tax justice network

"Transfer Pricing in Developing Countries,"

By TP Ostwal of TP Ostwal & Associates, Chartered Accountants based in Mumbai.

The aim of this paper is to highlight problems with the current approach and practice of cross-border taxation of multinational enterprises, and in particular the transfer pricing methods which are used to derive an arm's length price. It explains why Formulary Apportionment (FA) should be considered as an alternative to current transfer pricing methods, especially for developing countries.

Ostwal emphasises that existing transfer pricing laws are not based on defensible economic principles or on transparent rules that all countries apply uniformly, and the rules produce arbitrary results. The inherent nature of multinational enterprises, involving corporate synergies, is in contrast to arm's-length principles; the rules are also based on an outdated concept – of so-called "permanent establishment;" they make artificial distinctions among legal entities (subsidiaries and branches); and the current system drives income to low tax jurisdictions.

The Ostwal study also discusses difficulties with implementing transfer pricing methods (Section 7.2) . These problems include, especially, the problem of finding comparables; their complexity; the determination of so-called "location savings;" as well as arguments that transfer pricing methods are not based on sound economic principles. These methods include methods known as “CUP”; Resale price and Cost plus methods; the profit comparison methods; and the profit-split methods.

The study also analyses the role of the Internet and e-commerce, which it calls “the Achilles Heel of the current International Taxation Regime (Section8).

The Ostwal Study details the Formulary Apportionment method: what it is; why it is needed; how such a system would work; current uses of formulary apportionment systems around the world (Section 10); Developing Countries and Formulary Apportionment (Section 11), Critiques of the Formulary Apportionment method (Section 12). It also notes, in Section 13, that the OECD’s Transfer Pricing methods, on the one hand, and Formulary Apportionment methods, on the other, should not be seen as polar opposites, but as part of a continuum of methods.

The Conclusion in Section 14 says:

> *“We believe the time has come for developing countries to move to a formulary apportionment (FA) system . . . we showed how FA would be suitable especially for developing countries.”*

The study ends with a quote from Victor Hugo:

“An invasion of armies can be resisted, but not an idea whose time has come.”