

# VIEWPOINTS

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## Making Transfer Pricing Work for Developing Countries

by Michael C. Durst

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### Introduction

I recently had the privilege of engaging in conversation with knowledgeable people about the challenges faced by developing countries in administering transfer pricing rules. The discussion below is designed to synthesize some recommendations that have arisen from these conversations. The following observations and recommendations are intended to be short on theory and long on practice; one hopes they can be readily translated by tax administrations into practical, straightforward policies and procedures.

Before offering particular suggestions, I should briefly describe the views that motivate them. As indicated in prior writings,<sup>1</sup> I have several serious reservations about whether current transfer pricing rules are serving the global public effectively. One of my reservations — which is particularly relevant to countries with limited resources to expend on tax administration — is with the practice of many governments to encourage or even require taxpayers to maintain “contemporary documentation” of their transfer pricing practices. This documentation typically contains extensive computerized searches for “comparables,” as well as detailed and often bulky factual studies (“functional analyses”). Those studies, while costing both the global private and public sectors hundreds of millions of dollars per year, seem to do little if anything to facilitate tax compliance or administration. The current system, in my view, results in large costs with no corresponding ben-

efit. It is unfortunate enough that such wasteful practices seem to be entrenched in developed countries around the world. These practices also seem to be spreading to even the most resource-constrained countries of the developing world, and I believe the resulting waste should be considered intolerable.

Despite my negative assessment of the arm’s-length standard, however, I do not advocate that any particular country seek to reduce administrative costs by taking on the politically challenging task of constructing a full-scale alternative to arm’s-length transfer pricing. This article instead suggests some incremental ways in which developing — and other — countries might reduce costs while enhancing the effectiveness of administration.

### Elements of a Simplified Approach

The key point is that many of the business activities that multinational companies conduct in developing countries consist of operations that can reasonably be classified as: (i) distributing products within the country; (ii) providing research and development activities or customer service on behalf of affiliates; (iii) manufacturing; or (iv) some combination thereof. Under current transfer pricing practices, entities that conform to these descriptions — as long as they do not perform R&D or otherwise develop intangible property for their own future benefit, as opposed to the benefit of the parent — overwhelmingly use “profit-based” pricing methods such as the comparable profit method under U.S. terminology, or the similar transactional net margin method (TNMM) described in the OECD transfer pricing guidelines.

The current transfer pricing method for those entities therefore is to ensure either that their distribution operations receive at least an adequate net operating margin based on sales revenue, or that their service and

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<sup>1</sup>See, e.g., Michael C. Durst, “It’s Not Just Academic: The OECD Should Reevaluate Transfer Pricing Laws,” *Tax Notes Int’l*, Jan. 18, 2010, p. 247, *Doc 2009-26892*, or *2010 WTD 11-14*; and Durst, “The President’s International Tax Proposals in Historical and Economic Perspective,” *Tax Notes Int’l*, June 1, 2009, p. 747, *Doc 2009-11696*, or *2009 WTD 103-14*.

manufacturing operations achieve adequate markups on specified measures of their costs. This means that the companies or their tax advisers estimate arm's-length margins or markups, based on computerized searches of financial data reported by publicly traded companies. Based on these searches (i) a list of companies is selected that appear comparable in function to the tested entity, and (ii) a range of margins or markups is determined based on these companies' results. The tested entity is considered to have priced in compliance with the arm's-length standard as long as its margin or markup falls within the estimated range.<sup>2</sup> Also, countries typically require that contemporaneous documentation contain a factual description of the taxpayer's operations, generally geared to reassure the tax authority that the entities do not create valuable intangible property for their own account.

Typically, the database searches and accompanying written analyses are performed by consultants employed by large accounting, law, or economic consulting firms. The required work is expensive. A single study can cost \$100,000, and large multinationals, which must produce simultaneously documentation for use in many countries, spend millions of dollars annually on these reports.

Despite the cost, however, contemporaneous documentation has proven to be almost useless as an enforcement tool for tax authorities. The apparent reason is that real-life data of even functionally similar companies typically do not tend to cluster closely around a central median, but instead — reflecting the real-life experience of widely differing results among competing companies — seem to distribute themselves very broadly, with little central tendency. The result is that arm's-length ranges tend to be so broad as to be meaningless.<sup>3</sup>

For example, it is not infrequent for the arm's-length range of net operating margins for a distributor to extend from, say, 1 to 5 percent, suggesting for a particular company with \$100 million in sales that the acceptable income level is anywhere from \$1 million to \$5 million — hardly the degree of precision needed to run a tax agency. Similarly large ranges are common in many other circumstances. It is even common for arm's-length ranges to extend below zero, suggesting that a company need not earn any income at all, even

though the global group of which the company is a member may be quite profitable. As a result, contemporaneous documentation has become an empty ritual, perhaps giving a veneer of legitimacy to arm's-length transfer pricing but serving no other apparent purpose.

The sensible course of action for developing countries, therefore, seems to be fairly straightforward, and parallels an approach that even the United States sometimes uses. Developing countries should permit companies falling within the distributor, service-provider, or manufacturer paradigms outlined above, and which do not create significant intangible property for their own use, to qualify for the CPM/TNMM, as is generally allowed today. Instead of requiring companies to endure the ritual of database searches, the tax authority should prescribe minimum margins or markups for wide ranges of different situations. This practice would be similar to that employed by the United States under its services cost method for some routine services performed within commonly controlled groups (for which the U.S. regulations prescribe a minimum markup of costs of zero),<sup>4</sup> but would be extended to a wider variety of situations.<sup>5</sup>

Required minimum margins and markups (which seem to be used tacitly by many tax examiners around the world, even if they do not conform formally to applicable legislation and regulations) can properly be described not as a departure from the arm's-length approach, but as an application of it. Indeed, the use of the services cost method by the United States belies the notion that the suggested approach can be seen as a challenge to arm's-length pricing.

There is, to be sure, an important conceptual issue that some countries will need to address in determining the appropriate margins and markups. Labor costs in developing countries often are lower than in other countries, and this raises the question whether arm's-length levels of profitability, including arm's-length markups on cost, will be higher in developing countries than elsewhere in the world. Economists operating under the current arm's-length paradigm generally agree that this question should be answered on the basis of whether competition among different low-cost labor markets tends to remove the ability of business owners to enjoy increased profitability from "location savings," or whether — at least in the early days of the growth of a local labor market — owners are able to keep some of the location-savings benefits in the form of higher profits. (Theoretically, this debate might be

<sup>2</sup>For example, if the transfer pricing analysis is being performed for Distribuco, the Country X distribution arm of Parentco, a German corporation, then Distribuco is the "tested" entity; it must earn an operating margin at least equal to the level determined to be at the bottom of the arm's-length range if it is to avoid a transfer pricing adjustment by tax authorities in Country X.

<sup>3</sup>This topic is addressed with reference to economic theory in Durst and Robert E. Culbertson, "Clearing Away the Sand: Retrospective Methods and Prospective Documentation in Transfer Pricing Today," 57 *Tax L. Rev.* 37, 108-114 (2003).

<sup>4</sup>The services cost method is described in reg. section 1.482-9(b).

<sup>5</sup>The envisioned system is similar to practices followed in Brazil as well as to transfer pricing reforms that the Indian government is implementing. See generally Tripti Lahiri, "Indian Budget Proposes ADR Mechanism, Pricing Safe Harbor," 18 *Tax Mgmt. Transfer Pricing Rep.* 211 (July 9, 2009).

settled by viewing the actual profit levels of independent companies that conduct business in the developing countries, but in practice, the local comparables data needed to perform such an analysis only infrequently exist.) Differences between the tax administrations of developing and other countries over the treatment of location savings already arise today, and they also would be present under a simplified system.

It therefore would make sense, as part of the process of moving to a regime of specified margins and markups, for competent authorities to seek to resolve differences concerning the proper treatment of location savings on a country-wide basis. Of course, the need to resolve location-savings issues under a simplified approach should not be seen as a reason to avoid implementing a simplified system. The location-savings issues under that approach would be similar to those that arise under today's more complicated approach. Under a simplified system, however, it would be more feasible for competent authorities to resolve those issues on a country-wide basis. The result should be less exposure of companies to double taxation.

Once a practical answer is found to the location savings problem, the determination of appropriate margins and markups should face few important technical obstacles. Because of the wide arm's-length ranges generated when contemporaneous documentation is used as the basis for transfer pricing compliance, the margins or markups prescribed by the tax authority almost certainly will fall well within the arm's-length ranges that would have been determined if taxpayers had been required to go through the motions of database searches. In other words, the results under the suggested, simplified system should not depart significantly if at all from those reached under a full-blown economic analysis.

Compliance efforts of the tax authority, with respect to taxpayers using the simplified method, will involve verification of the taxpayer's local financial statements and application of the prescribed margin or markup. There will be no need for economic studies, and less need for exhaustive functional analyses to determine the precise activities of the local taxpayer (although it will remain necessary to verify that the taxpayer's activities fall within one of the categories that are eligible for the simplified approach). In short, better tax compliance will be achievable, and at far lower costs, if the tax authorities specify arm's-length margins and markups in advance, rather than requiring taxpayers and their consultants to devise inevitably useless arm's-length ranges separately for every taxpayer.

Several practical questions arise in connection with the implementation of the simplified method, perhaps the most important of which is the identification of taxpayers eligible to use the method. Conceptually, the method should be suited for all companies that do not generate valuable intangible property for their own account. In practice, however, determining whether this

condition is present can be difficult, if not impossible. It is suggested that companies be permitted to use the simplified method if:

- their sales or operating expenses do not exceed specified levels — say, in countries the size of India or China, the equivalent of US \$1 billion or \$2 billion in local sales, or \$200 million or even \$400 million in operating expenses; and
- the companies do not perform R&D for which ownership of resulting intangible property is not clearly assigned to the parent company under contract.

Companies too large to meet the sales and operating expenses test would need to receive permission to use the simplified method through an advance pricing agreement, as described below.

Another important question is whether the specified margins and markups should be required of all companies that qualify for the simplified arm's-length method, or whether the margins and markups should instead be presumptions subject to rebuttal. In my view, while the administrative demands of offering a program for discretionary exceptions are potentially quite serious, some degree of flexibility will be desirable. One approach might be to permit companies to obtain permission to report reduced rates of return or market for a reasonable period of time — for example, two tax years — based on compelling evidence that their system-wide (that is, global) levels of profitability are less than would be required of the local entity. The reduced margin or markup that is allowed locally should be set so as to approximate the group's global rate of profitability (with a minimum of zero — a break-even result in the local jurisdiction — if there are system-wide losses).

An important question is whether a system that depends heavily on prescribed margins and markups, instead of individual database searches, will encounter difficult political resistance. The system suggested herein is similar to a safe harbor system, and historically, the concept of safe harbors in transfer pricing rules has encountered serious opposition. The OECD guidelines, for example, express hostility to the notion of safe harbors.<sup>6</sup> This hostility may in part reflect the historical fact that during the first half of the 1990s, safe harbors faced strong opposition as signs of a potentially dangerous wavering of international support for arm's-length transfer pricing generally. In particular, some governments around the world feared at the time that the United States might implement a safe-harbor-like approach as part of a unilateral attempt to increase

<sup>6</sup>OECD, "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations," paras. 4-94 to 4.123 (1995), available at [http://www.oecd.org/document/24/0,3343,en\\_2649\\_33753\\_1915490\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/24/0,3343,en_2649_33753_1915490_1_1_1_1,00.html).

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the taxable income of U.S. subsidiaries of foreign-based multinational companies, particularly in the automobile and other tangible-goods industries.<sup>7</sup> While some aversion to safe harbors as potential harbingers of a move away from the arm's-length standard may remain, the intensity of feeling is possibly less than when the OECD guidelines were being written. Accordingly, while events may prove this observation wrong, I do not believe that attempts by developing countries to construct simplified arm's-length pricing systems such as those outlined above will meet disabling political resistance.

Another important question is what the most desirable role is for APA programs in connection with the simplified arm's-length approach outlined above. APA programs are not without their difficulties and limitations; in particular, the costs and supervisory requirements of an APA program suggest that the programs should be made available by governments only when their benefits are likely to be substantial. For most countries, APA programs probably will be desirable in connection with the envisioned simplified pricing method for three purposes:

- i. Addressing under income tax treaties situations in which application of the prescribed margins or markups poses a problem of double taxation for a particular taxpayer. APAs in these circumstances will be bilateral and will be especially important when competent authorities have not yet developed generally applicable policies regarding the treatment of location savings.
- ii. Evaluating requests for exceptions to the required margin or markup on the ground of insufficient system profit.
- iii. Determining transfer pricing methods for companies that do not qualify for the simplified approach because they exceed the applicable maximum size thresholds or engage in substantial R&D activities for their own account.

An additional question to be addressed is whether the simplified arm's-length approach should be seen as suited for developing countries only, or whether it might be suitable for adoption by heavily industrialized countries. Substantively, I think the benefits for industrialized countries would be the same as for developing countries. Specifically, a simplified arm's-length approach would eliminate controversy in a large number of transfer pricing cases while leaving only the more difficult cases to be addressed under the current, costlier approach. If it is sensible for developing countries to adopt the simplified approach, it also should be sensible for industrialized countries to adopt it.

Politically, however, it might be more difficult for industrialized countries, particularly the United States, to adopt the simplified approach. In industrialized countries, political attachment to transfer pricing rules based on searches for comparables may be particularly acute because of the nexus between such rules and companies' global effective tax rates. If, however, political opposition does not prove insurmountable, then I believe considerable cost savings could be achieved by adopting a simplified system in highly industrialized countries such as the United States as well as in the developing world. ◆

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<sup>7</sup>See Durst and Culbertson, *supra* note 3, at 77-81.