

Transfer Pricing Context and Challenges

“Chase was the oil companies’ preferred bank, and it had asked Hudson to study the petroleum industry’s impact on the U.S. balance of payments to provide ammunition that would help the oil companies claim they were “good for America” and help them lobby for special government perks. One of his tasks on this project was to find out where the oil companies made their profits. At the producing end? At the refineries? In the gas stations? David Rockefeller, Chase’s president, arranged for Hudson to meet Jack Bennett, Treasurer of Standard Oil of New Jersey, now part of the ExxonMobil empire.

Bennett gave him his answer. “The profits are made right here in my office,” the oilman said. “Wherever I decide.”

*--from *Treasure Islands*, by Nicholas Shaxson*

1. Context: Transfer pricing is an enormous challenge globally, but the challenge is more acute in developing countries. And the exhaustible nature of mineral resources means that transfer pricing abuse is particularly urgent in resource rich developing countries.
 - a. It has been estimated that two thirds of all business transactions worldwide take place within a group.
 - b. International Tax Compact researchers have calculated that many developing countries collect only 40% of their tax potential. While this is not entirely due to transfer pricing, transfer pricing abuse and aggressive tax planning have been identified as the largest components of this revenue loss.
 - c. In the current economic climate, it is becoming more and more apparent that domestic resource mobilization has to be a key driver of development. In resource rich countries, this means that fiscal regimes must be established to capture an adequate share of resource revenues, and these fiscal regimes needs to be backed up with robust enforcement.
 - i. G-20 Cannes Communiqué: “Consistent with the Multi-Year Action Plan agreed in Seoul, we strongly support developing countries’ mobilization of domestic resources and their effective management as the main driver for development. This includes technical assistance and capacity building for designing and efficient managing of tax administrations and revenue systems and greater transparency, particularly in mineral and natural resource investment. We urge multinational enterprises to improve transparency and full compliance with applicable tax laws. We welcome initiatives to assist developing countries, on a demand-led basis, in the drafting and implementation of their transfer pricing legislation. We encourage all countries to join the

Global Forum on Transparency and exchange of information in tax purposes.”

- ii. African Development Bank: “... the already shallow tax-base in most African countries is eroded further by excessive granting of tax preferences, inefficient taxation of extractive activities and inability to fight abuses of transfer pricing by multinational enterprises ... African countries get less money from resources than many other countries in the world. It is difficult to obtain a clear picture, however. Contracts are often subject to strong confidentiality clauses by the companies, governments, investors and banks involved. African governments also often lack capacity to negotiate contracts that allow them to generate fair share of rents from natural resource extraction.”
 - d. At the same time, this is not just a revenue issue. Tax administration is seen by many scholars as an important component of state institution-building, with ramifications beyond revenue figures.
 - e. Is there anything about mining that makes it more, or less, susceptible to transfer pricing abuses?
2. The challenge for resource-rich developing countries
- a. Developing countries often have weak tax administrative capacity.
 - b. Transfer pricing legislation is often weak or non-existent.
 - c. Developing countries often have a limited number of comparable, uncontrolled, transactions on which to draw.
 - d. Even where there are many mining companies within a given country, the prominence of multinationals means many of the potential comparable transactions may be affiliate transactions.
 - e. Documentation requirements tend to be weak by international standards.
3. Distinct challenges: transfer pricing on inputs, outputs and finance
- a. Thin capitalization
 - b. Home office services
 - c. Treatment of hedging
 - d. Interaction of transfer pricing with tax holidays and other incentives
 - e. Related issues: minority shareholder rights in the case of state equity.
 - f. What can contract negotiators do in the absence of robust legal and regulatory frameworks governing transfer pricing?
4. Possible solutions to the transfer pricing challenge
- a. Investing in tax administration: there is generally a high return to investments in taxing authorities
 - b. Regional cooperation
 - i. Explore the potential for regional cooperation to generate a useful database of comparable transactions.
 - ii. Possibility for coordinated approaches to transfer pricing/APAs
 - c. Robust legal frameworks

- i. Where contracts override or modify general rules, there is a big risk of transfer pricing potential being overlooked.
 - d. Improved Transparency
 - i. Payment disclosure
 - ii. Contract disclosure
 - iii. Country-by-country reporting
 - 1. There is currently a global push for country-by-country reporting as one means of generating information that will help stakeholders to better understand intra-group trade patterns.
 - e. Greater reliance on index prices
 - i. For pricing of mineral exports, the case for utilizing index prices is increasingly compelling. Spot market pricing is growing in subsectors where it had previously accounted for only a fraction of sales, and price indexes are become more widely used.
 - ii. There is no reason a royalty must be based on the actual price received by a company. Royalties are not taxes; they are compensation to the state for the permanent loss of a valuable resource, and there is no reason the “price” cannot be determined independently of the eventual sales price received by the mining company. Using index prices can remove transfer pricing risk from the revenue stream—the royalty—that is simplest to administer and less subject to risk.
 - iii. Use of index prices for income tax calculations arguably present greater challenges, but again the benefits outweigh the costs.
 - 1. Double taxation issues
 - 2. Relevance of index prices for accepted transfer pricing methods.
 - iv. In general, there should be a shift in emphasis away from theoretical “accuracy”, and toward systems that are fair and administrable. The concept of administrability is not “one-size-fits-all”, but should recognize the special challenges of resource taxation in developing countries.
 - f. Advance Pricing Agreements (APAs)
 - i. Trends favor increased use of APAs in both developing and developed countries.
 - ii. policy and administrative considerations