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TRANSFER PRICING: INCREASING TENSION BETWEEN MULTINATIONAL FIRMS AND TAX AUTHORITIES

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ABSTRACT

Transfer pricing taxation is a significant source of tension between Multinational Firms (MNFs) and tax authorities. The tension relates to the different perspectives of MNFs and tax authorities. MNFs view taxes related to transfer prices as costs to avoid. On the other hand, regulators and tax authorities view taxes related to transfer pricing from the perspective of making sure that MNFs pay their fair share of taxes to the country or territory where MNFs generate profits. Previously, the U.S. was the primary world leader in the area of transfer pricing taxation. The Organization of Economic Cooperation and Development (OECD) have replaced the U.S in this role. The new OECD project titled Base Erosion and Profit Shifting (BEPS) will dramatically change transfer pricing taxation, on a worldwide basis. It also has the potential to affect change in foreign direct investment (FDI). These changes will take place in both developed and underdeveloped countries. This article informs regulators, tax authorities, MNF management, academics, and tax professionals about several major emerging issues related to BEPS. The article also informs accounting and taxation academics about future research needs in this area.

JEL: F23, H26, K34, M48

KEYWORDS: Transfer Pricing, Tax Avoidance, Multinational Firms, Tax Regulation

INTRODUCTION

A Multinational Firm (MNF) has a taxation issue related to transfer pricing anytime the group produces goods or services in an entity located in one country or territory and then transfers those goods or services to a related entity in another territory or country. In some cases the second entity may add to the production process and even transfer the product or service to a third related entity before the product or service is sold to the final consumer. Each transfer results in marginal profit for tax purposes. This marginal profit becomes part of the tax base in each country where the related entities are located. In recent years, tax authorities have expanded transfer pricing to include not only goods and services but to include transfers of intangible property, rent, and loans as well.

Transfer pricing has always caused tension between government regulators and MNFs. However, in the current environment regulators and tax authorities exacerbate the tension in Organization of Economic Cooperation and Development (OECD) countries by seeking to limit tax base erosion and profit shifting. This movement is due to decreasing tax revenues, even as MNF profits increase. The foundational cause of tension is rooted in the different concepts of taxation held by government authorities and MNFs. Regulators and tax authorities view tax from MNF marginal transfer price profits as an important portion of government revenue. MNFs view the tax on transfer price marginal profit as a cost to avoid by strategic tax planning. This tax planning includes putting the transfer price marginal profit in the lowest tax country possible, and the use of tax havens and tax incentives. The use of tax havens and tax incentives by MNFs causes inter-

country tension. This tension is increasing between tax haven/tax incentive countries and OECD countries that view limiting tax base erosion by MNFs as a top priority.

The next section summarizes selected academic research on transfer pricing and related tax planning activities on the part of MNFs. A section that describes the OECD Base Erosion and Profit Shifting (BEPS) action plans designed to limit tax avoidance through transfer pricing and other tax planning strategies follow this. Then there is a discussion section followed by concluding remarks.

LITERATURE REVIEW

The concept of transfer pricing was originally a managerial accounting concept dating back to the late 1880s. As companies increasingly organized around divisions and segments, management designed a methodology that internally allocates profit among different divisions and segments (Levey & Wrappe, 2010). The concept of using transfer pricing for taxation purposes originated in the U.S. in 1928 when the IRS began to allocate profits among related parties in order to inhibit tax avoidance (Section 45, Revenue Act of 1928). In 1935, the U.S. introduced the arm's length standard as a means of determining intercompany marginal profit for transfer pricing tax purposes. This standard requires MNFs, on paper, to sell goods and services to related entities at a price that is close to the price that those same goods and services would sell to outside parties. The OECD adopted the standard in 1979 (Morris, 2011). Since that time, global tax regulators have enacted statutes that delineate how tax is determined on goods and services that transfer between MNF related parties. The current foundation of this worldwide system is still the arm's length standard. However, regulation of transfer pricing for tax purposes on a global basis has evolved into a very complex set of rules and regulations that can vary from country to country. The implementation of these diverse rules is complex due to the lack of comparable third party transaction arm's length data, and the desire of some countries or territories to attract MNF business by the use of tax incentives.

Tax authorities throughout the world impose the arm's length principle (ALP) to determine transfer prices for MNFs. However, Keuschnigg & Devereux (2013) show that the use of ALP does not reflect the economic reality of how a MNF works, and transfer prices set by the ALP often do not reflect what an actual third party would pay. ALP may increase the tax base in the corporate parent's country, but at the same time reduce tax revenue in countries where the subsidiaries are located. The overall impact is a reduction in total tax revenue available for government agencies in the different countries involved. Yao (2013) finds the same thing for the case where the subsidiary is located in the parent's country. That is, overall tax revenues do not increase by the imposition of ALP even when the parent and subsidiary are in the same country. These findings seem to be in contrast to what most tax authorities believe.

Hyde & Choe (2005) discuss the operational reality that MNFs keep two different sets of books for transfer pricing purposes. One set for management purposes to internally assess subunit profitability, and a second set to determine the overall lowest tax for each subunit. This implies that a change in tax policy influences the internal incentive cost structure of a MNF. Similarly, a change in cost structure affects MNF tax policy.

From an economic standpoint, Copitthorne (1971) indicates that transfer pricing for a MNF is a two-stage process motivated by profit maximization. The first stage is to maximize pretax profit among related entities on a global basis. The second stage is to allocate transfer prices among the controlled entities in a way that minimizes the overall tax cost. As might be expected, the MNF will seek to allocate as much profit as possible to the countries or territories with the lowest transfer pricing tax rates. Grubert & Mutti (1991) empirically affirm that transfer pricing taxation results in the shifting of MNF income to low tax countries, as well as, the shifting of investment to these countries.

Taylor, Richardson & Lanis (2015), in a sample of 286 U.S. MNFs, empirically confirm that U.S. MNFs seek to reduce taxes paid by manipulating transfer pricing among related entities. They find that this occurs

when MNFs seek to take advantage of low tax rates and incentives offered by countries that they do business in. Often, the mechanism used involves transfer of goods or services that lack available comparable sales data that would support an arm's length transfer price, for example, intangibles. Even when dealing with goods and services other than intangibles, tax authorities have to use incomplete and indirect information to establish transfer prices because there often are no comparable market prices to determine an arm's length price.

There is some empirical evidence that a majority of tax managers involved in transfer pricing for MNFs focus on compliance rather than aggressive tax avoidance. Klassen, Lisowsky & Mescall, (2013) surveyed senior tax managers from 219 MNFs the survey asked 114 questions. The results of the survey indicate that a majority of the surveyed firms establish their transfer prices on a compliance basis versus an aggressive tax avoidance basis. Interestingly, the results show that nonmanufacturing firms use aggressive tax avoidance more than manufacturers.

In spite of the mixed motivations of MNF tax mangers, the reality is that the public perception and the perception of regulators worldwide is that MNFs are abusing transfer pricing and not paying their fair share of taxes. The IRS started a major transfer pricing initiative in 2010 (Ossi & Sheperd, 2010). The Large and Mid-Size Business Division (LMSB) reorganized into the Large Business and International (LB&I) division. This division now has a separate Office of Transfer Pricing Operations, comprised of transfer pricing specialists. These specialists are from within the IRS as well as outside hires. There has been an increased emphasis on knowledge management within the LB&I. Initiatives include an intranet Transfer Pricing Center and a December 2014 release of 46 International Practice Units (IPUs). IPUs are training modules on various tax topics that will educate and assist IRS employees before and during an audit. Twenty of the 46 IPUs discuss transfer pricing. MNFs can expect a higher level of scrutiny and IRS auditors with more expertise.

Chan, Lo, & Mo (2015) indicate that Chinese tax authorities have gained much transfer pricing expertise over the last two decades. As a result, they have significantly increased their transfer pricing audits; especially targeting Western MNFs. Sakurai (2002) finds that there is a difference in the regulatory styles of tax authorities. The IRS tends to rely more on litigation and adversarial audits, whereas, the tax authorities in the U.K. prefer informal negotiation, and Japanese tax authorities prefer regular interaction with MNF personnel. Regardless of style, MNFs can expect a higher level of scrutiny and expertise from international tax authorities, as well as, U.S. tax authorities.

Sikka & Willmott (2010) report that the Chinese tax authorities believe that they are losing almost $4 billion annually in tax revenue due to tax avoidance and wealth transfer related to transfer pricing. The authors also report that the loss of tax revenue from transfer pricing seems to be widespread in both developing and developed countries. In developed nations, as corporate profits have increased, in most cases, MNF effective tax rates have decreased. They suggest that this is due in large part to transfer pricing manipulation. They propose that future research should focus on the losses to society caused by lost taxes from transfer pricing manipulation. In an examination of 203 of the largest Australian corporations, Taylor & Richardson (2012) found that the firms use a combination of methods to avoid taxes. The top two methods for tax avoidance were the use of thin capitalization techniques and transfer pricing manipulation. They also found that the firms often combined the use of tax havens with both thin capitalization and transfer pricing.

There is long standing evidence that MNFs shift profits in response to tax rate increases in OECD countries. Bartelsman & Beetsma (2000) found that a tax increase on the part of individual OECD countries did not result in increased tax revenue from MNFs for those countries due to income shifting by transfer pricing on the part of MNFs. In a study of recent transfer pricing legislation of 26 European countries, Lohse & Riedel (2013) find that legislation that increases transfer pricing documentation and transparency, coupled with stiffer transfer pricing penalties does limit some income shifting on the part of MNFs. They hypothesize

that the revenue gained from these kinds of legislation is important in spite of increased administrative costs on the part of tax authorities.

Wells & Lowell (2014) discuss several different proposals to ameliorate tax base erosion and income shifting. They propose a system that requires confirmation of a transfer price from both parties to the transaction coupled with a refundable upfront surtax on the gross amount of tax reduction due to deductible expenses of affiliates. In the process of developing their proposal they examine the status quo, discuss a territorial system for transfer pricing, look at a formula based approach, discuss ending tax deferrals related to transfer prices, discuss increasing expense disallowance, discuss imposing a withholding tax based on gross transfer price, and discuss the recently proposed OECD Base Erosion and Income Shifting project (BEPS). They are critical of BEPS and indicate that foundational problems with transfer pricing are rooted in the long-standing OECD transfer pricing guidelines and the OECD Model Treaty transfer pricing provisions. They call for modification of these documents as a prerequisite for solving tax base erosion and profit shifting.

Harding & Javorcik (2012) find that attracting foreign direct investment (FDI) is an important economic strategy for developing countries. Buettner, Overesch & Wamser (2014), in an empirical analysis, show that imposition of thin capitalization rules and reducing deductibility of intercompany interest on debt results in a decline in MNF FDI for that country. They also found that regulation of transfer pricing has a neutral impact on FDI. They hypothesize that MNF management can offset new transfer pricing restrictions by other tax planning methods. Like Wells & Lowell (2014), they are critical of the BEPS proposals.

THE OECD's BASE EROSION AND PROFIT SHIFTING (BEPS) ACTION PLANS

In September 2013, the G20 group of finance ministers and central bank governors endorsed the OECD's Base Erosion and Profit Shifting (BEPS) action plans. The G20 declared the following:

> *"Cross-border tax evasion and avoidance undermine our public finances and our people's trust in the fairness of the tax system. Today, we endorsed plans to address these problems and committed to take steps to change our rules to tackle tax avoidance, harmful practices, and aggressive tax planning." (OECD, 2014).*

The endorsed plans include 15 action initiatives that range from dealing with challenges that tax authorities face in the digital economy to changes in the OECD Model Tax Convention. This section of the article focuses on four initiatives directly related to transfer pricing, two initiatives related to tax planning, and one initiative involving tax havens and tax incentives.

The four BEPS initiatives directly related to transfer pricing are contained in Action Plans 8, 9, 10, and 13. Action Plan 8 revises the transfer pricing rules related to intangibles, making transfer of intangibles more transparent and difficult to manipulate. Action plans 9 and 10 will limit the ability of MNFs to avoid tax by large allocations of capital and risk to low tax affiliates. Action Plan 13 will require more transparency and increased documentation of transfer pricing. In addition, this plan calls for electronic sharing of transfer pricing information among global tax authorities. Part of the information shared will be MNFs allocation of worldwide income and economic activity of each affiliate on a country-by-country basis. The IRS has already adopted this OECD action plan and will require MNFs to report activity related to transfer pricing on a country-by-country basis starting in late 2016.

Action Plan 4 will limit MNFs ability to shift income by using large intercompany interest deductions and other financial related payments as deductions to reduce income in high tax countries. Action Plan 5 affects MNFs that have historically used tax haven countries or countries that offer tax incentives to foster economic growth within their country. This action plan involves political pressure and more transparency

related to tax haven countries and those countries that use tax incentives to attract investment. Finally, and importantly, Action Plan 12 will require MNFs to disclose their tax planning methods.

DISCUSSION

As early as 1971, Copitthorne predicted that MNFs would seek to minimize tax by using existing tax rules and tax rate differences to shift taxable income to low tax countries. The problem for MNFs at this point in history is that the issue has received worldwide public attention in recent years. Tax revenue from MNFs, as a percentage of GDP, has declined in many countries, while MNF overall effective tax rates have declined. From a business perspective, the argument is that MNFs are more adept at effective international tax planning. From a tax authority and political perspective, the argument is that MNFs are abusing transfer pricing and not paying their fair share. From a sociologist or economist perspective, reduced tax revenues result in losses to world welfare. For the first time in history, large segments of the population around the globe view MNFs negatively. This has opened the door for increased tax regulation of MNFs, especially in the transfer pricing area.

An example of this is ongoing in the U.K. as Parliament debates how to deal with transfer pricing. In 2012, Starbucks had U.K. sales around 400 million pounds but paid no taxes to the U.K. (BBC News, 2013). The company shifted income to a Swiss subsidiary and used a special tax incentive offered by the Netherlands to get Starbucks to locate its European headquarters in the Netherlands. The U.K. operation paid royalties to the Swiss subsidiary and Dutch headquarters companies, these royalties were expenses for U.K. tax purposes resulting in no taxable U.K. income. In Switzerland, the royalty payments tax rate was as low as 2%, and the royalty tax rate for the Dutch headquarters was well below the Netherlands normal corporate tax rate, due to the special tax incentive deal. Google reduced its tax rate by locating its European headquarters in Ireland where the maximum corporate tax rate is 12.5%. Amazon located its European headquarters in Luxembourg where the tax on royalties is as low as 6%. These cases were widely reported in the U.K., causing public outcry and political pressure to pass laws that will prohibit such behavior in the future.

Researchers suggest several different methods for dealing with tax base erosion and income shifting. Several researchers are critical of the OECD BEPS plan. However, the OECD is proceeding at a rapid pace with BEPS. Much of the preliminary work on the 15 BEPS Action Plans will be complete by December 2015. Seven countries including the U.S. have already enacted legislation or implemented tax rules based on the OECD action items. Australia recently enacted an anti-avoidance rule that requires MNFs who operate in low or no tax countries to prove that they have significant economic activity in those countries.

Prior academic research indicates that MNFs can expect increased audits of their transfer pricing, on a worldwide basis. In addition, tax auditors now have higher levels of expertise. The OECD even has a proposal to share experienced transfer pricing auditors among different jurisdictions. The changes for MNFs are real and substantial, the countries involved in BEPS account for over 80% of the world economy.

Most of the OECD discussion has focused on tax policies that will limit tax base erosion and profit shifting by transfer pricing. However, a related issue that has received little attention on the part of the OECD is the fact that MNFs have the ability to shift investment among countries when tax burdens become excessive. A recent survey indicates that a majority of respondent MNFs would consider changing corporate headquarters country if taxes increased by 5% in the home country (Taxand, 2015). BEPS action plans would limit deductibility of intercompany interest and impose more stringent thin capitalization rules (Action Plans 4, 10 and 11). Researchers have found that when this happens there is a decline in MNF direct investment for those countries that restrict this type of tax planning. Researchers also find that the use of tax incentives to attract foreign direct investment (FDI) is an important economic development tool for developing countries.

Apple provides us with an example of how tax policies affect the movement of capital and related FDI. Stewart (2015) reports that Apple holds liquid assets of $158 billion of its $178 billion total overseas. The U.S. is one of two countries in the world that taxes its corporate taxpayers on worldwide income. However, under the U.S. Controlled Foreign Corporation (CFC) rules, (IRS Code sections 951 through 965), a U.S. MNF can defer U.S. tax on certain types (not all types) of foreign income earned by controlled foreign subsidiaries. The tax is not due until cash from those earnings is repatriated to the U.S. in the form of dividends to the U.S. parent. The intent is to help U.S. firms be more tax competitive in foreign markets. For example, assume that foreign subsidiaries of a U.S. MNF use a combination of transfer pricing, tax havens, and tax incentives to reduce the overall effective tax paid to foreign countries to 10%. If the U.S. parent keeps the cash from deferral eligible subsidiary income overseas, the U.S Corporate parent does not owe U.S. tax until the cash returns to the U.S. parent. In Apple's case, if it returned the $158 billion cash held overseas to the U.S. parent it would have to pay substantial U.S. income tax. Using the example above, since the U.S. maximum corporate tax is 35%, Apple would have to pay 25% of the $158 billion in U.S. tax after receiving a Foreign Tax Credit for the 10% tax paid to foreign countries. As might be expected, Apple is keeping the cash overseas and has gone so far as to borrow money for U.S. operations rather than repatriate cash from overseas. Apple and many other U.S. MNFs hold huge amounts of liquid assets overseas that they might invest in the U.S. but for the repatriation rules. These MNFs are in the position to move substantial amounts of capital and investment anywhere in the world if the tax system of a country becomes onerous. According to Stewart (2015), U.S. non-financial businesses have over $1.7 trillion in cash or short-term securities held overseas.

BEPS action plan 5 addresses what the OECD calls "harmful tax practices." If implemented, this action plan will be another source of tension between tax authorities and MNFs as MNFs seek to use tax haven countries and tax incentives as an important part of their tax planning. It will also increase tension between OECD countries and tax haven/tax incentive countries. It will also increase tension among some of the OECD countries themselves. Japan, Spain, and the U.K. recently announced a reduction in their international tax rates. This seems contrary to Action Plan 5. It is important that regulators consider that MNFs may vote with their feet in the event the tax burden in any given OECD country becomes excessive. Additionally, putting political pressure on countries to not reduce tax rates or offer tax incentives or become tax havens seems overreaching, and not in the best interests of those countries. In recent years, developing countries have attracted more FDI than developed countries. This is an important part of their economic development and is due in large part to favorable tax rates and the use of tax incentives by developing countries.

The implication for tax regulators and authorities is that there is a need for a carefully integrated tax policy for MNF transfer pricing taxation and restriction of tax planning methods. An onerous transfer pricing policy makes the use of tax havens and tax incentives more attractive. MNFs will be motivated to accept tax incentives or move operations to tax havens to reduce overall costs, and to lower the tax burden. MNFs will also be motivated to transfer FDI to more tax friendly territories.

CONCLUDING COMMENTS

This article draws attention to the increasing tension between MNFs and tax authorities related to transfer pricing and the use of other tax planning techniques. The article also highlights the potential for increasing tension between tax haven/tax incentive countries and OECD countries, and tension among the OECD countries themselves.

The primary findings of this research are several. First, MNFs will use all the tax-planning techniques that are available to avoid tax. Empirical research shows that these tax-planning techniques include use of transfer pricing to shift income to low tax countries, use of thin capitalization, deducting intercompany

interest payments, use of tax havens, and the use of tax incentives. Secondly, there is a substantial global movement on the part of regulators and tax authorities to prohibit MNF use of aggressive tax planning. This movement focuses on transfer pricing. It includes more audits, the sharing of MNF information and auditor expertise between jurisdictions, and increasing regulation of transfer pricing. The movement also includes discussion about limiting thin capitalization, limiting deductibility of intercompany interest, and trying to stop countries from becoming tax havens or offering low tax rates and tax incentives. The OECD BEPS action plan orchestrates this movement.

Third, for many years, developing countries as well as certain OECD countries have used reduced tax rates and tax incentives to attract FDI. For many countries, FDI is an important part of their overall economic development plan. Research shows that limiting transfer pricing has a neutral effect of FDI. However, limiting thin capitalization and deductibility of intercompany debt can result in a decline of FDI for those countries that limit this type of tax planning. Research also shows that U.S. corporations have huge amounts of liquid assets held overseas that are easily moved between countries. This implies that MNFs can rapidly redeploy FDI to another country when a tax system becomes burdensome.

This research has a few limitations. An emerging research stream looks at the moral and ethical aspects of a MNF not paying a fair share of tax due to tax planning when they have significant sales and a physical presence in a country. Related to this, the digital economy poses significant challenges to tax authorities and regulators, and offers significant tax planning opportunities for MNFs. The issue of international digital nexus can have a significant impact on transfer pricing and other tax planning techniques in the future. This article does not address either of these issues. In addition, this article addresses seven BEPS action plans that directly apply to transfer pricing and tax planning. The remaining nine action plans include items such as preventing treaty shopping, strengthening CFC rules, improvement in dispute resolution, and modification of OECD model tax documents. These issues are important but they are beyond the scope of this article.

Most of the research on transfer pricing and taxation is by academics that are outside the accounting and taxation disciplines. There is a need for research that examines accounting and taxation perspectives on transfer pricing and tax avoidance planning. An immediate research need is to determine how the OECD proposals will change the way that MNFs handle internal transfer pricing for both managerial accounting and tax purposes. There is also a need for researchers to help regulators understand the issue of how the OECD proposals may result in the movement of FDI out of OECD countries. Additionally, new tax planning strategies proposed by tax advisors and University professors designed to circumvent the OECD proposals are of interest. As the pressure increases on MNFs, there is much opportunity for accounting and taxation researchers to examine the tension caused by BEPS and increasing tax regulation. BEPS not only causes tension for MNFs but it will also increase tension between the have and have not countries.

Buettner, Overesch & Wamser (2014, p.26) aptly describe the pivot point of tension: "…tax policy is facing a trade-off between limiting base erosion and increasing adverse tax effects on foreign direct investment."

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