded to an intergovernmental commission—was being considered. The Group of 77 and China, representing about 131 countries, has favored such upgrading. But the OECD and the EU have adamantly opposed such upgrading. Also, at that March 15 meeting, the 2012 revision of the UN Model Double Taxation Convention between Developed and Developing Countries was presented.

At that meeting, the Ambassador from India strongly supported the upgrading of the UN Tax Committee and summarized a letter dated March 12, 2012 from the Indian Ministry of Finance to the United Nations:

(1) India reiterated its position that the UN Tax Committee be upgraded to an Inter-Governmental Commission with a balanced representation from the Governments of developing and developed countries.

(2) India emphasized that the OECD Guidelines only reflect the agreement of governments of the OECD member countries, and accordingly tend to take care of the interests of only developed countries, and the OECD Guidelines do not give right of taxation to source countries thereby eroding taxing rights of developing countries.

(3) India asserted that the mandate of the UN Tax Committee does not require that United Nations guidance should be based on OECD Transfer Pricing Guidelines. However, there is a strong view in the Sub-committee on Transfer Pricing of the UN Tax Committee that due to decision taken by an earlier Group of Experts in 1999, the Sub-committee should not deviate from existing OECD Guidelines. India believes that OECD Guidelines cannot be imported to UN guidance particularly when such recommendations of the group in 1999 is not considered by the present UN Tax Committee and is beyond the scope of the non-governmental UN Tax Committee. Contrary to inter-Governmental composition of OECD, at present, all the experts of the UN Committee are working in their individual capacity.

(4) India requested that the United Nations consider constituting an inter-Governmental Commission (including sub-committees), having representatives from Governments of the developed and developing countries, on various issues relating to International Taxation and Transfer Pricing, to develop guidelines on the basis of consensus amongst Governments of all countries which take care of the interests of the developing countries. Further, in developing such guidelines, the recommendations of the Committee of Experts (1999) that the OECD principles as set out in the OECD Transfer Pricing Guidelines should be followed, must be ignored.

(5) India indicated that it is also aware of the concerns of the OECD on the work of the United Nations to develop standards in the areas of international taxation and transfer pricing alleging that it would be duplication of work. India does not agree with this concern for the following reasons

(i) OECD Model Tax Convention and the OECD Transfer Pricing Guidelines have been developed on the basis of consensus arrived at by

> the Government of 34 countries (all developed countries). These guidelines only protect the interests of OECD countries which are partial to such Convention. Since the Governments of developing countries are not party to the OECD Guidelines, it is improper to suggest that they represent international agreed guidance knowing fully well that concerns of developing countries have not been taken care of in the OECD Model Convention and OECD Transfer Pricing Guidelines.
>
> (ii) It is inconceivable as to how a standard developed by Government of only 34 countries can be accepted by Governments of other countries as the 'standard' of sharing of revenue on international transactions between source and resident country particularly when it only takes care of the interest of developed countries and has seriously restricted the taxing powers of source countries.
>
> (iii) Views of OECD and UN on sharing of tax revenue by developing and developed countries are not the same and accordingly concerns of duplication of efforts should be ignored.

Therefore, the attempt by Ms. Bennett to cloak the OECD's Guidelines with the alleged approval of the United Nations and to imply that the OECD Guidelines have universal support and are an "international standard," is ill founded and misleading. See also the discussion below about the relationship of Article 9 and Article 7 of the OECD Model Tax Convention on Income and on Capital ("OECD Model Tax Treaty") and the UN Model Income Tax Treaty).

<u>A Consistent Global Transfer Pricing System?</u>

The OECD Staff Report emphasizes the need for "A Consistent Global Transfer Pricing System;" in order to avoid double taxation:

> The core principles espoused by the OECD in the area of taxation focus on the importance of minimizing or eliminating double taxation. Double taxation occurs when two or more countries imposed income taxes on the same income without an offsetting credit for the taxes paid in the other country. When unrelieved double taxation exists, it burdens the free flow of trade in goods and services with resulting diminution in global economic well-being.
>
> The OECD Model Tax Convention exists primarily to establish objective guidelines for dividing primary taxing rights over the global tax base so that double taxation will not occur. Transfer pricing rules that apportion income among countries under a consistent set of rules are an important element of the treaty effort to eliminate double taxation. The transfer pricing rules are intended to establish a common rules book for the

> resolution of disagreements among countries over the allocation of income and expense for taxation purposes.

But why should the OECD, a club of 34 rich countries, representing only 18 percent of the number UN member countries, and with a declining share of world trade and investment, be the arbiter, the rule maker, of such a "consistent global transfer pricing system?" Why should the OECD try to impose its transfer pricing rules on major developing countries such as Brazil, China and India, and other developing countries?

Philip Stephens of the Financial Times has written about the establishment of "global rules" and that "the big lesson is that the west can no longer assume that the global order will be remade in its own image:"

> The shift eastwards in global economic power has become a commonplace of political discourse. Almost everyone in the west now speaks with awe of the pace of China's rise, of India's emergence as a geopolitical player, of the growing roles in international relations of Brazil and South Africa. Yet the rich nations have yet to face up properly to the implications. They can imagine sharing power, but they assume the bargain will be struck on their terms: that the emerging nations will be absorbed-at a pace, mind you, of the west's choosing-into familiar international forums and institutions. When American and European diplomats talk about the rising powers becoming responsible stakeholders in the global system, what they really mean is that China, India and the rest must not be allowed to challenge existing standards and norms….The case for global rules-that open markets need multilateral governance-could not have been made more forcefully than by the present crisis. Yet the big lesson is that the west can no longer assume the global order will be remade in its own image. For more than two centuries, the US and Europe have exercised an effortless economic, political and cultural hegemony. That era is ending. [46]

In spite of this significant and growing change in global economic power, the OECD is still trying to fashion the "global order" as it sees fit, and to impose its standards and norms on the rest of the world.

If the OECD countries are so prescient and wise, how can they explain the Western Financial Crisis of 2007-2008 and its aftermath, and the present Eurozone Crisis? Kishore Mahbuhani, Dean of the Lee Kuan School of Public Policy in Singapore, points out, in "Asia Has Held Enough of Excusing the West." [47]

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[46] Stephens "The Global Consensus Is Beginning to Crack," Financial Times September 4, 2007, page 7.

[47] Financial Times, January 26, 2011, page 11.

> Most crisis [sic] are known by their origin, from the Mexican peso crisis of 1994/5 to the Asian crisis of 1997/8. Given there are no doubts who caused our world's latest troubles, it should adopt its logical name: the western financial crisis. This reluctance to call a spade a spade reflects on inability to reckon with changes the U.S. and European have to make to avoid a repeat…..most fundamentally, we need an end to the pretence that the U.S. and EU are masters of the universe.

Will the OECD adjust to reality?