The impact of transfer pricing in corporate tax planning

Presentation by

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THE MEANING OF LIFE
TAX AVOIDANCE ADVICE

Tax quote

"Secrecy, complex organizational structures, tax havens and profit hungry accountancy firms are the key ingredients of the tax avoidance industry. They all come together in the biggest tax avoidance scheme of all known as "transfer pricing". The name of the game is to shift profits to low tax jurisdictions and avoid taxes in countries where corporations have substantial trading operations" (Prem Sikka: Shifting Profit across border- 2009)

SCOPE OF PRESENTATION

- Meaning of transfer pricing
- Drivers of transfer pricing schemes
- How MNC's exploits transfer pricing for tax planning
- Impact of BEPS on transfer mis-pricing schemes

Meaning of transfer pricing

- A transfer price is a price adopted for book keeping purposes which is used to value transactions between affiliated enterprises integrated under the same management at artificially high or low levels in order to effect unspecified income payment or capital transfer between those enterprises *(OECD Glossary of statistical terms)*
- *price- consideration- payment in kind- offsets – foregone rights- future obligations etc*

Drivers of transfer (mis)-pricing

1) Increase in tax rates and multiple taxation

- welfare state argument

- Cases of double taxation (absence of DTA, Failed MAP)

- China Case: low taxes and other incentives.

70% of MNE's making losses?

Drivers of transfer (mis)-pricing

2) Globalization

- Integration of national economies and markets
- Free movement of capital especially IP
- Shift of mfg bases from high cost to low cost locations (case of china and Vietnam)
- Removal of trade barriers, technological and communication developments (Google case European sales done from Ireland)
- Relaxation of forex controls – repatriation of cash

Drivers of transfer (mis)-pricing

3) Existence of different tax rules in different countries- creates gaps and frictions

- Gap – double non taxation (Apple case)
  - U.S – residence, Ireland - mgt
- Friction – double taxation
- Consequence: *room for arbitrage by taxpayers*
- *Need to develop clear & predictable international rules*

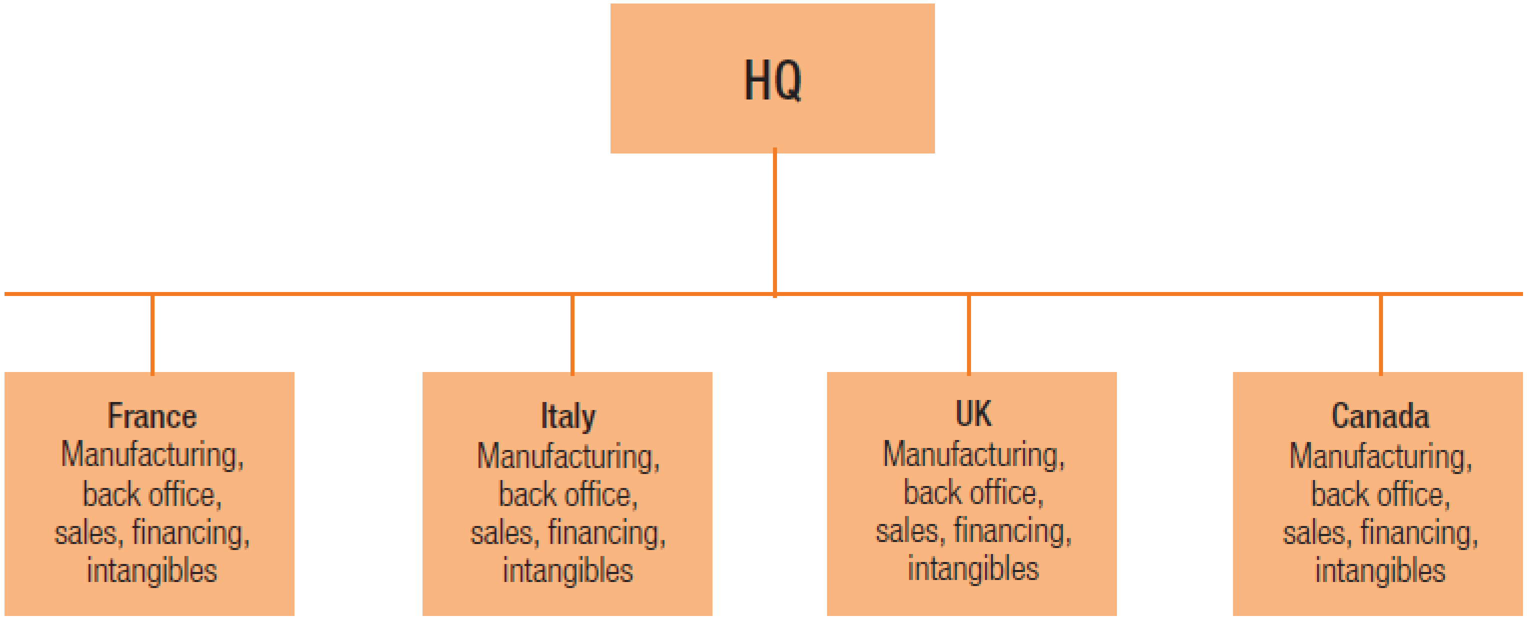
Drivers of transfer (mis)-pricing

4) Shift from country specific operating models to global models

- Matrix managing orgs & integrated supply chains
  - Centralization of functions at regional or global levels
- Increased importance of service component & digital products delivered over internet

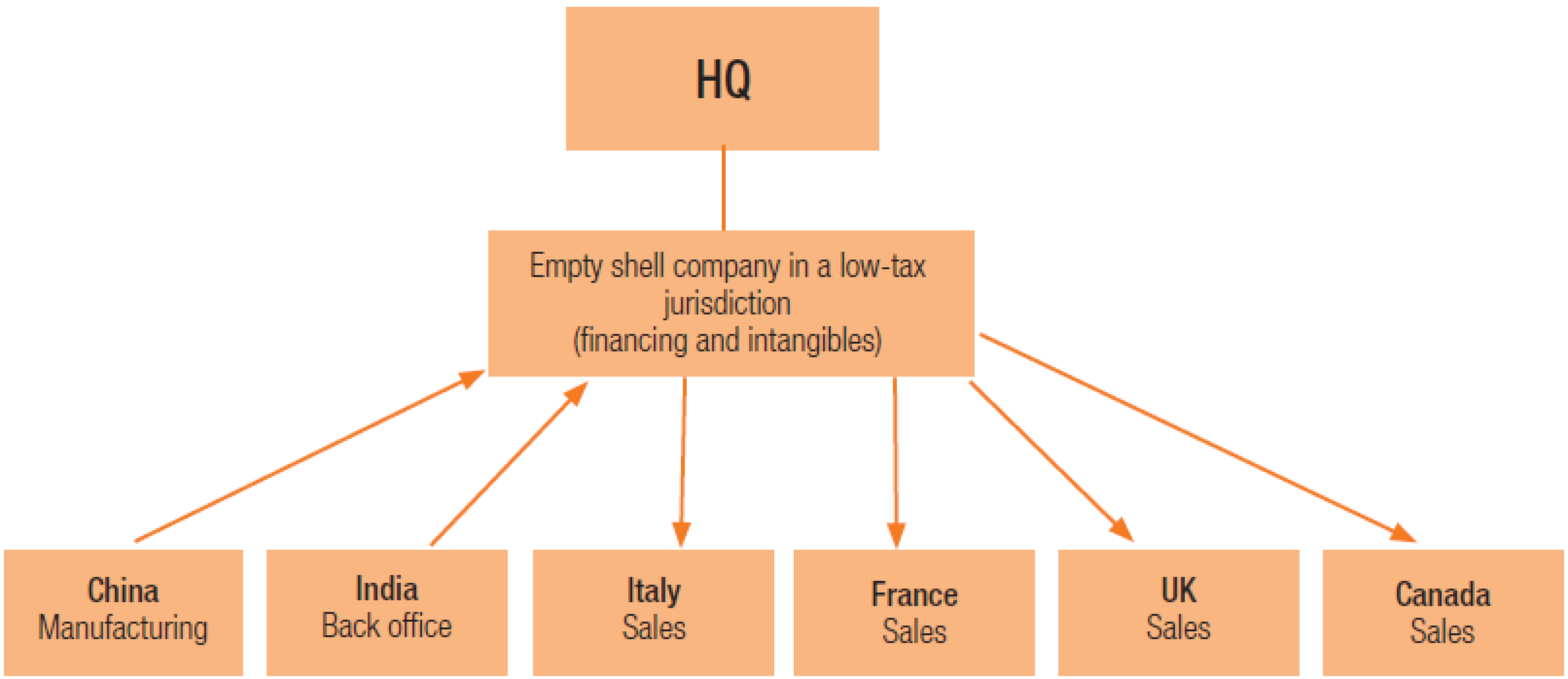
4) Shift from country specific operating models to global models

FIGURE 1: TRADITIONAL STRUCTURE OF A MULTINATIONAL ENTERPRISE



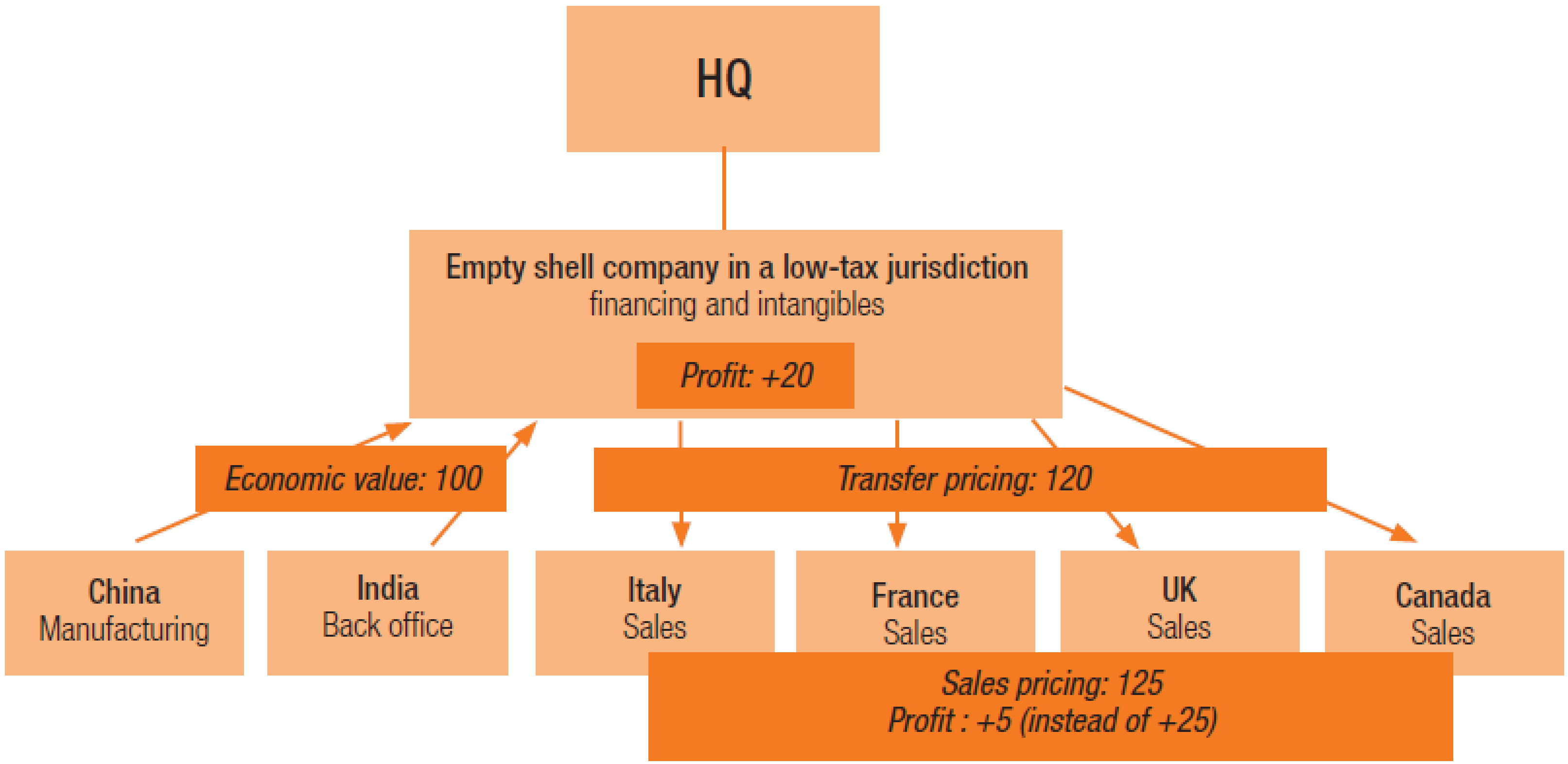
4) Shift from country specific operating models to global models

FIGURE 2: MNE STRUCTURE BASED ON GLOBAL VALUE CHAINS



4) Shift from country specific operating models to global models

FIGURE 3: MANIPULATING TRANSFER PRICING



Drivers of transfer (mis)-pricing

5)Upsurge in multinational / transnational enterprises

- Mergers and takeovers- economies of scale
- Diminishing comparables- MNC dominated markets
- Divisionalization, joint ventures, subsidiaries and affiliates necessitates *estimations of costs* to measure performance and *taxable profits*
- Corporations enjoy considerable *discretion* in allocating costs and profits to products/services and geographical jurisdictions

Drivers of transfer (mis)-pricing

5) Upsurge in multinational / transnational enterprises cont..d

Top 500 transnational corporations control 70% of the world wide trade , 30% of the global GDP , 75% of all commodities trade and 80% of the trade in management and technical services

- 6 MNC's hold 70% of wheat trade
- One MNC controlled 98% of the production of packed tea
- 80% of the entire production of world grain is distributed by just two companies *(Prem Sikka and Hugh Willmot, 2010)*

Drivers of transfer (mis)-pricing

6) Transfer Pricing Schemes as a business

- "The sale of potentially abusive and illegal tax shelters is a lucrative business … accounting firms ... have been major participants in the development, mass marketing, and implementation of generic tax products sold to multiple clients" **(*US Senate Permanent Subcommittee on Investigations-2005)***

Drivers of transfer (mis)-pricing

6) Transfer Pricing Schemes as a business

- A former senior PwC employee admitted that the firm's policy was that it would sell a tax avoidance scheme which had only a 25% chance of withstanding a legal challenge ***(UK House of Commons Committee of Public Accounts, (2013).***

- The other three firms admitted to "selling schemes that they consider only to have a 50% chance of being upheld in court" ***(UK House of Commons Committee of Public Accounts, (2013).***

Drivers of transfer (mis)-pricing

6) Transfer Pricing as a business

- PwC is credited with developing Ireland as a tax haven and particularly with refining a scheme which subsequently became known as the Double Irish Dutch Sandwich ***(Bloomberg, Man Making Ireland Tax Avoidance Hub Proves Local Hero, 28 October 2013; http://www.bloomberg.com/news/2013-10-28/man-making-ireland-tax-avoidance-hub-globally-proves-local-hero.html)***

- The UK Supreme Court - Commissioners for *Her Majesty's Revenue and Customs v Pendragon plc and others; [2015] UKSC 37*. *It related to a VAT avoidance scheme designed and marketed by KPMG. The scheme would have enabled car retailing companies to recover VAT input tax paid while avoiding the payment of output tax . The scheme was declared unlawful and abuse of law*

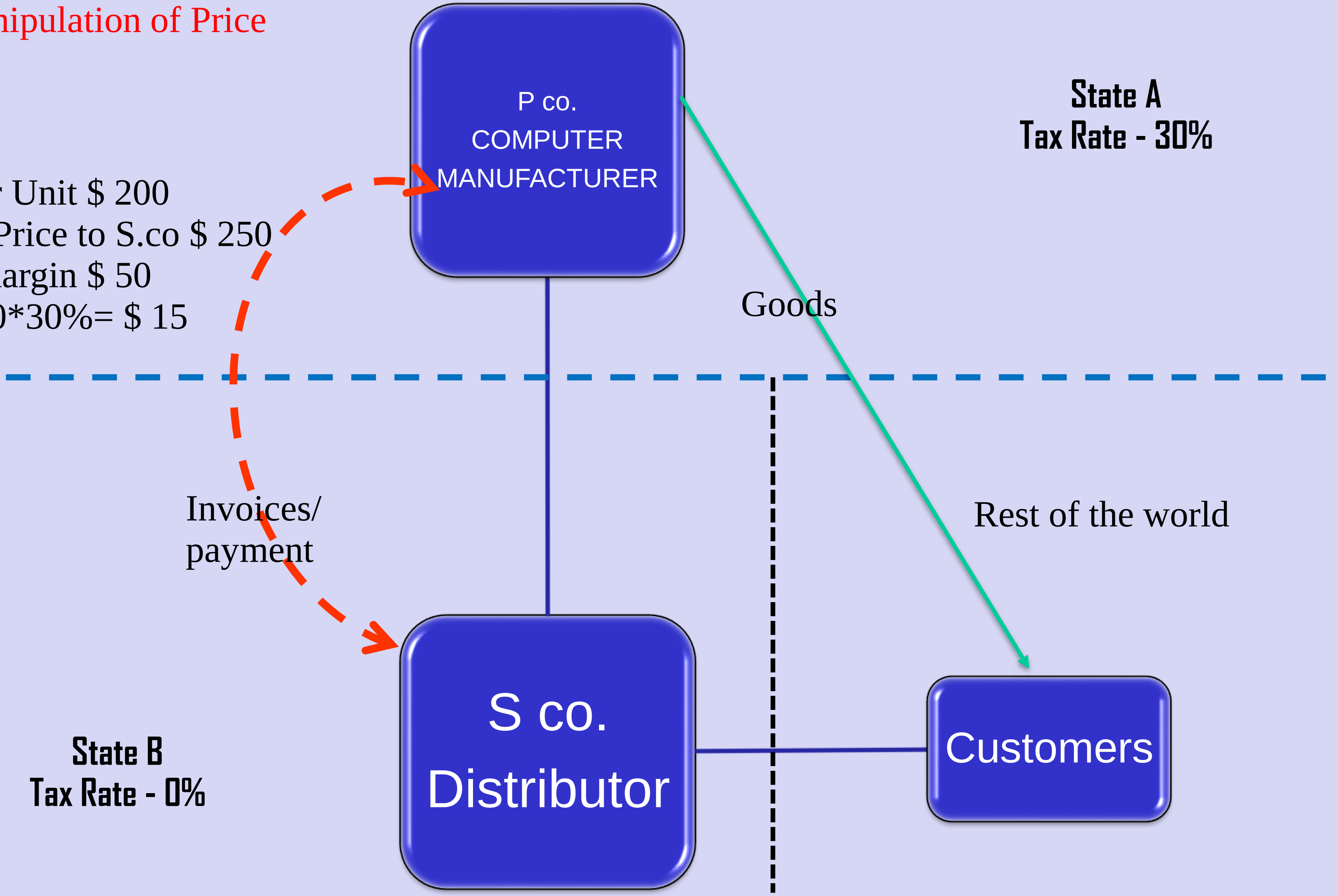
Exploitation of transfer pricing Rules

- MNE's for tax purposes are not viewed as one even where they are owned by the same share holders and are trading together
- *Due to the weaknesses of International tax Rules, profits are easily shifted to low tax jurisdictions through:*
  - *Manipulation of intra group pricing*
  - *manipulation of Arms Length Principle (ALP) in (1)cost contribution arrangements (2) Artificial shifting of Risk*

Exploitation of Transfer Pricing Rules

1) Manipulation of Price

Cost per Unit $ 200
Selling Price to S.co $ 250
Gross margin $ 50
Tax $ 50*30%= $ 15

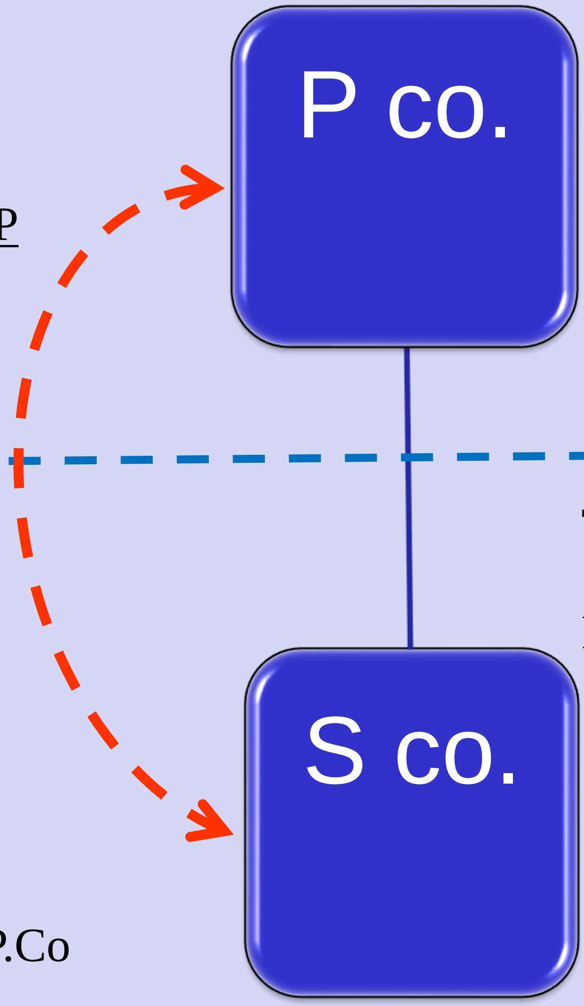


Price $ 500
Gross margin $ 250

Exploitation of Transfer Pricing Rules

2) Manipulation of ALS through CCA

<u>CCA in development of IP</u>
P.Co = 20%
S.Co = 80%



IP exploited by P.co and 3rd party manufacturers

State A
Tax Rate - 30%

Total Income = $100m
S.Co = $ 80m
P.Co = $ 20m

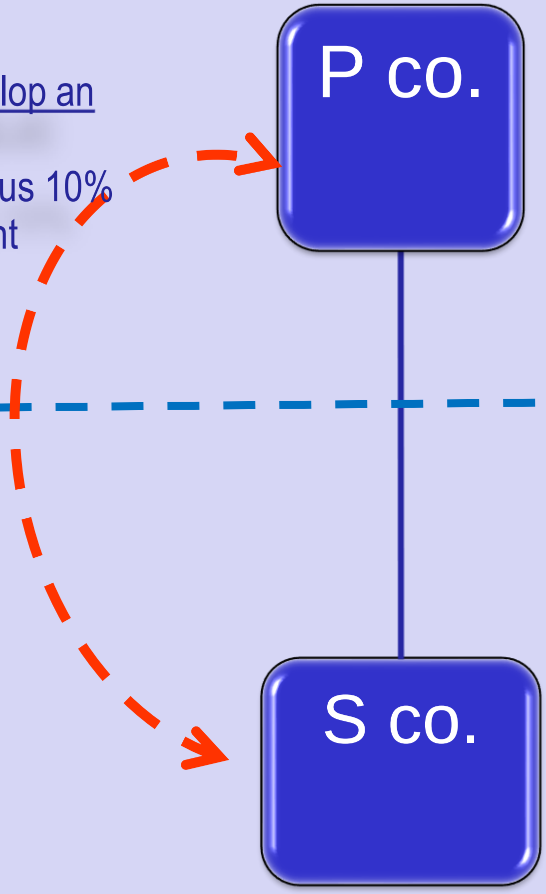
S.Co is 100% owned by P.Co
Financing = Equity
No Employees

State B
Tax Rate - 0%

Exploitation of Transfer Pricing Rules

3) Manipulation of ALS by shifting of Risk

S. Co contracts P. Co to develop an intangible asset
P.Co compensated at cost- plus 10%
S.Co retains risk of investment



IP exploited by P.co and 3rd party manufacturers

State A
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Total Income = $100m
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S. Co has no Employee

State B
Tax Rate - 0%

Amendments to Chapter 1 of OECD TP Guidelines

Action 8, 9 and 10- targeted "cash-boxes"

- Capital-rich entities without any other relevant economic activities
- Seen as primary cause of BEPS
- No "special measures" were prescribed
- All measures are consistent with the ALS
- Cash-boxes are likely to be eliminated

Action 8, 9 &10

Amendment to chapter 1 of OECD TP Guidelines

1) **Delineation of the actual transaction between associated enterprises**

- "written contracts versus conduct" issue
- In identifying the transaction, start with the written contract
- Written contract can be clarified, supplemented or even replaced by the conduct of the parties
- Who won the debate? Conduct!

Action 8, 9 &10

Amendment to chapter 1 of OECD TP Guidelines

2) **Risk should be allocated between the parties, using the same "delineation of the actual transaction" approach**

- Start with the contractual allocation of risk
- Then validate (or change) that contractual allocation, by reference to the conduct of the parties
- Contractual allocation of risk to a party will be respected only if that party:
  - Controls the risk
  - Has the financial capacity to assume the risk

Action 8, 9 &10

Amendment to chapter 1 of OECD TP Guidelines

2) **Risk should be allocated between the parties, using the same "delineation of the actual transaction" approach… (Cont'd)**

- A party will be considered to **"control a risk"** if it satisfies two requirements:

  – The capacity to make decisions to **take on, lay off, or decline a risk-bearing opportunity**, together with the actual performance of that decision-making function

  – The capacity to make decisions on **<u>whether and how</u> to respond to the risks associated with the opportunity**, together with the actual performance of that decision-making function

Action 8, 9 &10

3) **Non-recognition of the accurately delineated transaction**

- Contracts have always been important, they are now more than ever
  - Ambiguous, incomplete or not-followed. Contracts opens door to re-characterization
- Non-recognition is permitted only if the parties are **not acting in a commercially rational manner**
- Re-characterization can occur when
  - The behavior of the parties is inconsistent with the contract
  - Control of financial capacity fails on specific risks

Action 8, 9 &10

4) **location savings and other local market features**

These items are not intangibles -they are comparability factors

- The amendments describe a **4 step analysis** to determine the impact (if any) of these features on the pricing. Consequently, it is necessary to consider:
  - whether location savings exist;
  - the amount of any location savings;
  - the extent to which location savings are either retained by a member or members of the MNE group or are passed on to independent customers or suppliers; and
  - where location savings are not fully passed on to independent customers or suppliers, allocate the savings in the manner in which independent enterprises operating under similar circumstances would allocate any retained net location savings.

Action 8, 9 &10

5) **MNE group synergies**

Incidental benefits from membership of a group (e.g., a supplier offers an entity a discount because the entity is a member of the ABC group)- should not be compensated

- However, benefits which are derived from **deliberate concerted group actions** (e.g., establishment of a centralized procurement company in order to obtain volume discounts from suppliers) **should be shared by the group members according to their contribution to the synergy**. In the procurement example, this would suggest that the centralized procurement company would not be able to keep the benefits, other than a return for its functions

Action 12: Disclosure of aggressive tax planning

- To augment disclosures intended to address domestic tax avoidance e.g. U.K Disclosure of tax Avoidance Schemes Rules (2004)
- Not a minimum standard.
- Allows promoters and users of aggressive tax arrangements to be identified and deterrent measures put in place
- disclosure regimes considered:
  - Transaction based
  - Promoter based
  - Hybrid

Action 12: Disclosure of aggressive tax planning

- Test:
  - whether obtaining a tax advantage is a main benefit of the arrangement
  - A de minimis rule e.g. transaction size/ materiality
- *Domestic tax schemes*: Use main benefit test as a precondition, and de minimis rule attached to specific hallmarks/characteristics
- *International tax schemes*: Use specific hallmark only. May not always be clear in one jurisdiction whether tax advantage has been obtained in another jurisdiction
- Penalties for non-compliance

Re-examine transfer pricing documentation (Action 13)

Objectives:

- **Ensure Consideration of Tp Requirements**
  - Taxpayers must give appropriate consideration to TP requirements in establishing prices
- **Tp Risk Assessment**
  - Provide tax administrations with the information necessary to conduct an informed TP risk assessment.
- **TP AUDIT**
  - Provide tax administrations with useful information to employ in conducting a TP audit. Additional information might be delivered during audit progress.

Re-examine transfer pricing documentation (Action 13)

Proposals:

- A three-tier approach to transfer pricing documentation:

  (1) a master file containing information relevant for all group members;

  (2) a local file referring to material transactions of the local taxpayer;

  (3) a Country-by-Country Report ('CbCR') containing data on the global allocation of income and taxes, and certain other measures of economic activity.

- The first two apply to all multinational groups. The CbCR applies only to groups with a turnover above €750m.

QUESTIONS