TRANSFER PRICING

Full Text- Krishen Mehta

1. Having had a 30 year career in public accounting, and serving now as an Advisor to GFI, I truly believe that if we are to succeed in our advocacy, we need to understand the point of view of the Multinational Companies (MNC's), and work with them to bring about the change that is needed.

MNC's bring capital, investments, technology, intellectual property, and management skills that can be useful to developing countries. We need to see how we can partner with them, rather than to hold them to blame for most of the ills or the poverty in the developing countries.

2. I do not deny the seriousness of the situation. Transfer mispricing can result in capital outflow from developing countries. Such outflow has a direct effect on economic deprivation. And, as we know, there is a clear connection between economic deprivation and human rights.

MNC's account for about 60% of international trade. And intragroup flows account for about 50% of all MNC transactions. These intragroup flows are often not subject to the same market forces as arm's length transactions, and there is significant potential for profit-shifting.

The arm's length principle of Article 9 of the OECD model tax convention, and Section 482 of the US tax regulations provide guidance on how such transactions should be treated for tax purposes. Through use of subsidiaries, affiliated companies, legal entities in tax havens and other secrecy jurisdictions, companies can misuse in practice the guidance articulated under these rules.

Transfer pricing abuses come in various types of categories. There can be over or under-invoicing of exports and imports, there is the cost sharing type of transfer pricing abuse, contract manufacturing type of such abuse, transactions structured as services when they are really transfer of intellectual property, and so on.

3. The Supreme Court Ruling, US vs Pasquantino, decided in May, 2005, dealt with a case of movement of goods between US and Canada and the avoidance of customs duties. The Supreme Court upheld a lower court ruling holding that involvement in a scheme (through use of US mails) to defraud a foreign jurisdiction of customs duties (and by inference VAT, income tax, etc), was a violation of US laws.

One could extrapolate this to transactions between US parents and foreign subsidiaries, whereby the setting up of financial structures to evade taxes could theoretically come under the purview of this ruling.

A strong challenge to a multinational company on the strength of this ruling could make transfer mispricing decisions by companies a very risky proposition. Clearly, the situation is serious and worthy of our attention.

4. Review of transfer pricing rules in various countries

Our understanding of the predicament of the Tax Director of a multinational company could be enhanced if we look at some of the global rules on transfer pricing. Put yourself in the position of one of these individuals and imagine that you have operations globally.

For your business in China you have very onerous transfer pricing rules. The rules are clearly articulated, and MNC's are audited very often to ensure that there is proper compliance. sometimes they are too onerous, requiring considerable time and expense on the part of the MNC's.

For your operations in Russia there is insufficient clarity. The rules are few and far between, enforcement is not consistent, and many tax officials are corrupt. Transfer pricing decisions can be subject to attack by the government, sometimes for political reasons, and a company could easily be disbarred from future business in Russia.

The Eastern European countries have a softer model, as it relates to transfer pricing, and generally follow the European Union model.

Mexico and Argentina require a sworn affidavit from the companies (and their auditors also) confirm that there is no transfer mispricing for the operations effecting these countries. If the sworn statements are later proven to be false, a company could be disbarred and its auditor subject to suspension or disciplinary action.

In Brazil, there are rules that are akin to telling a company what they expect the margin to be in each sector or industry. So if your margin is at variance with that, you still are obliged to meet the standard minimum.

In Asia in general, some countries have sophisticated transfer pricing rules, example China, Japan, and Korea, while others are still evolving.

In Africa, where the mining industry is the key sector of engagement for many MNC's, the transfer pricing rules are minimal at best, and there is widespread corruption.

Under these circumstances, it is not so easy for an MNC to always know what is the right policy or position to follow with regard to transfer pricing. Often, to minimize a company's risk, a company needs to hire internal and external accountants and lawyers to guide them through this maze.

In summary, MNC's are often caught in a dilemma. What is the law here, and what is our obligation to comply.

Clearly, we cannot create a world order in which everything is dictated, either by the countries (what you should pay), or by the MNC's (what we think we should pay). There has to be a middle ground. That brings us to the six recommendations that I have before you.

5. Recommendations for us to consider:

(a) For countries that have no transfer pricing rules, if they want foreign direct investment to come in, they can simply agree to adopt the OECD guidelines. The more clarity there is for MNC's the better. If there are rules, people know what to do. Let us not recreate the rules for every country that does not have them. A good model already exists, let us follow it. And then if a company does not follow it, we have a right to criticize.

(b) It is important for countries also, if they wish to have FDI by MNC's, to accept the global intellectual property rules. Let me give an example:

Let us say a company from Europe or the US wants to invest in a $ 500 mill pharmaceutical plant in Brazil. They would bring their own intellectual property, the payment for which can only be recovered through royalties. But under Brazilian law, royalties cannot be charged. The MNC's now have a dilemma, how to recover their investment?

On top of that the companies run the risk that within a few years of the plant being set up, there will very likely be generic products that will compete with the products of the facility, mainly because of the weakness of the intellectual property laws.

Basically, where there is a protectionist model economy, where intellectual property is not respected, it is difficult for a company to expect investment, technology, capital, etc. It is important that intellectual propety be honored if such investments are to be secured.

(c) In certain specific industries that are very sensitive to transfer pricing, it is recommended that the country-by-country reporting model be adopted. As an example, the extraction of raw material is one of the most sensitive to transfer pricing. The European Union has come out already in favor of it, and this subject will also be discussed later this afternoon.

(d) It is important for countries to be also smarter about their resources, their national wealth. Let me give an example. China produces over 95% of the world's supply of Dysprosium and Terbium, two rare minerals essential to break-throughs in certain high-tech industries that are vital to the manufacture of hybrid cars, cell-phones, large wind turbines, missiles, and computer monitors.

These are two of the most valuable, scarce, and most sought-after minerals, among the 17 rare earth elements. What would you do if you were China?

Basically, you would reduce the export quota on these rare-earth elements, impose a high tax, and invite companies to set up their R&D centers in China to have access to these minerals. This is exactly what China has been doing. In 2005 they exported 65,000 tons of these minerals, and the quota now is about 35,000 tons.

Clearly, developing countries need to get smarter about their resources, and should.

(e) There is merit to good and fair negotiations between countries and companies. Let there be clear arms-length binding agreements between countries that want foreign direct investment and technology, and companies that offer them. This can override the normal transfer pricing rules.

The finance or commerce ministers of countries often go shopping for the right MNC's in their jurisdictions. Let us take the example of Nissan opening an auto plant in Mexico under the Salinas administration.

The company was very clear on what all they would need if they were to invest, for example roads, airport, electricity, skilled manpower, and so on. Mexico argued that if it was build or provide all this, they would need certain taxes to make the investment sustainable long-term. A mutual agreement was reached that was beneficial to both sides. This happens all the time, and there is merit for this to continue.

(f) Lastly, there is an important role for accountants and lawyers here, under the overall subject of Responsible Tax Advising.

Since many transfer pricing decisions are aided or supported by accountants and lawyers, either working within a company or hired as consultants, it is important for them to examine their own role and to see how it can be more sustainable.

Clearly, we need a system of international tax advising that is more progressive and more in the public interest. It is not enough for accountants and lawyers to be creative on how to minimize their client's global tax costs. They need to view the societies in which they do business as a key shareholder that needs to be paid its dividend through fair taxes that are paid.

The Aspen Institute's Business and Society Program in New York has helped to initiate a dialogue on this subject supported by the Ford Foundation. GFI was a participant in that dialogue, in which the major accounting firms were included. This dialogue is now continuing. At its November 2009 meeting the group will look at transfer pricing in a more holistic manner, seek to collaborate on best practices, identify egregious tax positions that they will not condone, and take other steps that demonstrate their dual responsibility not only to the companies that they serve, but also to the societies in which they operate.

Thank you.