Presentation by The Tax Justice Network to the Meeting on Transfer Pricing at the United Nations, June 8, 2011

The Tax Justice Network respects the expertise of the members of the Transfer Pricing Subcommittee of the UN Tax Committee and the tremendous efforts of the Subcommittee in this project. The distinguished work of Stig Sollund the Coordinator of the Subcommittee, and of Michael Lennard of the UN Secretariat, deserve great praise by all of us.

The Tax Justice Network questions whether the project of the Subcommittee is leading developing countries down the correct road.

The OECD's Arm's-Length Principle has been receiving more critical analysis. This critical analysis is based at least on the following seven issues. Each issue has a practical solution.

First, the OECD Transfer Pricing Guidelines are so complex that even the tax administrations of many developed countries can not adequately administer those rules. Therefore, how can developing countries–especially the least developed countries – be expected to administer adequately those rules? Michael Durst formerly a U.S. Treasury Department official responsible for transfer pricing issues, points out that transfer pricing rules based on the arm's-length principle are inherently unenforceable. Indeed, he implies that the arm's length method exists because it is unenforceable, and that is why business lobbyists have supported it so energetically. Therefore, the Transfer Pricing Manual should concentrate on practical measures of simplification and enforceability.

Second, the Manual should be more objective about the availability of comparables. Chapter One of the Manual on pages 32 and 33 emphasizes the difficulty of obtaining comparables, especially by developing countries. See paragraph 5.2 in Chapter One which states that all OECD transfer pricing methods rely directly or indirectly on comparables. But without comparables, for developing countries, what effect will the OECD Guidelines have? The Subcommittee and the Manual must confront more directly this major issue.

Third, the description of the OECD Transfer Pricing Guidelines emphasizes throughout Chapters One and Five the problem of obtaining sufficient information. Therefore, to help solve this major problem of information deficiency, the Manual should explicitly support the adoption of obligatory country-by-country reporting by multinationals.

Fourth, alternative measures should be discussed in more detail in the Transfer Pricing Manual. For example, the safe harbor system, which is referred to in paragraphs 8.5 and 8.6 of Chapter One, should be detailed in Chapter Five. Although the OECD's Transfer Pricing Guidelines reject safe harbors (Chapter IV, paragraph E), even the OECD has recently confronted reality, and is apparently more amenable to considering safe harbors, apparently because the OECD realizes that they are unavoidable. The Transfer Pricing Manual should cover this in detail, and also the issue of fixed margins, with different measures about rebuttability. Unfortunately the OECD, in its recent revisions of Article 7(4) of OECD Model Treaty, has deleted references to the profit split method, and that should be reconsidered. (Paragraph 7.4 of Chapter One). Paragraph 7.11 of Chapter One states that when there are no comparables, a profit-split approach can be used. But Chapter Five seems to limit the use of a profit split method to specified circumstances. The residual profit split method does seem to reflect an apportionment concept, the use of which should generally be reviewed in more depth in the absence of comparables. Therefore, hybrid methods should be considered.

Fifth, the OECD in its 1998 seminal Report "Harmful Tax Competition: An Emerging Global Issue," mentions (page 61) the relationship of transfer pricing issues and low-tax and no-tax jurisdictions. Of course, one essential element of transfer mispricing is the efforts of multinational enterprises to shift profits to low tax or no tax jurisdictions. That 1998 OECD report states:

> d. <u>Application of Transfer Pricing Rules and the OECD Transfer Pricing Guidelines</u>
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> 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 the true functions performed by each part of a group of associated enterprises, does, in that respect, constitute a useful counteracting measure.

> 167. It may be appropriate, however that the [OECD Fiscal] 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 (see subsection (a) above) would fall in that category. One action that could be taken in that respect could be for the [OECD Fiscal] Committee to supplement the OECD Transfer Pricing Guidelines with more guidance on the application of the OECD's Transfer Pricing Guidelines in relation to tax havens and regimes constituting harmful tax competition.

However, Chapter 5, on Transfer Pricing Methods, does not refer to this major issue of the interplay between (a) transfer mispricing and (b) tax haven jurisdictions and privileged fiscal regimes. Marcos Valadao spoke yesterday about the Brazilian approach to this problem. Chapter 5 should be modified accordingly.

Sixth, a significant source of support, for the OECD Transfer Pricing Guidelines and its Arm's Length Principle comes from people who have a significant vested interest in the continued use of those Guidelines and the Arm's Length Principle: auditing firms and law firms and economic consulting firms which derive substantial income from advising and consulting about those Guidelines. The more complex those rules are and the more difficult to administer those rules, the more money those firms make. And employees of governments and international organizations who have developed expertise in the OECD Guidelines and whose careers depend to some significant degree on the OECD Guidelines also have a vested interested in the continued use of the OECD Guidelines and the Arm's-Length Principle. To quote Martin Sullivan, a distinguished economist: "There is the small but influential army of private-sector pricing consultants– many of them former [U.S.] Treasury officials and U.S. Internal Revenue Service officials–who have built careers around the arm's-length method." Therefore, there should be more involvement by disinterested academics and NGOs in the development of the Manual and transfer pricing rules, especially for developing countries.

Seventh, the task of the UN Tax Committee as specified in ECOSOC Resolution of November 11, 2004 is to "give special attention to developing countries and countries with economies in transition." The project of the Transfer Pricing Subcommittee, in focusing on Transfer Pricing Issues for Developing Countries, in theory helps implement that ECOSOC resolution. But by focusing solely on the OECD's arm's-length principle, the Subcommittee could be considered to be prolonging the life of an ill patient, rather than trying to analyze and resolve the underlying problem: the disease of transfer mispricing.

At the meeting of ECOSOC in New York on April 26, 2011, with regard to the proposed strengthening of the UN Tax Committee, the Group of 77 and China spoke very forcefully against the OECD and EU countries trying to impose their rules, as the Rule Makers, on the rest of the world as Rule Takers. Yesterday, Jomo Kwame Sundaram, United Nations Assistant Secretary General for Economic Development, referred to this important issue that the OECD Guidelines were developed by a small group of countries.

The Transfer Pricing Manual should be prepared emphasizing the interests of developing countries, using a more flexible approach. What will the G-77 and China say about a Practical Manual for Developing Countries that in effect basically repeats the OECD Transfer Pricing Guidelines? Unless the Manual takes into consideration the needs and views of those non-OECD countries, the work of the Subcommittee runs the risk of serious criticism.

There is a great similarity between (1) the OECD's policy of exchange of information upon request, and (2) the OECD's Transfer Pricing Guidelines. The OECD claims that both are effective and that both are the international standard.

However, with regard to information exchange, automatic exchange of information has been adopted by many OECD countries in the EU. Many OECD, countries exchange information automatically among themselves. And the recent FATCA legislation in the United States in effect provides for automatic exchange of information. Even though the OECD vigorously asserts that exchange of information upon request is effective and that it is the "international standard," the adoption by many OECD countries of automatic exchange of information clearly proves that the OECD is wrong about exchange of information upon request.

Similarly, the OECD vigorously asserts that its Transfer Pricing Guidelines are effective and are the "international standard." However, most states in the United States have rejected that arm's-length policy internally. And the European Union is moving step-by-step toward a similar policy.

Therefore the OECD's Arm's-Length Principle can not really be considered the "international standard" nor can it be considered as effective as the OECD asserts.

The Transfer Pricing Manual should reflect reality.

David Spencer