Collision course

Transfer pricing is in a mess, with different countries adopting conflicting principles. A global consensus could take a decade to achieve and the OECD's guidelines are far from watertight. **Paul Armstrong** investigates an issue plagued by imperfect solutions

WITH AN ESTIMATED TWO OUT OF THREE of the world's transactions taking place between related parties, transfer pricing is the issue on everyone's lips. And it is likely to remain so until its imperfections are ironed out. Alexander Voegele, whose Frankfurt-based transfer pricing boutique, Voegele Partner, became part of Nera Economic Consulting on 1 October, thinks that substantive changes are likely to need 'a minimum of ten years'. He explains: 'The current transfer pricing rules are still in the tax treaties, and they can't be changed in the short term.'

Most developed countries now adopt the OECD's guidelines on transfer pricing (including all 30 OECD members, with more being added to the list all the time)

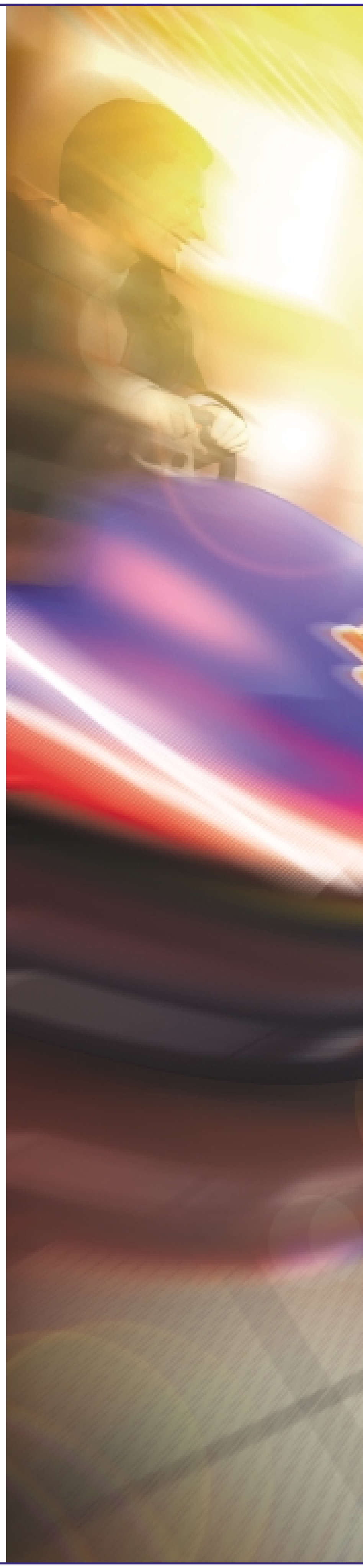

Illustration **Ian Naylor**


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Lewis: OECD rules are imprecise

Calleja: states will never agree tax bases

but jurisdictional idiosyncrasies are rife. 'The substantive rules around the globe still don't match perfectly,' says Steven Wrappe, partner and director of advance pricing services at Deloitte in Washington, DC. 'That puts a lot of pressure on procedural measures to work out the differences between states, mostly through the international tax treaty network. Most developed countries say they adhere to the OECD guidelines, but it's their interpretation of the guidelines that's the problem. There's plenty of room for case-specific disagreements.'

Some experts insist that a global consensus on transfer pricing can never be achieved – that it is in the nature of the beast to remain imperfect. Even Wrappe, who is keen to suggest a number of ways in which the rules could be tightened up, believes 'it's inevitable that there will be some disputes'. Angel Calleja, a partner at Garrigues in Madrid, is of the same opinion. 'If you're talking about a crystal ball conjuring up an image of the future where states agree on tax bases, then I don't think that's likely,' he says. 'In transfer pricing it's impossible to find solutions to certain problems.'

Patricia Lewis, a partner at Caplin & Drysdale in Washington, DC says the answer is not to seek perfection, but rather a workable set of global transfer pricing rules. 'Transfer pricing is insoluble if what you're looking for is perfection, but not if you're looking at having some principles to work by – that goes a long way. Transfer pricing is not on-off; it's a spectrum. It's open to interpretation,' Lewis says.

And it is in this spirit that efforts are being made on a variety of fronts. In December, the European Union's Joint Transfer Pricing Forum (JTPF), made up of representatives of tax authorities and the business community, will present a draft of its blueprint for a common approach to documentation to the European Commission. This so-called 'master file' approach will, according to Pim Fris, head of Nera's transfer pricing group: 'cover most of the needs of all the countries in the EU, so that only small additional changes will be needed for individual countries'.

Although the timetable is considered ambitious by tax advisers, the JTPF hopes to have a common set of transfer pricing documentation ready for implementation in March or April 2005.

Fris says that such a common starting point, not only in documentation but also in trickier areas such as creating a common tax base, is fundamental to a consensus on transfer pricing. 'What you need is a common institutional framework as a starting point – like the US, which has its single, federal system, whereas in Europe, for a market of a similar size, you've got not one, but 30 systems.'

Fris argues that, helped by its strides towards a federal tax system, the EU is moving more quickly towards a consensus than other regions: 'Looking at Europe, a ten-year time frame may be sufficient to create something that would effectively allow simpler ways of dealing with transfer pricing. Europe is trying to work a long-term solution by supporting a common taxation system.'

There are those who see not all the developments in the EU as positive, however. Gareth Green, director of one-man-band boutique Transfer Pricing Solutions in London, views the wave of anti-discrimination judgments by the European Court of Justice as a 'disruptive force that may transform transfer pricing' – and not for the better. Green says: 'For now, governments have applied sticking plasters to their transfer pricing legislation in response. Perhaps that is how it will stay. But might we, for instance, see the removal of transfer pricing and thin capitalisation rules between EU countries?'

The OECD debate

And what of the OECD's role, unable as it is to dictate individual government policy on transfer pricing or anything else? As Patrick Ellingsworth, head of tax at Shell, says: 'There's an increasing trend for even the largest jurisdictions, led of course by the US, to deviate from the OECD's guidelines on transfer pricing.'

'The OECD has got a way to go on two counts,' Lewis says. 'First, the concepts are imprecise and subjective in many ways. Even two like-minded people, using the same principles, can come up with different results. And second, they are guidelines – they don't dictate how jurisdictions should handle transfer pricing.'

'The OECD is fundamentally a forum for representatives of tax authorities, whereas the JTPF has a balance between the tax authorities and business. It makes a difference,' Fris says.

Greg Ballentine, name partner of Ballentine Barbera Group in Washington, DC, is stronger in his criticism. 'I do not think of the OECD as being an active participant in transfer pricing issues today, much less in the future,' he says. 'The guideline-writing role of the OECD cannot really deal with the difficult and very fact-specific circumstances of individual companies' transfer pricing issues.'

Most tax advisers, however, agree that the OECD does have its uses. Deloris Wright, managing principal at US boutique the Analysis Group in Lakewood, Colorado, says: 'The OECD is by and large doing a very good job of trying to look at these issues globally. Anyone could stand on the sidelines and say: they could've done this, or they should've done that. But that's what we in this country call "armchair quarterbacking".'

Could *Tax Business* persuade Wright herself to indulge in a little 'armchair quarterbacking'? 'The overriding concern in transfer pricing globally is education. If the OECD were to foster greater education for governments coming to terms with transfer pricing issues for the first time, I think they'd be doing a great service to all companies, all over the world,' she remarks.

'In countries that are developing transfer pricing systems, you tend to see governments that think that anything they don't understand must be criminal, when in reality it may be anything but,' she adds.

Green agrees: 'Much of the disagreement between OECD members arises more from their differing application of transfer pricing principles, rather than disagreements as to the principles themselves. This often reflects differing levels of experience dealing with the realities of transfer pricing analysis. The OECD could perhaps help here by promoting a wider understanding of how transfer pricing analysis works in practice.'

'I think in a decade to 20 years, when there's more experience of dealing with transfer pricing, the OECD could tighten up its guidelines to incorporate the conventions that individual governments are now beginning to set,' Wrappe says. 'These are being set independently of the OECD. But I think what falls to the OECD is to sort these out and to include the rules in their guidelines some time in the future.'

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>
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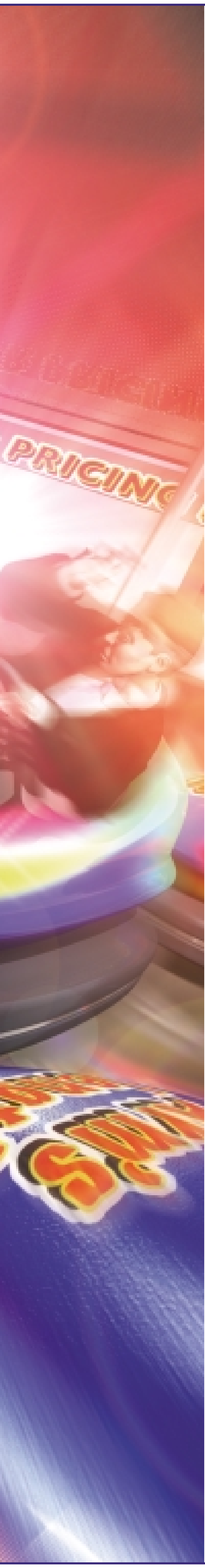
So is there nothing the OECD can be doing now? 'Certainly, the OECD can be doing things now,' Wrappe replies. 'The US is advancing the development of the detail within the industry, but the OECD should wade in to distill the principles and guide any disputes between countries.' Ellingsworth says that one way the OECD



> 'In the long term, the arm's-length principle cannot be used. It's not appropriate for big corporate groups.' Alexander Voegele, Voegele Partner

could continue to contribute would be in promoting 'mandatory arbitration, where a company in a cross-border transaction would pay one tax rather than two, as decided by an independent arbitrator. This seems to be quite effective for commercial matters, under the arbitration of the International Chamber of Commerce.'

'If not us, who would be at the centre of the consensus on transfer pricing and how would they achieve that?' says Jeffrey Owens, director of the OECD's Centre for Tax Policy and Administration in Paris. 'We are constantly adapting to the demands of a changing business environment; we are extending our guidelines into new areas, including recently the financial services area; and we have a well-established process for monitoring the application of our guidelines.'

Owens points out that, in July, the OECD drafted a document on the transfer pricing of stock options, while a month earlier it started looking at ways of improving dispute resolution, including arbitration.

Arm's strength?

One problem with the OECD's guidelines are their reliance on the 'arm's-length' standard for pricing services between related companies. The standard varies from country to country, even between OECD members.

The US uses the comparable profit method as prescribed in section 482 of its Tax Code, while the UK uses the transaction-led margin method, which is slightly different in the way it compares companies under audit with a multitude of unrelated, third-party companies. Worse, the standard is not used in all countries deploying transfer pricing rules – and some tax advisers go so far as to say that, in the longer term, arm's-length will have to be abandoned as the basis for any kind of global regulations.

'There are two things you've got to ask when dealing with transfer pricing for a particular jurisdiction. First, do they use the arm's-length standard and then, if the answer is yes, what is their interpretation of that standard?' Wright says.

'Certain former eastern European countries are not fully using the arm's-length principles. Also, Canada is very idiosyncratic as to what the arm's-length standard should be, and Brazil has a very unique view as to how it should be applied.'

'The arm's-length standard is imprecise,' Lewis says. 'Ask two unrelated parties to price something, and you're always going to get different amounts. And it's difficult to get evidence of an arm's-length value, so determining it is left to indirect methods.'

Voegele says: 'In the long term, the arm's-length principle clearly cannot be used. It's not appropriate for big corporate groups with 1,000 establishments and more, all doing business with one another. Also, it calculates a company's ordinary, non-consolidated profits, whereas companies work on the basis of consolidated profits. The arm's-length principle immediately distorts reality.'

So what could replace it? 'Nothing at the moment: the arm's-length principle is in all the tax treaties,' Voegele replies. 'The principle has no future in the long run, but for the next five to ten years I don't think it will be replaced. It might be interpreted differently from now, though.'

But in the long run? 'A profit-split methodology that splits the profits of a multinational company' is Voegele's recommendation. 'Some people think this approach would be easier than the arm's-length method. That's not true – but the results would be more appropriate.'

The solution that Voegele is touting is known as formulaic apportionment (FA): a single formula, or set of formulae, for determining a transfer price via a set of specific criteria. Individual states in the US use such a method for determining third-party prices. But most tax advisers perceive FA to be flawed, even within a system with a common tax code.

Daniel Frisch, name partner at Horst Frisch, says his clients 'generally find it easy to avoid FA or to minimise its effects when they want to do aggressive transfer pricing to reduce their income tax'. Without the common basis enjoyed in the US, it is simply not feasible, most argue.

'To apply formulaic apportionment, you would need to put in place a number of apparatus first,' Fris of Nera says. 'You can't apply it without a shared institutional starting point. As long as you don't have that, formulaic apportionment is an illusion.'

'Proponents generally claim formulaic apportionment would end transfer pricing disputes, so it is interesting to watch US states battle transfer pricing arrangements that taxpayers are using to avoid state taxes on income from intangibles,' says Valerie Amerkhail of Economic Consulting Services in Washington, DC. 'I'm inclined to consider the EU the most feasible test of formulaic apportionment in an international setting, because at least it has some institutional arrangements to promote consistent application across countries.'

'If, for example, the standard is the reduction in disputes and uncertainty, a rigid formulaic apportionment rule could be appropriate,' Ballentine says. 'If, however, some consistency with the arm's-length standard is desirable, formulaic apportionment is not appropriate. Among the toughest issues in transfer pricing is the relative values of different intangible assets. All of the formulaic apportionment rules I am aware of simply ignore intangible assets.'

If formulaic apportionment is not workable, what is a feasible alternative to the arm's-length principle? Tax advisers around the world report an increase in the number of their clients seeking advance pricing agreements (APAs) with their tax authorities – predetermining a third-party price so that the revenue cannot subsequently impose an arm's-length value the company does not agree with.

Airbus has recently concluded APAs with France, the UK, Germany and Italy, via a group of tax advisers. An informal poll revealed that tax professionals consider the revenues of Australia, Mexico, the US, the Netherlands and the UK (in that order) to be the most amenable to APAs, with France, Germany, Japan and Switzerland, in no particular order, making up a second division.

High stakes

The problems that the OECD and others are trying to solve with regard to transfer pricing are acute. As Wrappe of Deloitte says: 'Transfer pricing is the tax issue with by far the largest amounts of money involved. A slight difference of opinion in the grey areas can produce an extremely different result.'

Tax advisers say that transfer pricing is of particular concern in the case of intangibles, such as intellectual property, where values are more notional. In terms of tangible assets, the industries that pay the most attention to transfer pricing are: pharmaceuticals (which Wrappe describes as having 'a lot of in-house capability'); automotive; and capital markets, particularly derivatives.

Asia has unique transfer pricing problems to contend with – particularly because of the region's higher incidence of family owned corporate groups. Hong Kong, for example, has no transfer pricing regulations in its tax law at all, nor does it adhere to the OECD's guidelines. 'Hong Kong is a place where profits tend to be directed, given our generally lower tax rate than elsewhere,' explains Charles Kinsley, a partner at KPMG's office in the territory.

Mainland China, however, does have its own transfer pricing regulations. Does this cause problems, given the predominance in many parts of the country of so-called 'red chip' corporations – companies owned and listed in Hong Kong but with their assets and operations on the mainland?

Ballentine: OECD has a limited role to play

'Certainly, Hong Kong billionaire Lee Ka Shing's Hutchison Whampoa and Cheung Kong groups will co-ordinate their assets to ensure that as much of their profits as possible are taxable in Hong Kong rather than the mainland – or in the case of Hong Kong assets, to siphon them off to, say, the British Virgin Islands, in order to minimise tax,' Kinsley explains. 'But Hong Kong has laws that tackle the shifting of assets if it's thought to be excessive. But these are not transfer pricing rules – they're part of our general tax law,' he adds.

Only in the last year, with a domestic law change, have Japan's transfer pricing rules come into line with US norms (in the absence of an international standard, despite the unifying force of the OECD guidelines, the US is the yardstick used by most specialists). Tokyo ➤

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> Daniel Rybnik, Enterpricing

previously did not use the US's comparable profits method, for example. 'Japan has the same principles now – how they apply those principles remains to be seen. But it's a favourable development. At least we're reading off the same page now,' says Lewis of Caplin & Drysdale in the States.

The situation in Latin and South America is, if anything, worse than it is in Asia. The variance in standards is marked compared to Europe or North America, with countries that follow the OECD standards to a major extent (for example Argentina, Colombia, Mexico, Peru and Venezuala); those with only limited transfer pricing rules, or none at all (including Bolivia, Chile, Paraguay and Uruguay); and one that uses a formulaic apportionment system (Brazil). 'The single tax base that is being talked about in Europe is a total utopia in Latin America,' says Daniel Rybnik, founding partner of Enterpricing in Buenos Aires, Argentina. 'Multinationals face no co-operation whatsoever between countries in the region. Tax treaties among Latin American countries are very limited. Some countries in the region are even blacklisted by other Latin American countries!

'So all transactions need to prove they are arm's-length, even if they are between parties that are totally independent. For these reasons, transfer pricing compliance costs in Latin America are among the highest in the world. Burdensome returns and reports need to be filed once or even twice a year in countries like Argentina.'

Green of Transfer Pricing Solutions sums up the problems faced by companies in developing regions. 'The likes of China, India and Brazil are catching on quickly to the importance of transfer pricing, but do not necessarily feel themselves bound by OECD norms. Their idiosyncratic approaches sometimes seem to demand one-off solutions, but this can set very unhelpful precedents for other countries,' he says.

Transfer pricing's global problems are also immediate, as fiscal authorities are increasingly on the prowl for a greater share of related companies' taxes. At US boutique Ceteris, most of Michael Heimert's clients are US multinationals.

'As long as a transaction has got the appropriate economic substance, you should be good – you should have a very defensible position,' Heimert says.

But he acknowledges that, for many companies, transfer pricing is a tax dodge, pure and simple. 'Companies that just set up a nameplate in, say, the Bahamas that has no real substance – the whole value of that company may be the tax advantages the parent derives by applying transfer pricing techniques,' he says. 'In my opinion, those companies that don't exist in reality shouldn't exist legally. And if the revenues were doing their jobs, they should be able to shut them down.'

All of these problems and controversies are inevitably creating many jobs for tax professionals – and it is a sector that is likely to be in the ascendant for some time. Transfer pricing has become a cottage industry populated by lawyers, accountants and economists.

As Wrappe says: 'Unlike other international tax issues, the transfer pricing industry is very operational in character. It requires the interpretation of business operations not required in more technical tax issues.' It is also one tax specialism where boutique firms can make more of the running. Most of that running now is towards creating a global standard – led, for all its faults, by the OECD. It will be interesting to see how far things have come in ten years.