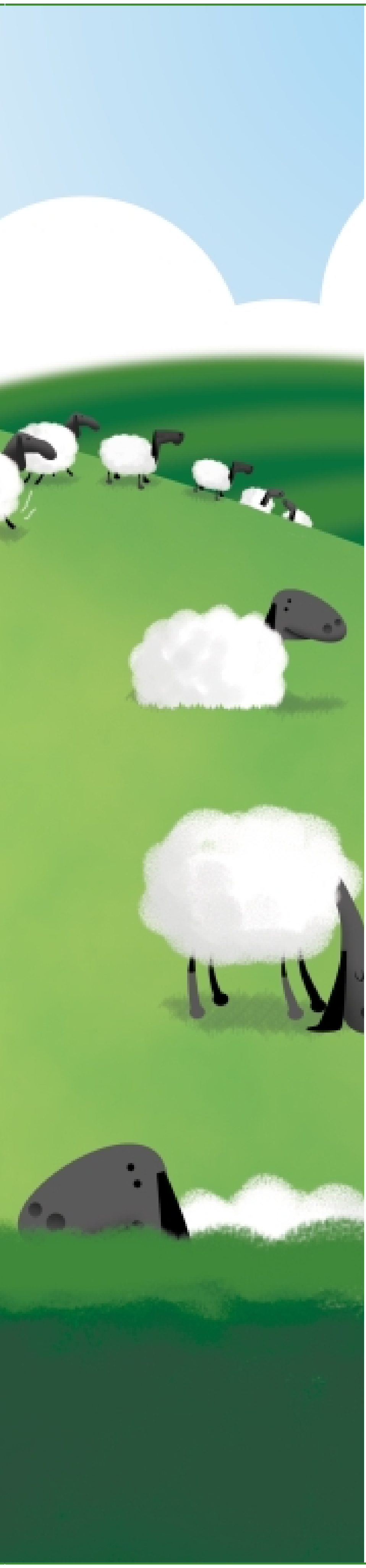

Illustration **Bill Ledger**

Go your own way

As more countries jump on the transfer pricing bandwagon, the OECD is increasingly unable to herd them in the direction it wants. The resulting confusion is hampering multinationals' efforts to find consistency, reports **Paul Armstrong**

AS PART OF THEIR NEVER-ENDING DRIVE FOR more revenues, governments are paying increasing attention to companies' transfer pricing arrangements. There is audit pressure on the corporate sector like never before. 'The bar has been raised – the authorities are holding taxpayers' feet to the fire with some vigour,' says Jill Weise, vice-president at transfer pricing specialist CRA International in Boston. Hendrik Blankenstein, head of the Zurich practice of Transfer Pricing Associates, lists the reasons for the increasing focus on transfer pricing as: 'Global brand and marketing strategies, centralised research and development, supply-chain initiatives, global information solutions, regional and global sourcing, centralised procurement, regional management, shared services centres, regional distribution and centralised cash management.'

In the US, every audit now begins with a question about transfer pricing – companies have to either submit any transfer pricing studies they have commissioned for the purposes of penalty protection, or provide information on all of their cross-border transactions. As Patricia Lewis, a partner at Caplin & Drysdale in Washington, DC, says: 'This creates a lot of fodder for the IRS.'

Green: clients should 'find a fig leaf'

Gibert: JTPF has advantages over the OECD

The biggest challenge for companies is 'learning to deal with numerous transfer pricing examinations going on simultaneously, all at different stages of development, and being carried out according to different national rules,' says Bill Dodge, Deloitte's global transfer pricing chief. 'It's a puzzle.' The puzzle is vexing all companies with cross-border businesses, but multinationals, and in particular financial institutions, are the worst affected. 'Financial institutions are at the sharp end of transfer pricing for the reason that they tend to have highly integrated global transactions,' says Gareth Green, director of Transfer Pricing Solutions in the UK. 'For example, a portfolio of investments that might be managed in London for eight hours, then New York for the next eight hours, and Tokyo for the eight hours after that. It's less easy to say what gets done where.'

Weise explains that revenue authorities are cracking down on banks because 'traditionally the authorities did not have the ability to analyse their incredibly sophisticated transactions, as they were so very specialised'. And, of course, she says, 'they tend to be very large dollar amount transactions', so the potential gains for treasury coffers are larger than for most industry sectors.

TP rules, OK?

While the world's developed economies are targeting transfer pricing arrangements, they are also busy reforming their rules. In the minds of corporates, they are moving the goalposts – often further away from OECD global norms. Witness the US's cost-sharing rules, announced in August and expected to pass into law at the end of the year. The government proposes changing cost-sharing (the contribution to a company's profit allocation of pre-existing or part-developed intangibles) from being a tax-saving scheme marketed to companies, to a tax-neutral arrangement, which is simply a different way of administering the allocation of IP profits. Lewis says the proposals were prepared in a 'very complex fashion – the regulations are 60 pages of tiny type'. She adds wryly: 'It's going to cause a lot of discussion.'

The new rules will almost certainly make it more difficult for corporations to transfer IP value offshore. Certain sectors such as the high-tech industry may be more adversely affected than others. And the rules may create additional exposure for companies that have existing sharing arrangements in place. Lewis does not think the new rules would necessarily drive the US's transfer pricing system further away from OECD conventions. 'The OECD norms permit cost-sharing and permit by-ins, they just don't have much detail,' she says. But she agrees that, at the very least, they are muddying already opaque waters.

Transfer pricing specialists say the same is true for the US Senate Finance Committee's investigation into the advance-pricing agreement (APA) process, which has been running since December 2003. Alex Zakupowsky of Miller & Chevalier in Washington, DC expects the IRS, as a result of the investigation, to start dealing with companies along industry lines in transfer pricing enquiries. The IRS recently aligned its APA staff into industry groups, which Zakupowsky says is a precursor of this. He is wary of this development: 'When this happens in any large bureaucracy, subtleties necessarily fall aside – and the IRS will be no different.'

The Committee was due to publish its report at the end of July. This did not happen. The leaking of a draft report at the beginning of July – 'quite rough, a lot of internal questions, quite incomplete,' according to Lewis – did little to restore corporate confidence. Canada, meanwhile, suspended its APA programme in September, creating havoc in transfer pricing. Rule changes are also affecting companies in the UK. Tax managers are fretting over their December tax declarations, which is the first time they will have to apply transfer pricing rules to domestic, as well as cross-border, transactions – the legacy of a European Court of Justice case concerning a German taxpayer in 2003. 'Companies are taking a wait-and-see approach; they can't quite believe they've got to expend so much effort and expense applying the rules when in 80% to 90% of cases there's no tax at stake,' Green says. 'We've got the bizarre situation that no one really wants to do it.' Describing the new rule as 'an annoying technicality', Green says he is recommending to his clients that they 'find a fig leaf: do the absolute minimum so they can claim with a straight face that they're compliant. Then the tax inspector can tick the box with a straight face, and move onto something that actually interests them.'

Transfer pricing rule changes are endemic across the EU, too, with Jeremy Pearson of pfTP describing their spread as 'a rash'. 'Managing new local documentation requirements in countries such as Germany, where they were previously minimal, has proved to be burdensome for many companies, as has getting to grips with new thin capitalisation rules,' he says. Steve Hasson, head of transfer pricing at PricewaterhouseCoopers in the UK, favours a 'a more standardised approach' across the EU. 'Regulations and guidance on transfer pricing and documentation differ considerably across the EU, increasing the administrative as well as the tax burden on businesses,' he says.

> ‘The bar has been raised – the authorities are holding taxpayers’ feet to the fire with some vigour.’
>
> Jill Weise, CRA International

Kert rustle

Simultaneously with individual governments making unilateral rule changes – taking their transfer pricing systems ever further from global norms – the OECD is continually trying to impose some consistency from the centre. But the OECD’s latest initiative, which tries to resolve apparent contradictions in the business profits article (BPA) of double taxation treaties, is fatally flawed, experts say.

The OECD proposes introducing the concept of the Key Entrepreneurial Risk Taker (Kert) to help multinationals apportion profits to permanent establishments, based on the idea that the centre where decisions are taken should have a higher profit weighting than other business units.

Yet, Green says, ‘multinationals are going to get more than they bargained for’ under the new rules, published in draft form in August 2004. Their implementation may be wider than first thought, he says, ‘influencing not just the calculation of branch profits, but transfer pricing more generally’ and affecting not just financial institutions, as originally intended. Green even believes that Kert could be contrary to the arm’s-length principle – one of transfer pricing’s basic tenets. (See box, page 48) ‘Perhaps this interpretation is not what the OECD intends,’ Green says. ‘But it is certainly what tax authorities will argue if the significance of the Kert concept is not clarified or revised.’

Caroline Silberztein, the Paris-based head of the OECD’s transfer pricing unit, admits that her organisation continues to discuss Kert, ‘in particular, further to comments received from the business community on the need to clarify its intended meaning and application’.

However, Weston Anson, chairman of California IP consultancy Consor, suggests that Kert’s shortcomings could be more fundamental than mere problems of comprehension. ‘Kert is a good effort, but it’s going to be awfully difficult to implement and it’s going to contradict the transfer pricing laws of certainly the US and the UK, and probably Germany,’ he says. ‘So, yes, it can be useful but, no, it shouldn’t be universal – calculations need to be made on a case-by-case basis.’

Many believe it is the failure of the OECD to centralise transfer pricing policy that is forcing individual countries, and groups of countries like the EU’s Joint Transfer Pricing Forum (JTPF), to take unilateral action. This, they say, detracts further from global consistency. Silberztein considers this view ‘interesting’. She explains that, as ‘the JTPF has a clear mandate to “work towards a more uniform application of transfer pricing tax rules in the EU”, its work should be “consistent with the OECD [Transfer Pricing] Guidelines” and “should not hamper more global solutions within the OECD framework”.’

The JTPF is making impressive progress, revamping the EU’s transfer pricing Arbitration Convention and its ‘master file’ documentation model. Praise for the JTPF is largely unstinting among transfer pricing experts. Dodge of Deloitte says the forum is ‘really to be commended’, while Angel Calleja, a partner at Garrigues in Madrid, says it has the advantage of working towards ‘realistic targets’.

Yet advisers say that many companies are too bogged down with this year’s transfer pricing audits to worry about policy in the future. Dick de Boer of LECJ in the Netherlands says: ‘The tax directors I talk to couldn’t care less about all these initiatives. They need to deal with transfer pricing now, as part of their annual compliance, and they’re not bothered about all the talks that take place ➤

at EU level.' Dodge holds a different view: that any debate is good. 'If you've got a healthy dialogue it may look a little chaotic in the midst of the dialogue, but you see a point in the future when you start to get a convergence,' he says. 'If you've got different views along the way, you get a better answer.'

Meanwhile, the JTPF's chairman, Bruno Gibert –also a partner at CMS Bureau Francis Lefebvre in Paris – says the global impact of the forum is positive. He argues that it is promulgating transfer pricing conventions that could, in time, be followed by the rest of the world. The forum has advantages over the OECD, he argues, such as its smaller size and what he says is the greater involvement of business.

Silberztein vigorously defends her organisation: 'The JTPF has 25 member countries, plus ten business representatives. The OECD has 30 member countries, so it is not bigger in terms of the number of delegates attending our meetings and working together towards consensus. I can't see how the fact that the JTPF does not include big players such as the US, Canada, Mexico, Japan, Australia, Korea and so on could be seen as an advantage in the world of transfer pricing.'

Going global

With the established players ruining any global consistency transfer pricing may have had, the last thing the world needs is for often ill-equipped developing countries to get in on the act, many experts say. Yet transfer pricing is sweeping across the developing world like wildfire.

China signalled its entry into the fray in August, signing its first transfer pricing APA with Japan. India also recently introduced transfer pricing laws, and has been very active: according to the country's Income Tax Department, it issued additional tax demands on international companies of more than 400m rupees ($9.13m) in the first full year of the new legislation. In Latin America, Chile, Colombia and Ecuador all introduced transfer pricing systems in the past year, largely based on OECD guidelines. The biggest problem in that part of the world is with those countries that have had their regimes for longer. Brazil is the worst offender, taking an un-OECD-like approach, with fixed margins rather than the arm's-length principle. Because of this, Brazilian courts are bogged down with litigation involving multinational pharmaceutical companies.

Argentina – which takes what EnterPricing chief Daniel Rybnik calls a 'fisc-always-wins approach' to pricing – is also riddled with transfer pricing disputes. Agricultural multinationals Cargill, Louis Dreyfuss and AMD all have cases progressing through the courts there.

Transfer pricing is even coming to Africa. Namibia (which implemented its rules this year) and South Africa (which has had rules in place since 1995) are the only jurisdictions on the continent to have transfer pricing regimes so far. Yet the Southern African Development Community (SADC) is implementing transfer pricing rules as part of its wider programme of tax semi-harmonisation (see news, p9).

Ironically, although none of the SADC members is part of the OECD, their shared system is expected to follow the OECD guidelines more rigidly than those in most developed countries. As the OECD changes its conventions, the SADC will reform its system accordingly.

Michael Honiball, a partner at KPMG in Johannesburg, expects other African jurisdictions to follow the SADC's lead. Botswana is likely to be the next to introduce transfer pricing laws, he says, followed by Mauritius. Then the former British colonies in east Africa: Uganda, Tanzania and Rwanda. Mozambique will lag behind, he predicts, while Nigeria cannot be expected to adhere to transfer pricing rules 'when it doesn't even honour its own tax treaties'. He says that, when they come, transfer pricing rules in developing countries 'will give multinationals some relative certainty'. Calleja adds: 'They send a very important message to multinationals: that we're exactly the same as other jurisdictions you do business in. They give a certain legal certainty to investors.'

The spread of transfer pricing also means African countries will no longer be reduced to 'using their general anti-avoidance legislation to try and coerce multinationals into paying a bit more tax', Honiball says. Or, as Deloitte's Marike Grove puts it: 'Implementing legislation with a transfer pricing smell.'

Yet in Africa and across the developing world, experts believe that most of these countries will be unable, or unwilling, to properly invest in their new transfer pricing regimes. This will lead, they say, to patchy implementation – and more inconsistency for multinationals to deal with.

'If you look at developed countries, the main transfer pricing problem is the pricing of intangibles,' Rybnik says. 'This requires a thorough understanding of the market and the industry. Authorities in developing countries don't want to do that – they want a more straightforward approach. They're not willing to get into legal arguments about pricing adjustments, and so on.' The result? 'A lot of uncertainty, because you don't know the tax authorities' next step – they can challenge everything.'

Luís Eduardo Schoueri, name partner at Lacaz Martins, Halembeck, Pereira Neto, Gurevich & Schoueri Advogados in Sao Paulo, believes: 'Our revenue service is not prepared for very sophisticated questions. I can't say how many transfer pricing experts the Brazilian authorities have in Sao Paulo, but I don't think it's as many as 20. So they'll have to apply pragmatic rules – they can't discuss margins on a case-by-case basis.' Jens Brodbeck, director of Sonnenberg Hoffmann Galombik in Cape Town, doubts the Namibian government will have the resources to make its transfer pricing system work properly. 'I think they'll maybe identify three, four or five companies, maybe with the assistance of South Africa, and will go after those,' he says. 'But I don't think they have the resources to go any further.' There is also a problem with training. As Dodge of Deloitte says: 'It takes a number of years to make a transfer pricing professional and there's no substitute for those years. It's like the old guilds – how else do you become a cooper?'

'But that's what the authorities in these countries don't understand: to make it work there will be major start-up costs in hiring well-qualified economists,' Honnibal says. Weise of CRA is more sympathetic to the developing nations' cause. 'If you go back a few years, Western countries weren't taking full advantage of what the rules had to offer,' she says. 'For example, the assessment of penalties is certainly a new phenomenon in the West, though the rules had provision for it then.'

Weise: governments are more aggressive

Silberztein: OECD asked to clarify Kert rules

In good company

Caplin & Drysdale's Lewis says that the move away from consistency in transfer pricing regimes is leading corporates to 'document their transfer pricing more comprehensively than before – in the past they tended just to focus on their major cross-border flows'. She continues: 'It is also leading the corporates to push for a lot more global uniformity in their systems. Companies will find ways to avoid being overwhelmed by the many requirements for transfer pricing documentation and analysis from various countries. It's going to become a matter of survival.'

Hubertus Baumhoff, a partner at Flick Gocke Schaumberg in Bonn, agrees: 'These days, intra-group transfer pricing guidelines are essential for large ➤

'In 80% to 90% of cases there's no tax at stake. We've got the bizarre situation that no one really wants to do it.'

Gareth Green, Transfer Pricing Solutions international companies. On the one hand, they ensure that a group implements a standard transfer pricing policy. On the other, they reduce the work generated in documenting transfer prices within the group.'

Dodge says: 'My advice to clients is: you need to recognise from day one that this transfer pricing audit is not going to go away. Don't underestimate the time you'll have to devote to it. Put it on a realistic time-line. Determine your range of preferred outcomes. Centralise your global defence team, because some issues should be coming up worldwide. Multinationals are moving towards trying to keep their defence analysis within a team that can then go from country to country as they're needed.'

Greg Ballentine, name partner at transfer pricing consultancy Ballentine Barbera in Washington, DC, says that many of his clients are being less proactive: 'They're taking a wait-and-see approach – and I think they're right to do it.' Ballentine believes the current crackdown on transfer pricing arrangements may only be a repeat of the situation in the US ten years ago when the first documentation requirements were met with a flurry of activity. Subsequent to that, though, audit activity dropped off again. He describes how many of his clients are thinking: 'We prepare the blessed documents, turn them over, the IRS ignores them, and we go on as before.'

But with the cost of a single transfer pricing enquiry at anywhere between $50,000 and $1m, most corporates will think they cannot afford such an attitude. Companies may be able to introduce a degree of certainty and consistency to their own transfer pricing systems, but experts agree it will be some time before their efforts are mirrored in the actions of the governments – or their representatives.

THE LENGTH OF A PIECE OF STRING

The perennial debate continues: is the arm's-length principle (AL) the best way of determining pricing for transfer pricing purposes and, if not, what would be the most suitable alternative? Angel Calleja, a partner at Garrigues in Madrid, points out that the main argument in support of AL is the fact that it is entrenched in the minds and methods of transfer pricing practitioners. Companies are used to using it (even if it is not the best fit for their internal processes) and it is anchored in many double taxation treaties, in line with Article 9 of the OECD Model Tax Treaty Convention.

'The AL rule is king and has been for ages,' Calleja says. 'Any time a government or organisation talks about changing it, the OECD insists they continue with the AL rules.' Jeremy Pearson of London transfer pricing boutique pfTP adds: 'A global abandonment of the AL principle is, I feel, highly unlikely in the near future, given the amount of political capital that has been invested over the past few years in getting this far with the implementation of the OECD guidelines.'

Pearson does, however, think that 'further refinements' of AL may be necessary. And Calleja believes that the transfer pricing community 'should grow the wings of other methods and make them fly' – in case AL's many downsides render it impracticable.

One of the big problems with AL is obtaining comparable prices. As Gareth Green, director of Transfer Pricing Solutions in the UK, says: 'Often the only real comparisons are commercially proprietorial transactions, which competing companies will do their utmost not to disclose. So, often a company will simply use its own transactions with third parties, or a database of the financial results of third-party companies, which are sold commercially.' Bob Turner, a partner at Ernst & Young in Toronto, says that the US and Canada, for example, have 'fundamental differences as to their approach' towards AL pricing: Canada takes a very structured, transactional approach, he points out, while the US adheres to a bottom line results approach. 'This has led to different results in apparently similar cases,' he says.

Perhaps the most popular alternative to the AL principle would be what is known as formulaic apportionment (FA). This would involve a single formula or set of formulae for determining a price via a set of specific criteria – enter the necessary values into the equation, and you get a straightforward answer. Only, in practice, the answer may not be as straightforward as the FA theory makes it sound. Intangibles, after all, remain intangible, no matter which method is used to price them, and this leaves room for inconsistency. Deloitte's global transfer pricing chief, Bill Dodge, says: 'FA's not going to be simple. It might not be effective, and it has its own host of issues.'

Others say that a transactional net margin method might work, or perhaps a unitary system, which would depend on various economic variables to set prices. 'I'm not positive that we can put this into practice yet – the economy is not globalised enough,' Calleja says. Yet he concedes that it may be possible in the EU in the not-too-distant future given the European Commission's work towards a consolidated tax base.

Flick Gocke Schaumburg partner Hubertus Baumhoff believes that AL could be replaced with a pricing method more in line with the practices of modern multinationals. 'Profit-oriented methods are becoming more and more important in strongly integrated large multinational companies,' he says. 'Current decisions handed down by the German courts and regulations by the tax authorities have also tended to move more away from the classical AL principle.'

But, for the moment, AL is here to stay. As Dodge says, it 'has proven to be rigorous over a number of decades, during which people predicted its imminent demise'.