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FACULTY OF LAW
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Taxation of Multi-National Enterprises

- State and corporate responsibility regarding the issue of transfer pricing

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Summary

This thesis concerns the issue of how MNE affects their taxable profit through transfer pricing. When companies transfer assets between subsidiaries in different states they need to price the assets so the taxable profit that arises reflects the value of the subsidiary. The pricing is calculated to comply with 'arm's length price', which means the internal price should be the same as if the asset was purchased from an independent enterprise. The development of the international market has resulted in different non-material assets being transferred between subsidiaries. The uniqueness of the assets makes it hard to find a comparable transfer price. The problem arises when MNE over- or underestimates the transfer price to be able to report the profit in the state with lowest corporate taxation. The lack of comparable assets and the amount of accepted transfer pricing methods makes it easy for MNE to manipulate the pricing.

The problem has been given attention on many levels and OECD has developed guidelines on how MNE shall act and how states shall react. A competitive situation arises between states as they try to attract foreign investment to get job opportunities and economic development in the region. Many states offer cheap workforce, poor regulation of environmental control and tax breaks which results in that states and their population ends up in a worse position than before.

There is no supranational organisation that offers an international tax regulation. It is within state sovereignty to regulate taxation and impose obligations upon companies. Critics claims MNE should accept responsibility for their acts and not exploit the weaknesses in the system, while others say MNEs' only obligation is to comply with the regulation within the state. Different organisations have highlighted the issue and recommended increased documentation requirements and transparency in the system. It is imported that each part knows what is expected of them.

Sammanfattning

Uppsatsen berör frågeställningen hur multinationella företag påverkar skattebasen via internprissättning. När företag överför tillgångar mellan enheter i olika länder krävs det att tillgångarna prissätts så att den beskattningsbara vinsten som uppkommer speglar omsättningen/värdet på enheten i det landet. Prissättningen beräknas med en 'armlängds avstånd', vilket menas att det interna priset ska vara det samma som om varan handlats med en oberoende part. Marknadsutvecklingen har resulterat i att fler typer av ickemateriella tillgångar överförs mellan bolag. Tillgångarnas originalitet gör det svårt att finna en jämförbar prissättning. Problematiken uppkommer när företagen över- eller under estimerar det interna priset för att kunna överföra vinsten till det land med lägst bolagsskatt. Bristen på jämförbara tillgångar och mängden accepterade metoder som används för att finna ett pris gör att företag lätt manipulerar prissättningen.

Problematiken har uppmärksammats på många plan och OECD har utvecklat riktlinjer för hur företag ska agera och stater ska reagera. En konkurrensmässig situation uppstår mellan stater när de vill attrahera företag. Etablering av utländska bolag innebär arbetsmöjligheter och ekonomisk utveckling i regionen. Ett flertal länder erbjuder billig arbetskraft, svag reglering när det kommer till miljöhantering och nu även skattelättnader vilket sammantaget resulterar sämre position för staten och dess invånare.

Det finns inget överstatligt organ som ger en övergripande internationell skattereglering, utan det åligger staterna att reglera skatter och företags skyldigheter i landet. Kritiker har ifrågasatt om inte de multinationella företagen borde ta eget ansvar för sina handlingar och inte utnyttja svagheterna i systemet, medan andra menar att företag enda skyldighet är att följa de regler som åligger dem i landet de verkar. Olika organ har uppmärksammat problemet och den främsta rekommendationen för både stater och företag är ökad dokumentation om prissättningar och transparens i systemet. Det är viktigt att alla parter vet vad som förväntas av dem.

Preface

Writing this thesis has been a lesson learned for life and I am grateful to start my working career with this experience. Given the opportunity to study at the faculty of Law at Lund University I have received great knowledge of the Swedish legal system and a god insight of the international legal sphere. The international legal environment has shown to be just as confusing as interesting. Hopefully the interesting part weighs just as heavy in forty years from now as is does today.

I want to dedicate a special thanks to my supervisor Radu Mares for the patience he has shown me. Thank you for the guidance much needed all those times I got on the wrong track!

Finally, I would like to thank my family for all their support and encouragement. A special thanks to my nice Eva who gave me all the joy needed during this process!

Ängelholm May 2013

Cecilia Siegbahn

Abbreviations

ABF	Associated British Foods
ATAF	African Tax Administration Forum
ALP	Arm's Length Price
APA	Advanced Pricing Agreements
BTT	Bilateral Tax Treaties
C+	Cost Plus Method
CFA	Committee on Fiscal Affairs
CFC	Controlled Foreign Corporation
CIAT	Inter-American Centre of Tax Administration
CPM	Comparable Profit Method
CSR	Corporate Social Responsibility
CUP	Comparable Uncontrolled Price
EITI	Extractive Industries Transparency Initiative
EU	European Union
EU JTPF	EU Joint Transfer Pricing Forum
EU TPD	EU Transfer Pricing Documentation
FDI	Foreign Direct Investment
GFA	Global Formulary Apportionment
IGO	Inter-Governmental Organisation
MNE	Multi National Enterprises
NGO	Non-Governmental Organisation
OECD	Organisation for Economic Cooperation & Development
PATA	The Pacific Association of Tax Administration
PSM	Profit Split Method
RPM	Resale Price Method
SGATAR	Study Group on Asian Tax Administration and Research
TNMM	Transnational Net Margin Method
TP	Transfer Pricing
TPG	Transfer Pricing Guidelines
UN	United Nations

1 Introduction

1.1 Background

For the last couple of decades globalisation has substantially accelerated. An important reason for the fast development of some developing countries into fast growing economies has been globalisation. Globalisation has thus become a contributor to the society welfare as it has resulted in more job opportunities, increased transfers of technology, higher revenues and increased buildings of schools and medical facilities etc. The rapid globalisation that has taken place has not only resulted in a dramatic change of societies but also in the accelerated growth of multinational enterprises (MNEs). The improvement of infrastructure makes it easy to transfer goods across the world and gives MNEs an opportunity to increase their business. Any company now has the possibility to invest in states with large untapped labour resources and underutilized natural resources that are necessary for that particular company without having to transfer the legal home of the company. The elimination of boundaries has also increased the freedom for foreign investors, which has led to increased economic growth for both states and MNE. The well-established foreign direct investment (FDI) protection that exists to avoid discrimination of foreign companies in the host state makes the international market attractive for MNEs seeking growth.

The economic growth that follows when a company establishes in a state has led to that the competition for FDI between states has increased. One way for states to attract foreign investors is to create a regulatory framework adapted to fit the needs of MNE. The trend has resulted in producing states lowering their standards when it comes to employment and environmental regulation. Countries aspiration to attract FDI has to some extent resulted in a situation where they are in competition with each other and one might say the competing states engage in a '*race to the bottom*'.[1]

International regulation through in treaties and international agreements mainly concerns investment protection. There is a lack of international

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[1] Shah, Anup "*Corporations and workers Rights*"

regulation when it comes to the responsibilities of MNEs regarding minimal standard of socially responsibly business conduct. Many of the MNE declare their commitment to '*Corporate Social Responsibility'* (CSR). However, it is not universally agreed what should be included in the CSR. Traditionally CSR covers the company's labour conditions and the environmental effect of their production as a response to the lack on international regulation in this area.

Recently some MNEs have started to include the regulation of taxation as an aspect of CSR when deciding on where to establish subsidiaries and what function they shall have. MNE normally wants to move taxable profits to states that offer a lower taxation level. The approach of lowering standards and to give MNEs' tax advantages are not illegal methods for the states nor is it an illegal act by MNE to gear towards the favourable regulations offered in some states. In the long run loosing out of tax revenues does however damage the development of states and can be considered to be a human rights and developmental problem.

1.2 Identifying the problem

The issue of transfer pricing, the price set on assets bought by one unit from another unit within the same enterprise, has become an widespread issue since the MNE can choose where they wish to report their taxable profit by mispricing the asset. The correct term is *transfer mispricing*, but for simplification, it will be referred to as transfer pricing (TP). It is not clear how extensive the tax revenue losses are due to transfer mispricing, but it is known that approximately 30 % of the global trade is between unified companies.[2] This indicates that minor mispricing of internal transaction can lead to big losses in tax revenues. If the price is set too low the profit moves from the selling unit's state to the buying unit's state and vice versa.

There are different issues that can be discussed regarding the MNEs' way of working in different countries. The most common issues often regard human rights and environmental violations since these issues are most obvious to us. It has become more and more common for the MNEs to take an official stand when it comes to e.g. child labour or the demand for environmentally friendly materials in their products. What often gets overlooked is the fact

[2] UN, "*Practical Manual on Transfer Pricing for Developing Countries*", Foreword

that an operational tax system is fundamentally important for the economic growth and development in a developing country. Tax revenues are the necessary financial means for a state to build schools, hospitals and infrastructure. When the MNEs choose to transfer its profit to another state, the first state misses tax revenues. Even though the MNE is using the system to avoid taxation, e.g. via transfer pricing, they pay the amount they are obliged to and are abiding by the laws of both counties. This results in a problematic legal situation.

1.2.1 Purpose

The purpose of this thesis is to identify how the lack of international regulation of TP becomes taxation-problem for the state. When not reporting as much taxable profit as a domestic company would do, the state will loose out on tax revenue and MNEs will get unjustified advantages towards domestic companies. This thesis will aim to give an understanding to the problematic situation by answering these following questions:

- What is transfer pricing and what problems can it cause
- How has the international community recognised transfer-pricing issues?
- What is expected by states and MNEs regarding transfer pricing?

The taxation issues regarding MNE are rapidly changing and it is hard for the states to close all the loopholes with the speed it requires. There are no worldwide organisations that control the MNEs global taxation responsibilities and therefore it is hard to detect these loopholes. If the system gives the MNE a disadvantage, it will be within the MNE's interest to alert the taxation authority on the unfair taxation level. Many bilateral agreements and other existing taxation regulations therefore focus on protecting MNE from double taxation. The double taxation is less of a problem today than it used to be. The existing protection regulation has led to MNE getting tax advantages or even being exempted from taxation in the host states. This makes it possible for the MNE to eliminate or reduce their taxation and the low tax burden gives the MNE a competitive advantage over local smaller businesses. The low tax burden hurt not only governmental investment and economic growth but also employment in regional companies.[3]

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[3] OECD Newsroom

During the last decades of economic development, states have signed bilateral agreements that deal with conflicts regarding national taxations law[4] for trade. These tax treaties concern how the national regulations should be interpreted when they are in conflict with each other. They do not include how states should tax the MNE within its jurisdiction or what responsibilities lay upon the companies within the country. This benefits MNE since they are free to take any actions they wish as long as they stay within the national regulations.

CSR is a fairly well established and accepted tool to prevent violations of human rights and environmental issues. When committed to writing a CSR MNEs are pushed to take a stand and give their point of view on these matters. There have been discussions whether or not taxation should be included in the company's CSR. The basic idea of CSR is to help them state and implement a transparent set of values that represent the company. The CSR concept was developed to be a positive tool in the process towards a better sustainable development. The lack of follow up of the CSR is however considered to be somewhat problematic since the due diligence approach mainly regard the efforts made by the MNE and not the result. Some critics say that MNE only need to 'mark the box', as they have tried to follow the intentions set in their CSR.[5] Others say the CSR is of great importance since it creates transparency for all subsidiaries within the same corporation.[6] When a company has stated its commitments to CSR and adopted management systems to comply with it, it is easier for its subsidiaries to follow.

Over the past couple of decades the MNEs have more aggressively focused on minimising their taxation burden and many MNEs create subsidiaries and shell-companies to take advantages of the lower taxation levels in some states. Tax regulation lies within the state sovereignty and when MNE takes control over their tax liability through tax planning it is considered to be a violation towards the state.[7] The regulations that exist today do not reflect

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[4] Rugmand, Alan & Brewer, Thomas "*Oxford handbook of International Business*" p. 591

[5] Corporate Watch "*What's wrong with Corporate Social Responsibility?"* p. 11

[6] European Parliament resolution (2012/2098(INI))

[7] Jeffery, Ramon J. "*The Impact of State Sovereignty on Global Trade and…"* p. 734

the economic collaboration of corporate entities within MNE or the value of intellectual property and this is damaging for the development of states.[8]

1.2.2 Limitation and scope

This thesis will look into how companies set these prices and which methods that are being used to transfer profits. There will be no description or comparison between different states taxation levels since the main focus will be on the function of transfer pricing. The result of these transfer-pricing policies has generally been that developing states are mostly affected by losses in tax revenues, and industrialised/developed states have benefitted. I will however not limit this paper to only concern the transfer of taxable profit from a developing state to a developed, but rather focus on the violation of state sovereignty when the MNE are allowed to 'choose' where to report their taxable profit. These various actions taken by MNEs are normally legal. I will discuss the different positions a MNE can have towards taxation.

In this paper I will accept CSR as a successful tool and not regard the to critics' discussion about the success or failure of the CSR concept. I will however discuss whether or not taxation is a suitable issue for CSR.

1.3 Method

This thesis will focus on different sides of the transfer pricing mechanism. It is important to understand how profits are transferred via transfer pricing between the MNE corporate units in different states. I have used a descriptive and analytical method to present the functioning of transfer pricing. The description is important in order to understand if companies can or should take responsibility on where the profits should be taxed.

I will analyse reports written on this matter, but this paper is not a comparative analysis of which system is better than the other. It is rather an analysis of important elements that should be taken into consideration both by companies and by states. I will not be able to present any legal cases

[8] OECD Newsroom

since tax avoidance in not an illegal act. I will however regard cases given attention to in media where the MNE actions have been questioned.

It is not totally settled what a company shall include in their CSR but taxation is getting more focus in the international debate.[9] To establish if MNE should include taxation into their CSR I will look into the on-going debate, but especially what different organisations guidelines state about taxation and CSR.

1.4 Disposition

This thesis is divided into three parts. The first part (chapter two) describes the problems regarding transfer pricing and how the MNE can use transfer pricing as an economic tool to avoid taxation. The chapter describes how it works and why it is a problem that companies transfer their profit from one state to another. The chapter's aim is also to give a clear view on why fair taxation is important to others than the state in focus. This problem is getting more attention. To show how it has been recognised in the media I will present a short summary of three examples. The first one deals with how the international coffee-chain Starbucks transferred all its profits from the United Kingdom to states with lower taxation levels. The second example concerns the online book-selling giant Amazon's establishment in Luxemburg and the last case concerns Zambia Sugar's usage of bilateral tax agreements and developing states tax breaks.

The second part (chapter three) focuses on the recognition this issue has had in international legal and policy instruments. The chapter will describe the difficulties to get a harmonised international taxation system when there is no supranational organisation to set international taxations rules. The chapter will therefore focus on international organisations that have the ability to influence its members. The main focus will be on OECD '*Transfer Pricing Guidelines'*. Even though the OECD has a limited number of member states, it has developed guidelines that subsequently have been adopted by both the UN and regional associations like the EU and The Pacific Association of Tax Administration (PATA). Most MNEs and all OECD member states as well as several other states consider these guidelines of great importance.

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[9] UNRISD, "*The 'Pay Your Taxes' Debate: Perspectives on Corporate Taxation…"* p. 5

The third part (chapters four and five) will focus on what is expected of the states and companies. It is within the state sovereignty to regulate taxation but to close loopholes is difficult without collaboration with other states. MNEs have to act within the country's framework of taxes. The MNE's TP will be discussed in this context. I will also present the possibility to include taxation in the company's CSR.

2 International Taxation & Transfer Pricing

2.1 Positions towards taxation

There are three ways a MNE can act regarding taxation. The first position is for those that do not adjust their structure or actions with specific intent to lower their taxation burden. The second is tax evasion and the third position is tax avoidance.

2.1.1 No adaption

The first position is to not regard taxation as a possibility to lower the corporate costs. The company is indifferent to the tax level and do not adapt their business structure to avoid taxation. This position is preferred by states since it gives them the freedom to develop a system suitable for the corporate environment in the state. The tax authorities can change domestic tax regulation to close any loopholes that arise in the domestic system, but cannot control the international tax system. This position is common for companies that only work within one state and less common for MNE that function on the international market and has the possibility to use other states tax systems.

2.1.2 Tax evasion

The second position towards taxation is 'tax evasion' and its extent is harder to estimate since it is an illegal approach. Tax evasion means that the taxpayer withholds assets from the tax authorities so they do not become subject to taxation. Any criminal activity or offence of dishonesty that involves the reduction of taxation payment will result in a punishment of civil penalties.[10]

MNE can create a business structure that makes it impossible, or at least difficult, for third parties to hide assets from the tax authority. To actively counteract tax evasion by third parties MNEs can e.g. demand specified

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[10] KPMG, "*Tax and Corporate Social Responsibility*", p. 15

receipts on every purchase or service and demand correct actions by suppliers, customers or contractors. Tax evasion will however not be the focus of this paper even though it concerns the MNE taxation philosophy and a good possibility for MNE to limit third parties' incentive for tax evasion.[11]

A sharp distinction is often drawn between tax evasion and avoidance where the latter is considered to be the legal version of the former.[12]

2.1.3 Tax avoidance

The third position on taxation is tax avoidance, which means that a company adapts a system for which the purpose is to avoid being taxed higher than the company consider being necessary. Tax avoidance is difficult to handle since the various used methods of avoidance are so different and hard to identify. The common denominator for the problematic issue of avoidance is the actions being made within the legal sphere to either minimise their taxable profit within a state or transfer the profit to states with lower corporate taxation.[13]

2.1.3.1 Pure tax avoidance

Economists are often looking for 'pure' tax avoidance, which means there is no excess burden such as: information problems, transactions cost and institutional restriction for the MNE. This means a MNE can with simple adjustments use well-known loopholes without any extra cost for the company or the society.[14] Actions that lead to pure tax avoidance rarely exist since there is often a direct effect relating to any action made by a company. If a company changes its structure and turn the company into a trust or a large limited partnership, these adjustments might lead to a more effective taxation for the company.[15] This type of actions is not a problem in a legal context and even if it may result in lower tax burdens for the MNE there is a risk that this type of actions brings disadvantages to other areas. MNE need to make careful considerations when adapting these structural changes. According to some writers are many of the actions that are

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[11] United Kingdom Government "*Reducing tax evasion and avoidance*"

[12] Cooper, Graeme "*Tax Avoidance and the Rule of Law*" p. 53

[13] Cooper, Graeme "*Tax Avoidance and the Rule of Law*" p. 54

[14] Cooper, Graeme "*Tax Avoidance and the Rule of Law*" p. 64

[15] Cooper, Graeme "*Tax Avoidance and the Rule of Law*" p. 67

considered to be pure tax avoidance by the MNE, on the borderline of being classified as tax evasion.[16]

One way of dealing with this problem might be to increase the excess burden for the MNE. This would mean a MNE have to go through a more complicated process to avoid taxation. The main problem of making the excess burden higher for MNEs is that it usually increases the excess burden for the controlling state as well.[17] The implementation of controls could result in extensive cost for both companies and states and there is no guarantee the tax revenues would cover the costs for the extra controls.

2.1.3.2 Legal aspects

Corporate changes that do not alter the substantive character of an activity or transaction, but turn it into a more favourable taxation position than before is of interest from a legal point of view.[18] These actions are unlikely to occur if the company has not abused the system in some way.

In many developing states, the lack of experience is one reason for generally poorly drafted taxation regulations. Normally, there are many loopholes that MNE takes advantage of when they try to avoid taxation. These loopholes rarely demands any specific measures by the MNEs and this is one of the reasons why not any extra burden affects the MNE when avoiding tax in a state with developing tax regulation. For internal transactions and business agreements, e.g. transfer pricing as defined below, it is hard for an outsider to determine what '*constitutes a legitimate business purpose'* and what arrangements are not functional and only used to avoid taxation.[19] Without a clear and stable legislation that gives every part a clear guidance it is difficult for local authorities to discover as well as to close the existing loopholes. Today, the MNE are much more flexible and can easily change their structure so that they can use any loophole. The risk with a very stable legislation is that it could become too inflexible and this might complicate the procedure when to close loopholes in the system.

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[16] Cooper, Graeme "*Tax Avoidance and the Rule of Law*" p. 53

[17] United Kingdom Government "*Reducing tax evasion and avoidance*"

[18] Cooper, Graeme "*Tax Avoidance and the Rule of Law*" p. 71

[19] Cooper, Graeme "*Tax Avoidance and the Rule of Law*" p. 73

Businesses might claim that tax regulation is not based on universal principles. The main goal for tax regulations is to get in tax revenues but at the same time is there no universal 'right' tax rate that determines taxation levels. There is rather a 'right' way for the companies to act that consequently will result in the right amount of taxation.[20] According to this way of reasoning the obligation does not lie within the tax rate paid to each state, but rather that the company has acted according to any regulation they are subjected to.

2.1.3.3 Impact of tax avoidance

"Tax avoidance (…) is a market response by the taxpayer to a structure that is non-neutral and discriminatory, but is taken as given or exogenously determined. Through behavioural adjustments in markets, under the given tax structure, taxpayers seek to reduce their tax liabilities and, in effect, shift part of their tax burdens to others"[21]

This statement regarding the tax burden being shifted from the company to another taxpayer is only partly true. It is true in the sense that companies utilise public goods such as infrastructure, educated workforce etc. that are financed via tax revenues paid by other citizens. However, it is normally not possible for the tax authorities do demand higher tax revenues from other taxpayers to cover for the extra cost.[22] The loss of tax revenues when companies avoid paying tax affects the society in different ways and normally public expenditures needs to be cut.[23]

The state obligation to uphold the welfare in the society is hard to comply with if it cannot rely on stable revenues and stability in the tax structure. It is of importance for states to have knowledge of the accessible amount of tax revenues when calculating the national budget. When tax revenues decreases, e.g. by tax avoidance, the government will prioritise to cover immediate and necessary issues. This is problematic since governments will thereby not take preventive measures to solve long-term problems e.g. improving education, environment or medical care.[24]

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[20] KPMG, "*Tax and Corporate Social Responsibility*", p. 17

[21] Cooper, Graeme "*Tax Avoidance and the Rule of Law*" p. 78

[22] KPMG, "*Tax and Corporate Social Responsibility*", p. 20

[23] Cooper, Graeme "*Tax Avoidance and the Rule of Law*" p. 71

[24] KPMG, "*Tax and Corporate Social Responsibility*", p. 20

If a subsidiary within a MNE transfers profits, they will pay lower taxation compared to if they would have paid profit tax on the full profit in the state they are situated in. By other transactions, these less taxed profits could be transferred back to the subsidiary if necessary. These actions consequently give the subsidiary a competitive advantage towards smaller national companies. MNE are subject to more than one legal system and can 'pick the raisins out of the cake' in the global society, while local companies do not have that choice. National companies have to pay more local tax and this puts them in a less favourable competitive position vs. a MNE that has reduced its costs by tax avoidance. The MNE can thus out-compete the local company by its use of tax avoidance.

2.2 States, tax and sovereignty

State sovereignty prohibits implementation of direct or indirect regulation of companies in other states.[25] This principle of sovereignty concerns any act committed by the subsidiary even if the act is completely controlled by the parent company. Regulation of taxation levels is within the state sovereignty and therefore it is not allowed for other jurisdictions to regulate taxation within the states territory. A state is not allowed to use the MNE as a 'Trojan horse' to create regulation in another state no matter if it concerns illegal acts with criminal charges or tax regulations.[26] So when defining who is accountable for an action committed by a unit within a MNE the rule is '*one brand – two responsibilities'*. This emphasises that each unit of an MNE is considered to be an individual company and has the responsibility to act according to the regulation within the jurisdiction of the state where it is stationed.[27]

Since it is not within the culture of a company to pay more tax than legally necessary, it will, if given the opportunity, try to avoid taxation. MNEs regard the differences in national corporate taxation as imperfections in the taxation system and they use these imperfections as an economic tool. Therefore, even if the parent company and the subsidiary have different responsibilities they are still under the same corporate umbrella and profits

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[25] Jeffery, Ramon J. "*The Impact of State Sovereignty on Global Trade and…"* p. 734

[26] Rugmand, Alan & Brewer, Thomas "*Oxford handbook of International Business*" p. 597

[27] The Guardian "*OECD calls for crackdown on tax avoidance by multinationals*"

can easily be transferred via transfer pricing to the company with the lowest corporate taxation. MNE justify the advanced tax planning via transfer pricing as '*one brand-one profit*'. Since the state sovereignty does not allow implementation of tax regulation that concerns the taxation in another state, a state cannot get the overall right to tax every unit of a MNE, nor can the state implement regulations that would prosecute the MNE if transferring profit to a state with low corporate tax. As long as every act is according to each states regulation it is not illegal to use the system with tax planning and place subsidiaries in states with low corporate tax.

2.2.1 State interest

Transfer pricing is an important issue for both the taxpayer and the tax administrator. The transfer price concerns the inter-trade within a MNE but the pricing will also determine where the profit will be reported and taxed. The tax administrators in a state do not have an incentive to stop trade or make trade difficult for the MNE. If there is a larger profit reported in the state, there will be high tax revenues for the state. It lies within the states interest to create an environment so that the MNE want to report the profit in the state.[28] The states focus lies on the supervision of how the transfer is made. MNEs thereby needs to make it credible that the transfer price charged for a transaction in material assets, services or intellectual property is fair by adapting the 'arm's length' principle.[29] No concern is given to questions like who has the 'right' to collect tax on the profit or who as the biggest 'need' of tax revenue. It does not matter if State A claim the right to taxation since it is where the seller and buyer made an agreement or if State B claim the right to taxation because it was in State B where the item the item was manufactured.[30]

Politicians use taxation levels as important tools and the main discussion regard tax rates at national level. The effective tax levels and procedures on international level create debates. Internal disagreements create political obstacles that complicate the process of effectively trying to control and overcome the problems of tax avoidance on an international level.[31]

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[28] Jeffery, Ramon J. "*The Impact of State Sovereignty on Global Trade and…*" p. 741

[29] Gupta, Sayantan, "*'Transfer pricing' – an international issue…*" p. 40

[30] Cooper, Graeme "*Tax Avoidance and the Rule of Law*" p. 2

[31] Cooper, Graeme "*Tax Avoidance and the Rule of Law*" p. 82-83

MNE care about their global profit and how much it shall be taxed, while states care about revenues and not implementing regulations that results in double taxation for the MNE.[32]

2.2.2 State concerns

States focus on three types of problems when it comes to MNE and taxation. The first is the *jurisdictional* issue that determine which state has the right to tax the MNE. This issue often raise many subsequent questions such as who has the priority if both states have equal right? What if a tax base should arise in one state and not the other? Shall that state be allowed to tax the base even if it the other state has priority? It results in tax competition between states.[33] States regulate these issues with bilateral agreements or 'Advanced Pricing Agreements' with individual MNEs. When making these agreements they regard open-market conditions and assumptions for the future.[34] These agreements are necessary for the states since both states have the same legal value and no state is superior the other. State A does not have the possibility to implement regulations on how the subsidiary company shall act in State B and vice versa. Without international agreements a '*accountability gap'* or '*governance gap'* would arise when the MNE work on the international market.

The second issue is the *allocation* of MNE resources. The MNE wishes to allocate its recourses in the most optimal way while the state focus on how the cost and income from these recourses are allocated amongst states concerned.[35] When MNE transfers assets between jurisdictions it creates a problem that do not exist when companies function within one nation.[36] The state must work in a preventive manner and consider different ways MNE can take advantages of the system but they also have to be aware of the risk of double taxation.[37]

The third issue that states take into consideration is how MNE *value* the assets when setting their transfer price. The price is mainly bookkeeping

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[32] Gupta, Sayantan, "*'Transfer pricing' – an international issue…"* p. 40

[33] Rugmand, Alan & Brewer, Thomas "*Oxford handbook of International Business*" p. 596

[34] Gupta, Sayantan, "*'Transfer pricing' – an international issue…"* p. 45

[35] Rugmand, Alan & Brewer, Thomas "*Oxford handbook of International Business*" p. 596

[36] Rugmand, Alan & Brewer, Thomas "*Oxford handbook of International Business*" p. 594

[37] Rugmand, Alan & Brewer, Thomas "*Oxford handbook of International Business*" p. 596

prices set for internal reasons but since the transaction is crossing states' borders the transfer price is also necessary for the tax authorities' calculation of border taxes and corporate income taxation. The state has the possibility to influence the transfer price.[38]

2.3 Transfer pricing

OECD defines Transfer Pricing as a phenomenon: "a transfer of something of value (e.g. assets) and/or the determination or substantial renegotiation of existing commercial arrangements within an MNE group".[39]

Transfer pricing is a well-known taxation issue and most MNE in the world use it. Just a couple of decades ago it was a term mainly used by a few international taxation specialists. NGOs and IGOs took it to a public debate when realising that this method was a way for MNE to choose when they were deciding where they wished to report their profit. The transfer of profits, via transfer pricing, has a great impact on the taxable income in each state where the MNE is operating. Different tax rates lead to jurisdictional conflicts when two states claimed taxation right over a MNE that had transferred profit from the high tax state to the low tax state.[40]

The problematic issue arises when MNE use this pricing mechanism to manipulate the price charged on intra-group cross-border transaction to avoid taxation. The effect of a manipulated TP is that it produces a disproportionally taxable income in the state with lower corporate taxation.[41] *Transfer pricing manipulation* – is the correct term when MNE over- or under-invoicing goods to avoid taxation in a state. They can put a lower price, under-invoicing, to avoid a value-added tax (VAT)[42]. Transfer pricing is necessary for MNE's internal resource allocation, but it is the manipulations of these prices that complicate the taxation issue. [43]

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[38] Rugmand, Alan & Brewer, Thomas "*Oxford handbook of International Business*" p. 597

[39] OECD, "*About Transfer Pricing*"

[40] Rugmand, Alan & Brewer, Thomas "*Oxford handbook of International Business*" p. 598

[41] Gupta, S " *'Transfer pricing' – an international taxation issue…"* p. 40-41

[42] VAT, is a form of consumption tax imposed on the time of the transaction. Tax rate is levied on the purchase price. See 'Economy Watch'

[43] Rugmand, Alan & Brewer, Thomas "*Oxford handbook of International Business*" p. 594

When subsidiaries within the same MNE exchange goods it is referred to as a "controlled transaction". It means that the transaction is not subject to the same market forces as if the companies were not connected to each other.[44] Already in 1985 Eden argued that TP is the result of differences in corporate income taxation and noted that MNE sees the differences as "exogenous market imperfections that can be arbitraged through tax avoidance strategies"[45].

2.3.1 Transfer Pricing Mechanisms

When deciding on a transfer price, the price has to be within 'arm's length', i.e. the same price that would have been set between two independent enterprises. First of all the MNE must find a comparable asset whose selling price can be used as a pricing indicator for the company. Two different methods can be used when searching for an asset that will help the MNE to set their transfer price. The first method is called "*external comparable*" and the arm's length price is found when two parties, completely unrelated to the MNE, sets a price on a transaction similar to the internal transaction in question.[46] The second type is called "*internal comparable*" and use the price set on a similar asset by a unit within the MNE and an unrelated party. The price, already accepted by the MNE once, can later be used as an indicator on an internal transaction under comparable circumstances. It can be difficult to find an external comparable asset and then the MNE can turn to the pricing they found acceptable when trading with a third party in a previous situation. Once an internal or external asset has been identified the MNE will use a TP method to establish the price.

The OECD-states have since the mid-1990s gradually been accepting different TP mechanisms. These mechanisms are different ways a MNE can choose when pricing their internal transactions. When these mechanisms spread and become more accepted, it becomes easier for tax authorities to know what to look for when searching for a mispriced asset. The mechanisms can be divided into two main categories, transaction- and transactional-profit-based mechanisms, each with its own subcategories.

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[44] OECD, "About Transfer Pricing"

[45] Rugmand, Alan & Brewer, Thomas "*Oxford handbook of International Business*" p. 592

[46] Rugmand, Alan & Brewer, Thomas "*Oxford handbook of International Business*" p. 603

MNE 'seller-unit' MNE 'buyer-unit' Independent Enterprise

2.3.1.1 Transaction-based methods

The transaction-based method is considered to be the 'old' or 'traditional' mechanism since it focuses on finding a price on the asset that shall be transferred. This method is divided into three subcategories.[47]

The *comparable uncontrolled price* (CUP) is the first and oldest subcategory. CUP is based on finding a *comparable product* purchased by unrelated companies that the MNE then can use to price their own asset when doing a transaction internally. CUP focuses on comparing the products sold under similar circumstances. Sometime there are not any comparable products available or they are not being sold under similar circumstances so the CUP method cannot be used. Then MNE can use two other methods within the transaction-based method.[48]

The *resale price method* (RPM) focus on finding a comparable company that is in its function comparable to the combined "buyer" and "seller-unit" of the MNE. The basic idea is that if comparable companies have similar function, they also have similar margins (returns). The MNE gets the transfer price by reducing a 'resale price margin' from the given retail price sold to third party. This gives the 'buyer-unit' of the MNE the arm's length return, while the 'seller-unit' of the MNE only gets its costs covered. Since this transfer price is one-sided and only based on the return the buyer will get, all excess profit will go to the manufacturer and the method has often a tendency overestimating the transfer price.[49]

	TP € 75	(Margin 25 %)	Price €100
Given resale price		€ 100	
Resale price margin (25%)		-€ 25 → Arm's Length return	
Transfer Price		€ 75	

The *cost plus method* (C+) is the second functional comparable method. This method focuses on the suppliers' side of the transfer. First, the cost of production is determined and compared to similar manufacturers'

[47] Rugmand, Alan & Brewer, Thomas "*Oxford handbook of International Business*" p. 604

[48] OECD, "*Transfer Pricing Guidelines…*" p. 24 also King, Elisabeth "*Transfer Pricing and Corporate Taxation*", p. 22-23

[49] OECD, "*Transfer Pricing Guidelines…*" p. 25-26 also King, Elisabeth "*Transfer Pricing and Corporate Taxation*" p. 17-20

production set-up. A small profit, estimated from similar manufactures' profit, is added to get to the transfer price paid by the buyer-unit. The method is also a one-sided method that will give all unallocated profit to the buyer-unit and therefore tends to underestimate the price. [50]

2.3.1.2 Transactional-Profit-based methods

Until 1995 it was only the traditional transaction-based method that was accepted by the OECD-states. The lack of arm's length comparables led to that MNE started to use other methods when pricing their assets. When pricing intellectual property there were not any comparable goods to compare with and no manufactures existed so the transaction-based method became useless. American companies started to transfer intellectual property to subsidiaries in other countries to keep the income untaxed by the American government. This resulted in two different pricing methods that focus on the profit being made.[51]

The American tax authority introduced the *comparable profit method* (CPM) in 1992. In 1995 the OECD made some small modifications to the method and named it the *transnational net margin method* (TNMM). The basic idea is the same and focus on comparing the overall result with a company preforming the same type of business. The difference between the two models is that CPM is based on finding a comparable enterprise and then finding a transaction that is comparable to the MNE's internal transaction. TNMM focus directly on finding a comparable transaction.[52]

The *profit split method* (PSM) does not focus on comparing transaction with other enterprises. Instead, the idea is that the profit shall be divided between the units of an internal transaction. There are different ways on how to decide on the size of each share. This method was criticised as not taking external nor internal comparables into account. The comparable part of finding a transfer price is the foundation of the arm's length standard.[53] The method can either be used via 'residual analysis' or 'contribution analysis'. The residual analysis is divided into two steps. The first step allocates

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[50] OECD, "*Transfer Pricing Guidelines…*" p. 29-30

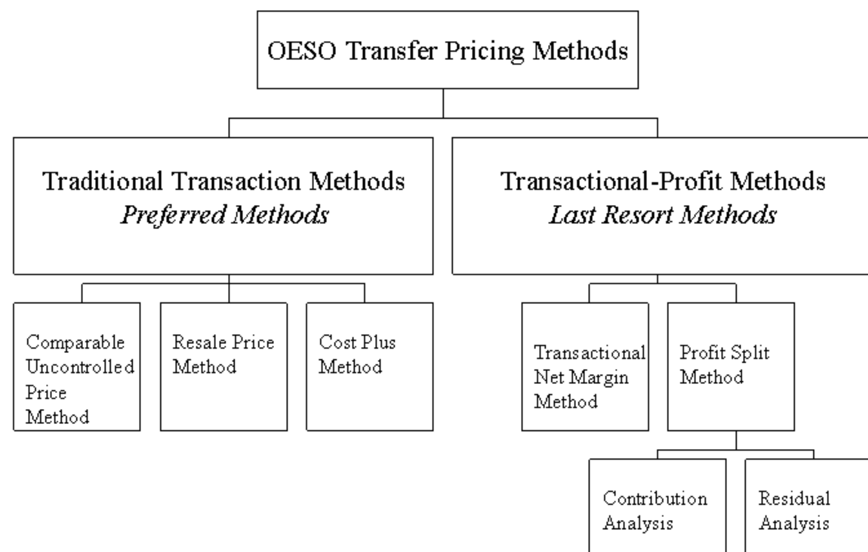
[51] Rugmand, Alan & Brewer, Thomas "*Oxford handbook of International Business*" p. 608

[52] OECD, "*Transfer Pricing Guidelines…"* p. 33-35 also King, Elisabeth "*Transfer Pricing and Corporate Taxation"* p. 11-15

[53] OECD, "*Transfer Pricing Guidelines…"* p. 43-44

compensation for non-unique cost that each part contributed with in this controlled transaction. In the second step is to allocate the profit based on an analysis of the contribution of each part. The other method referred to as contribution analysis divide the profit between the parties based on an approximation of what independent enterprises would have expected to receive in a similar transaction.[54]

Transfer Pricing Methods:



Source; [55]

2.4 Cases

This section contains presentation of three tax avoidance cases. The ’Starbucks’-case and the ‘Amazon’-case both deal with developed states that have transparent tax systems. The third case concerns the British food company, Associated British Foods’ subsidiary in Zambia, Zambia Sugar Plc. Zambia moved from being classified as a low-income to a lower-middle-income state last year. It should be noted that that this classification is not based on the increased income of the population but the state’s overall increased income.[56] Tax avoidance is better documented in the developed

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[54] OECD, “*Transfer Pricing Guidelines…”* p. 46 also King, Elisabeth ”*Transfer Pricing and Corporate Taxation”* p. 29-31

[55] Tax Consultants International

[56] ActionAid, ”*Sweet Nothings*” p. 1

states, but there is no reason to believe that it is less widespread in the developing world only because the lack of documentation.[57]

2.4.1 Starbucks

In October 2012 Reuters published a special report on Starbucks Coffee Company group's taxation in the United Kingdom. The company has been under scrutiny since Reuters published the article but there has never been any suggestion that Starbucks has violated any laws or used any illegal methods. The article resulted in customers protesting and demanding countermeasures by the tax authority.

The article sheds light on the complicated situation where a MNE has the possibility to use legal mechanisms to avoid taxation in the state where the gross margin is being made. For the last 15 years that Starbucks has been in the United Kingdom they have opened more than 735 outlets and sold coffee for more that 3 billion pounds, but only paid 8,6 millions pounds in tax in the United Kingdom. These numbers alerted Reuters and therefore they decided to examine how this was possible and where the regulatory gaps are.

Starbucks has used three main activities to combined create a slightly higher inter-price than necessary and this made it possible for the subsidiary to become a more or less a non-profitable company in the United Kingdom.

The first method used by Starbucks is by using royalties on intellectual property. The brand and the business process are categorized as 'intellectual property' and owned by *Starbucks Coffee EMEA BV* situated in Amsterdam. By charging its subsidiaries a royalty fee of six percent of total sales, they reduced the taxable income in the United Kingdom. To be able to deduct these fees in the United Kingdom Starbucks had to show that the price were set at 'arm's length'. According to Stella Amiss, tax partner with accountancy firm PwC, a MNE can charge its subsidiaries a royalty-fee of six percent if they can show it is essential for the subsidiaries profitability. Since the subsidiaries have reported losses each year, she believes this percentage might be considered too high.

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[57] ActionAid, "*Sweet Nothings*" p. 2

The second method Starbucks used to move profits was through the transfer price on coffee beans. A Switzerland-based subsidiary buy the coffee beans that subsequently are bought and used by units in the United Kingdom. Before the beans reach the United Kingdom, they pass through another Starbucks subsidiary in Amsterdam that roasts the beans before they are finally moved on to the subsidiaries. This process makes the beans very expensive for the Starbucks units. How much the beans cost when they bought from the Swiss-based subsidiary is not known, but it is clear that the Dutch unit only reported a profit that reflected one percent of total annual turnover. During this period the Netherlands and the United Kingdom had 25 respectively 24 percent corporate taxation on reported profits. Meanwhile Switzerland had a tax rate as low as five percent on profits linked to international trade.

A third way of cutting taxation responsibility was made via inter-company loans. This is a common technique to transfer money since it brings double tax benefits for MNE. The subsidiaries that borrow money to start a new Starbucks unit are allowed to deduct the interest they pay against any taxable income. The unit that lends out the money is then situated in a state that does not tax interest income. Starbucks does not give their subsidiaries beneficial interest rates, but the higher interest the subsidiaries have to pay, the larger amount of profit can be deducted against the profit to avoid taxations.[58]

2.4.2 Amazon

As a follow up to Reuters' inspection of Starbucks, they published a special report on the international book-selling company Amazon.

Amazon is an online retailer that chose to establish the logistic headquarter in Luxemburg in 2005. This arrangement resulted in that 25 of Amazon units situated in six European states, deprived tax authorities of tax revenues. Via inter-company payments, the MNE transferred profits to avoid taxation in both European countries and the United States.

The American company started their first subsidiaries in the United Kingdom and Germany in 1998 and in France in 2000. In the beginning, the

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[58] Reuters, "*Special Report: How Starbucks avoids UK taxes*"

units' worked independently and not even negations with suppliers were made with a combined effort.

The unit in the United Kingdom changed their principal activity from "marketing and selling of books via the Internet" to "provision of services to other group undertakings" and the consumers buying books on amazon.co.uk where now doing business with the American units based in Delaware. The European units became 'fulfilment units' that only distributed packages and handled customer services and the profits were shifted to the American unit. The American unit on the other hand had reported losses since 1995 and the European profits was put against these losses. This resulted in Amazon not having to pay any taxes on the overseas profits.

In 2003 the American unit started to make more money and profits that were brought from the European units was taxed with a high rate. Amazon then turned to Luxemburg that offered advantages to the MNE as being part of the European Union and also offering low tax rates. At the time, Luxemburg had a corporate income tax rate at 29 percent. Under specific conditions did the tax authority exempt 80 percent of the income earned through intellectual property from taxation. This resulted to the effective tax rate for Amazon dropped to below six percent.

In 2004 Amazon shifted some of its operations in the United States to Luxemburg where they established three units. The first, Amazon Services Europe SARL, controlled the contract with third parties and was liable for taxation. The second, Amazon Europe Holding Technologies, purpose was "to acquire (…) any intellectual property rights, patents, and trademarks licenses and generally to hold, to license the right to use it solely to one of its direct or indirect wholly owned subsidiaries". This company was a type of limited partnership that is exempt from income taxes in Luxemburg. The third company, Amazon EU SARL, was to become the supplier of goods and services within Europe and liable for tax.

Amazon EU SARL then paid a fee to Amazon Europe Holding Technologies for the use of Amazon technology. The only problem was the fact that Amazon Europe Holding Technologies did not have a technology to license out, since Amazon Technologies Inc. in Nevada owned this right. The inter-company deal that solved this issue has not been made public yet.

Company accounts show that Amazon Europe Holding Technologies received up to 583 million euros from the European subsidiaries, while paying Amazon Technologies Inc. 230 million euros each year.

Since 2005 Amazon Europe Holding Technologies has started to lend money to Amazon EU SARL in order to fund international expansion. The received interest on the loans has been estimated to 45 million euros and income of interest stays untaxed in Luxemburg.

In October 2011 Amazon revealed that the Internal Revenue Service (IRS) has demanded 1.5 billion dollars for unpaid taxes. Neither part has disclosed the reason for the demand but Amazon referred to the charges being linked to "transfer pricing with our foreign subsidiaries since 2005".[59]

2.4.3 Zambia Sugar

In February 2013 the non-governmental organisation ActionAid published a report of how the British-owned food-company, the Associated British Foods group (ABF), effectively avoided taxation through tax havens and tax concessions awarded by governments. ABF is one of the world's largest multinational food companies that own brands such as Twinings, Silver Spoon sugar and Kingsmill bread. This report focused on the Zambian subsidiary, Zambia Sugar Plc.

ABF acquired Illovo sugar group and in 2007 ABF launched the subsidiary Zambia Sugar Plc. According to ActionAid's calculations Zambia has lost approximately $ 17.7 millions in tax revenue since then. This has been done through financial engineering and payments into tax haven sister companies in Ireland and Mauritius. Even though the corporate tax level is 35 percent in Zambia, Zambia Sugar Plc. has managed to only pay 0.5 percent of its profits since 2007 and during the period from 2008 to 2010 not any tax at all. To make this possible ActionAid recognised four different strategies to remove taxable profit in Zambia.

Firstly, Zambia Sugar has paid its sister company in Ireland large amounts for 'purchasing and management'-fees and similar payments for 'export agency'-fees to its sister company in Mauritius. Not any of the two sister

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[59] Reuters, "*Special Report: Amazon's billion-dollar tax shield*"

companies have any permanent employees at the offices and which services Zambia Sugar gets in return for their payments is still unclear.

Secondly, Zambia Sugar has loaned money from South African and US commercial banks to expand the sugar industry in southern Zambia. Zambia Sugar makes their payment through a bank account held by an Irish company even if there is a possibility to make direct payment to the bank. This way of doing business is sometimes referred to as 'Treaty shopping'. The company take advantage of the treaty that exists between Zambia and Ireland that prevents the tax authority to impose tax rate on interest payments of loans.

Thirdly, Zambia Sugar shift profits to the parent company, almost tax-free, through a range of holding companies in Ireland, Mauritius and the Netherlands. When ABF reallocated the ownership of Zambia Sugar into holding companies in these states, they use tax treaty loopholes and the tax haven state that do not tax dividend payments.

Fourthly, Zambia Sugar has been able to exploit two different tax breaks given by the Zambian government. In 2007 the company took the Zambian Revenue Authority to court and got the right to classify their profits as 'farming income'. Three-quarters of their income originates from industrial sugar manufacture, but by being allowed to classify it all as 'farming income' they were allowed to reduce their tax rate from 35 percent to 15 percent. In 2012 the Zambian government reduced the farming tax to 10 percent, which gave Zambian Sugar even further tax relief. The other tax relief enjoyed by Zambian Sugar regard the expansion of factories. The Zambian Revenue Authority granted tax breaks for cost when expanding factories in Zambia to attract foreign investment.[60]

None of these actions are illegal in any state and Zambian Sugar has merely used the system being presented to them on the cost of citizens of Zambia.

2.5 Analysis

First of all one have to bear in mind that the problems associated with transfer pricing are relatively 'good' problems. The mere fact that MNEs

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[60] ActionAid, *"Sweet Nothings"* p. 1-4

contribute to the circulation of money results in that more individuals can use them and this is beneficial for both the community and the state. By using TP the MNEs do not hide assets through tax evasion but rather respects that tax should be paid. The problems that arise are not based on violation of human rights or national legislation, but on the MNEs choice to put their own interest above the states'. At a first glance the MNEs way of acting are not considered to be problematic since it should be within everyone's right to act for their own benefit. The problem, however, arises when MNEs try to prevent states to carry out its right to demand tax revenues. The fact that the benefits of MNEs' presence outweigh the disadvantages might be one of the reasons why states are not complaining more.

When MNEs reallocate assets, transfer pricing is a necessary tool to use in order to make a 'fair' distribution of profit. The MNEs, and not an objective organ, set the transfer price and it gives them a freedom to decide where they wish to report their profit. Tax authorities then examine if the transfer price is within ALP. If an objective organ were to determine the price from the start, states would perhaps get a more accurate pricing to evaluate.

The TP principle worked fairly well when mainly material assets where transferred between units. It ensured that the workers got paid and the developing state got some share of the profit. Today "new non-materials" assets enter the international market and MNE faces difficulties when pricing them. Non-materials such as intellectual property, loans, service and management do not have a fixed and defined price and comparable assets are hard to find. When 'new' resources enter the market, new methods to find ALP are developed. More methods increases the possibility for MNEs to manipulate a method and find a transfer price within ALP concept that is suitable for them.

By overestimating non-material assets MNEs can transfer profits to a subsidiary situated in a state with low corporate tax without the risk to violate any regulation. We could see in the Starbucks and Amazon cases how easy and openly they transferred profits between some of the more elaborated legal system in the world without any difficulty.

Developing and developed states both need MNEs to continue their economic growth, but both lose out on revenues when MNEs transfer

profits. Even if states are equal in a legal sense, they do not have equal possibility to implement regulation. There are difficulties for implementations, especially for developing states that lack experience in order to carry out an effective tax administration.

Developed states do not need MNEs to the same extent as developing states and therefore are they in a better position when negotiating with MNEs for a fair taxation. The competition between states also affects developing states more since they have problems in obtaining comparable information from others states in similar situations. Only the MNE knows the offered tax rates offered by other states and the negotiating state becomes the underdog. One cannot blame the MNE for wanting a better position, one rather has to go back and reflect on why they have been given this freedom in the first place.

The main problem is that MNEs are allowed to control where they wish to report their profit. It results in that the MNE gets the ability to offer states small taxable profits if given low tax rates, which is of course better than nothing. When given the freedom to negotiate with states, MNEs have created a competitive situation for states that forces the states to lower their tax rates.

When limiting the regulation to ALP, states also limit the possibility to regulate the company outside the principle. Every MNE have the same possibility as Amazon, Starbucks and Zambia Sugar to transfer profits to low tax states, but not every MNE chooses to avoid taxes. The ALP is not an obstacle for MNEs who wishes to avoid taxation and it is rather to be considered as a tool to set a fair transfer price, not a mechanism to control the transfer of profit.

3 International recognition of Transfer Pricing

3.1 International Tax regime

According to Professor Lorraine Eden there are three parts that have been important in the development process of international taxation and she predicts that they also will be important for the future development.[61] The first part is *globalisation* that helps MNE to function throughout the world. The globalisation is difficult to control and both MNE and states need to adapt to this fast growing development. The second driving force is, according to Eden, *Internet*. It creates the possibility for consumers in one state to buy goods from a company in a second state that in turn store its goods in a third state. This can even be done without external costs or time-consuming processes. The third part she recognises as a driving force in international taxation is *regionalisation.* Both the European Union (EU) and North American Free Trade Agreement (NAFTA) want to strengthen the MNEs since they are necessary for the regions development. To strengthen the MNEs position the MNEs need a clear regulatory framework so they know what is expected of them. It is important to get the regions to develop regulations for guidance otherwise the international disputes might increase.[62]

To get national tax regulations cohesive with other states regulation it is important to have a transparent tax system without loopholes. One step towards cohesive tax regulations for states and regional organisations is to adopt guidance from international organisations. A useful international tax regime provides regulations for behaviour, presents information on the international market, formalises dispute settlement mechanisms and set out principles, implicit or explicit, that various actors' expectations are jointed around.[63]

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[61] Rugmand, Alan & Brewer, Thomas "*Oxford handbook of International Business*" p. 615

[62] Rugmand, Alan & Brewer, Thomas "*Oxford handbook of International Business*" p. 615

[63] Rugmand, Alan & Brewer, Thomas "*Oxford handbook of International Business*" p. 598

The regime today is a combination of bilateral tax treaties (BTT), guidelines by the OECD and the UN. Many of states that are part of OECD have signed BTTs on tax bases[64], transfer pricing mechanisms and how to handle international dispute settlements procedures. OECD has played an important role when it relates to the development of cohesion of national tax legislations even though their guidelines are of course not legally binding for the states.

3.1.1 Connection to the State

OECD suggests that states with a connection, referred to as *nexus*, to the MNE should have a right to demand tax revenues from the MNE. This principle differs from the more common *source* and *residence* principles used to tax individuals. The *source* principle states that a country has the right to tax a company if the income has arisen within the states jurisdiction. Each establishment is looked upon as an individual legal entity with individual profit and taxed without considerations towards the parent company. Other states use the *residence* principle that gives them the right to tax entities that have a permanent residence in the jurisdiction. The interpretations vary and some states consider a company as residence if any part of the company is incorporated in the jurisdiction, while others determine company-residence as where the 'location of management' is seated. If a state adapts the residence principle they can either tax domestic income, worldwide income or a combination of the two. Depending on which method is used by the states, there is a direct risk that the use of different principles in different states will result in double taxation for the MNEs income. [65]

The OECD guideline suggests a combination of the two principles where the 'source nation' has the primary right to tax profit while the 'residence nation' has the primary right to tax other kinds of income. Since the residence nation tax the MNE after the source nation, they also have the responsibility to remove any regulation that would lead to double taxation of the MNE. Deduce the tax for the MNE's 'foreign income taxes' is a common way to get around the problem of double taxation. This results in almost every OECD-state using the same method; each state first tax the

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[64] Tax base, the measure made of assets used to determine tax liability. See 'Accounting Tools'

[65] Rugmand, Alan & Brewer, Thomas "*Oxford handbook of International Business*" p. 600

domestic source income for non-residents and then the worldwide income for resident.[66]

3.2 Transfer Pricing Guidelines

Within the international tax regime it is the Organisation for Economic Co-operation and Development (OECD) that has taken on the responsibility to develop guidance for TP. The OECD council approved the first general guideline for multinationals in 1976 and the first specific TP guidance in 1995. The area is quickly changing and in 2005 the committee of Fiscal Affairs (CFA) of the OECD started an undertaking to develop the specific guidance for MNEs and governments on how to handle TP. The business community that participated in a public invitation for commentators[67] and the 'business advisory group' warmly greeted this action. OECD also released a discussion draft that contained contributions by variety organisations and OECD considered these when developing the guidance.[68] Already in 1979 OECD published a summary on inputs given by MNE on the first guidelines.

Since OECD and UN are not geographically limited their guidelines etc. on transfer pricing has generated much international attention. It is should be noted that regional bodies such as EU Joint Transfer Pricing Forum (EU JTPF)[69], Inter-American Centre of Tax Administration (CIAT)[70], African Tax Administration Forum (ATAF)[71] and the Study Group on Asian Tax Administration and Research (SGATAR) are all focusing on the TP-issue and developing internal guidelines for their region. Both the regional organisations and the UN are using OECD guidelines as basis when developing guidelines and on the 22nd of July 2010, the OECD council approved the new and improved '*Transfer Pricing Guidelines for Multinational Enterprises and Tax administrations'* (TPG). TPG is a

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[66] Rugmand, Alan & Brewer, Thomas "*Oxford handbook of International Business*" p. 600

[67] OECD, "*Public invitation for Commentators"*

[68] OECD, "*About Transfer Pricing"*

[69] EU Joint Transfer Pricing Forum

[70] Inter-American Center of Tax Administrations

[71] African Tax Administration Forum

composition of methods and analysis that can be used by MNEs and authorities when determining the arm's length principle.[72]

The OECD Committee on Fiscal Affairs has been the developer of these guidelines. CFA is a combination of senior tax officials from OECDs member states where a majority comes from the United States. The guidelines have therefore been influenced by the American taxation system, which can create contradictions when applied in legal systems that are not similar to the American system.[73]

3.2.1 Business inputs for the future

OECD published their first report on transfer pricing for multinationals in 1979. The critique of the first publication mainly concerned the taxation effects on shared costs within the MNE. The critics claimed that this might influence the MNEs future international investments. The critique was analysed by CFA and summarized in three categories that OECD was recommended to take into consideration. The critique had a strong impact on the development on existing guidelines.[74] If all of these concerns had been met at that time, some of the issues faced today might not have been as problematic as they are.

Firstly, the business community did not want there to be any difference in the evaluations performed by tax authorities in various states. For instance if the cost for a company car for an employee is considered to be a deductible cost from the company's taxable income in one state but not in another state, this might this be influential when deciding on where to invest. It is therefore important that every cost is treated equal in every state so the incentive to transfer a cost from one subsidiary to another disappears. If the evaluations of tax costs differ between states, it will be more difficult for MNE to establish foreign subsidiaries since they have to be aware of the tax regulation before establishment.[75] The OECD answered this critique by saying that in principle there are no differences and therefore it will not be considered as an obstacle for the MNE when establishing new

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[72] OECD, "*About Transfer Pricing*"

[73] Rugmand, Alan & Brewer, Thomas "*Oxford handbook of International Business*" p. 599

[74] CFA, *"Transfer Pricing and Multinational Enterprises"* p. 90

[75] CFA, *"Transfer Pricing and Multinational Enterprises"* p. 90

subsidiaries.[76] It has not become a substantial obstacle, but since no effort was made to reduce the differences of evaluating costs, MNE have turned it into a loophole. In all three cases presented above, we can note that lending subsidiaries are placed in states where income on interest is not being taxed.

Secondly, the MNE emphasised that the tax authority's responsibility should not be to question and investigate the distribution of the MNE resources. Their focus should be to evaluate the recourses that are within the authorities jurisdiction and not evaluate why the MNE has chosen to establish a subsidiary with certain functioning within the jurisdiction. This would not be questionable if it was a domestic company and should therefore not be an issue of discrimination for foreign companies.[77] The matter of discrimination was more of an issue some decades ago when foreign companies had difficulties to establish in some states. If a state had the possibility/obligation to evaluate the reason for establishment in their state today, the MNEs would not be able establish 'shell-companies' that only contain a bank account for tax purposes.

Thirdly, the business community expressed that common costs for the MNE group should be deductible in one of the states when calculating taxable profit since this would eliminate the risk of double taxation. OECD did however not believe that the problem of double taxation would disappear if one makes the group cost deducible in one state. OECD replied that unifying taxation into an international system would be too complicated since it would include combining national taxation systems.[78] To make cost contributions deducible worldwide might have been too complicated and the analysis done by OECD in 1979 was probably correct. We have however seen regional suggestions on this matter reappear in the last decade.[79] Perhaps such a regulation should first be on regional level for administrative reasons.

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[76] CFA, *"Transfer Pricing and Multinational Enterprises"* p. 91

[77] CFA, *"Transfer Pricing and Multinational Enterprises"* p. 91

[78] CFA, *"Transfer Pricing and Multinational Enterprises"* p. 93

[79] COM (2006) 824

3.3 Control Transfer Pricing

How to handle the issues concerning TP is an on-going debate and it is difficult to find a single method that would be functional worldwide and on any type of asset. The widely accepted principle of 'Arm's length price' is not perfect and some alternative methods are being promoted. These methods have however not been met without criticism and so far the arm's length principle is still the method used to decide on the transfer price, and in the foreseeable future, will be the base for taxation.

3.3.1 Issues of taxing Arm's Length Price

Article 9 of OECD's '*Articles of Model Convention with respect to taxes on income and on capital*'[80] is considered to be the basis for all bilateral agreements and treaties to avoid double taxation. Paragraph 1 is the foundation for the arm's length price (ALP). As part of OECD Model Convention this article is applicable to all OECD member states. Many MNEs are based in OECD member sates. The article got a broader impact when the United Nations (UN) adopted the article into United Nations' '*Model Double Taxation Convention between Developed and Developing Countries*', which made it applicable in all UN member states.[81] The ALP is the most important principle used today to solve the problems that comes as a result of TP.[82]

The arm's length principle requires that two related parties set the same price on an asset being transferred internally as the price being set on a similar asset between two unrelated companies. The approach to treat the entities of the MNE as two independent enterprises aims to give attention to the conditions of the transaction and not to the parties performing it.[83] The two entities are treated as two separate companies for tax purposes and this should be reflected in their transactions.[84]

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[80] Supplement A

[81] Supplement A

[82] Gupta, Sayantan, "*'Transfer pricing' – an international issue…"* p. 43

[83] OECD, "*Transfer Pricing Guidelines…"* p. 5

[84] Rugmand, Alan & Brewer, Thomas "*Oxford handbook of International Business*" p. 602

The main reason to use ALP is that it provides equality between units within a MNE and independent enterprises in the same state. If both the unit and the independent enterprise receive equal profit, when trading with foreign parties, both will be obliged to pay the same amount of tax and the companies will be on an equal level.[85] ALP have been used for a long time and has shown to be applicable in any tax system and on a vide range of assets. There have however been situations e.g. on certain highly specialised goods where the principle has shown to be complicated to apply. OECD has accepted various methods, such as the transactional profit split methods described in section 2.2.1.2, as guidance in those situations.[86]

3.3.1.1 Critique of ALP

During development of ALP the business community has become more global and specialized and different methods have been accepted to determine the transfer price for all various types of businesses. It has been necessary to make ALP applicable on a wide variety of assets, but when accepting all different methods, they have also opened up the possibility for MNE to choose which method they find the most suitable for their transaction. The transaction-based method and the profit-based method are easy to manipulate into wished pricing.[87]

The tax authorities tend not to evaluate the MNE's TP as if independent parties would have used that method, but merely evaluate if the documentation provided by the MNE is acceptable. The difficulty to find a comparable transaction in practice makes it hard for the tax authorities to determine a price at arm's length and it increases the risk that MNE manipulated the pricing into a whished pricing.

One of the biggest concerns when using ALP is to obtain information of similar transactions. Tax administrations can have difficulties collecting enough data on transactions between independent enterprises. This can be because of confidentiality reasons or lack of data on previous transactions.[88] Even if finding a similar transaction there is no guarantee that the set transfer price represents the value of the asset or the subsidiary's

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[85] OECD, "*Transfer Pricing Guidelines…*" p. 6 section 1.8

[86] OECD, "*Transfer Pricing Guidelines…*" p. 6 section 1.9

[87] Rugmand, Alan & Brewer, Thomas "*Oxford handbook of International Business*" p. 614

[88] OECD, "*Transfer Pricing Guidelines…*" p. 6-7 section 1.13

contribution of the transaction. It only proves that this transfer price was accepted before. No objective opinion is given on what represents a ‘fair’ price. The fact that two companies agree upon a price does not necessarily make it representative for the asset’s value in the company.

3.3.2 Advanced pricing agreements

An Advanced Pricing Agreement (APA) is an agreement extending over several years, between the taxpaying MNE and one or more taxation authorities. The parties agree on the tax criteria, such as method, comparable assets and critical assumptions for the years to come and this agreement, shall determine the taxation of internal transfers for the MNE.[89] The APA should be a complement to the ALP and the criteria agreed upon should be based on the principle. The aim is to provide a proactive and cooperative method to resolve transfer-pricing disputes. An APA eliminates uncertainty and reduces the cost associated with document preparation and transfer inspection for the tax authority.[90]

It is hard for the tax administration to make a fair judgement on what is arm’s lengths pricing and this alternative regulation to ALP offers an agreement where MNEs and states can agree on terms that satisfy both parties. States are however sometimes hesitant to sign these agreement since they are binding for some years to come. MNE have the upper hand when it comes to estimating how the unit in the state will develop in the future. If the tax authority disagrees with the APA after a couple of years, there is very little flexibility to change the taxation.[91] In some states are MNEs obliged to report any APAs they have signed to the tax authority and in some states does the authority publish the APAs they have signed with MNEs.[92]

APAs are well used in the business world but it is not a complete alternative to ALP since the agreement is built on the principle and estimations of the future ALP is done.

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[89] OECD, ”*Transfer Pricing Guidelines…”* p. 135 section 4.123

[90] OECD, ”*Transfer Pricing Guidelines…”* p. 173 section 4.142-4.144

[91] OECD, ”*Transfer Pricing Guidelines…”* p. 174 section 4.148

[92] IRS ”*Announcement and Report concerning Advanced Pricing Agreements*”

3.3.3 Global formulary apportionment

In its Transfer Pricing Guidelines the OECD presents an alternative taxation method when taxing MNE called the "*Global formulary apportionment*" (GFA). This method focuses on determining a proper level of profit in each jurisdiction where the MNE is active through a subsidiary. A predetermined and mechanistic formula would allocate the global profit to the various jurisdictions of the MNE.[93] MNE shall, according to this method of taxation, calculate each unit's share of a certain factor as a percentage of the worldwide sum of the same factor existing in the MNE. This percentage shall then be taken of the global profit made by the MNE that year and referred to as that unit's taxable profit in the jurisdiction where the unit is situated. Three requirements are necessary for this method to work. First of all the boundaries for the MNE needs to be determined and which units shall be taxed. Secondly, an estimation of the global profit needs to be made. Finally, there is a need to establish a formula that will determine how the global profit will be allocated between each unit.[94]

Advocates for this method claim that it would simplify the taxation process for the taxpayers since the authorities would no longer have to collect documentation on transfer pricing when reallocating assets. This formula would consider the MNE on a group-wide bases and the assets would be valued so they reflect the economic value in reality. It is, however, hard to separate out units from highly integrated groups when determining the units share of the MNE's groups profit as is done today with these separate accounting method in ALP.[95]

However, even if some regional taxing jurisdictions have attempted this approach it has not been given any international recognition by the OECD states. The method is criticised for being too complicated to implement in practice. There is no implementation method that would ensure single taxations at the same time as it gives protection for double taxation. The operation also requires an unrealistic level of cooperation between states that do not exist today. States would have disagreements on factors that

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[93] OECD, "*Transfer Pricing Guidelines…*" p. 7 section 1.16-1.17

[94] OECD, "*Transfer Pricing Guidelines…*" p. 7 section 1.17 also Rugmand, Alan & Brewer, Thomas "*Oxford handbook of International Business*" p. 614

[95] OECD, "*Transfer Pricing Guidelines…*" p. 8 section 1.19

determine the local units share. The critics claim this would create an incentive for states to create formulas that would give them maximized revenue to the state.[96]

A third critique is the concern that these predetermined formulas are not being cohesive with the market conditions and the MNE allocation of assets and profit might lack realistic interaction with the international market which will damage the individual unit of the MNE.[97]

OECD summarised the critique and states that the formula cannot "recognize important geographical differences, separate company efficiencies and other factors (…) in determining the division of profits between enterprises in different tax jurisdictions."[98]

There are difficulties with the implementation and a high level of cooperation is necessary. Today states have no incitement to cooperate, but one shall not underestimate states willingness to cooperate if if the result might be to increase revenues. If a specific tax rate is offered to a MNE, competing states can offer a more advantageous level for the company. As long as there is a situation where MNE are given the opportunity to create a situation where states are in competition, there will be an unwillingness to cooperate. This method would guarantee a situation where MNE cannot in a legal manner avoid taxation and the revenue would increase.

3.4 Analysis

The international recognition of TP issues consists of both agreements and guidelines. A BTT targets both MNEs and states when establishing specified conditions between the states. The international regime focuses in general on how TP shall function seen from an objective point of view and not on an agreement between specific parties.

OECD is a neutral organisation that does not focus their guidelines on a specific state or on a company. In the beginning, OECD paid more attention to states' rights and showed almost no interest in the MNEs' rights and

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[96] OECD, *"Transfer Pricing Guidelines…"* p. 8-9 section 1.21-1.24

[97] OECD, "*Transfer Pricing Guidelines…"* p. 9 section 1.25

[98] OECD, "*Transfer Pricing Guidelines…"* p. 10 section 1.29

functioning. During the development process of TPG OECD improved the exchange of information with the MNEs and asked for their point of view. It is crucial to consider both parts opinion if OECD wishes to reach a sustainable TP concept. If prioritising one part over the other a one-sided relationship might appear. It is not recommended to create a one-sided relationship when both parts need each other and each need should be priority for the other part. States can offer more transparent systems for MNE and also offer them information needed to develop their company. MNE on the other hand can offer tax revenues and job opportunities.

OECD has started to define major problems with ALP and has presented alternative methods. ALP is not ideal and it is a time- and cost consuming process. The tedious ALP process has shown not to prevent MNEs wishing to avoid taxation. APA is not an alternative since the agreement has to be in accordance with ALP. APA can be used no matter which regulation method that is used, but it is not recommended as the only regulation. The non-flexible nature of APA makes it complicated for parties if conditions change frequently. This method is not the solution for TP issues and will not prevent MNE from avoiding taxation. States will also not be in a better position when negation with MNEs. APA is not the final solution to the problem.

OECD also launched GFA as an alternative solution. Even if this regulation would result in a more ‘fair’ division of profits and it would be the states that had the upper hand in the negotiations, OECD also presented difficulties of implementation that might appear when using this method. The main critique is based on the states difficulty to cooperate. Perhaps this critique is more of a projection of the problems faced today rather than predictions of the implementation of GFA. Today states have little to gain of cooperating. If a state use ALP and reveals tax reliefs given to a MNE, other states will uses this information when negotiation with the MNE. The MNE might be offered a lower tax rate in one of the other states and move from the revealing state. If revealing tax rates within GFA stats have noting to loose since the MNEs do not determine where they want to pay tax. The willingness for states to cooperate might increase if participating in a less competitive market. Even though GFA is not likely to rule out ALP it is always good to be proactive and try to find solutions on future problems.

4 State Responsibilities

4.1 Transparency of the taxation system

OECD Secretary-General, Angel Gurria, has said; “As governments and their citizens are struggling to make ends meet, it is critical that all tax payers – private and corporate – pay their fair amount of taxes and trust the international tax system is transparent”. [99]

Citizens, private and corporate, rarely want to pay tax but all wish to take part in the benefits it brings. It is therefore within the state’s responsibility to create a tax system with transparency so that taxpayers know what is expected of them. Some states try to handle the issues of transfer pricing on their own by broadening the tax base, raising the tax rate on personal income or implement VAT on products leaving the state to minimize the tax revenue losses.[100]. The variety of tax regulation in states makes an international coordination for transparency very difficult.[101]

Independent organisations also assist states and MNE to create a more transparent system. Extractive Industries Transparency Initiative (EITI) is developed and overseen by an alliance of governments, investors, NGOs and MNEs. The organisation aims to set global standards for revenues originating from states’ natural resources and create transparency for both states and MNEs. So far 37 states are participating in this initiative by EITI.[102]

4.1.1 Importance of documentation

Transparency is important for MNE so they know what is expected of them and for tax authorities so they know what they can expect.[103] In most states it is the tax authorities task to do a satisfactory examination of the MNE businesses and determine the taxation level. It is up to the tax authorities to

[99] OCED Newsroom

[100] Gupta, Sayantan, ”*’Transfer pricing’ – an international issue…”* p. 43

[101] Cooper, Graeme ”*Tax Avoidance and the Rule of Law*” p. 2

[102] EITI, ”*Fact Sheet01*”

[103] Jeffery, Ramon J. ”*The Impact of State Sovereignty on Global Trade and…”* p. 739

collect all the necessary documentation from the MNE and other parties. If the MNE does not cooperate and provide the authorities with requested documentation, the burden of documentation will shift to the taxpaying unit. They will often be requested to pay a higher tax rate or a fee if they cannot provide sufficient documentation.[104] In other states the MNE has to disclose documentation that show evidence of correctly set transfer prices - even without the tax authorities demanding it. Even if the responsibility of information gathering shifts in different states, MNE will always be responsible for presenting documentation.[105]

When performing an internal transaction the arm's length pricing principle should be in focus and supported with documents. The documents and data used when the MNE sets the transfer price shall be saved for later scrutiny by the tax authority. It is not within the tax authority's responsibility to find an arm's length price and then compare it to the price set by the MNE. The tax authorities task is to evaluate whether the price already set is within the arm's length principle.[106] When preparing the pricing the MNE shall use the *"prudent business manage management principle"* which means they shall prepare documentation in relation to the proportion of the transaction. The company have also to present any factor that has been taken into account when setting the price.[107] In the evaluation by the tax authority they have to consider which information was available to the MNE when setting their transfer price. [108]

4.1.2 International Guidance for documentation

The Transfer Pricing Guidelines developed by OECD is referred to by most regional organisations. EU wanted to ensure that the requirements of documentation are considered by the MNE situated in the EU region so they developed the EU Transfer Pricing Documentation (EU TPD). The purpose of EU TPD is to provide information to the MNE and the tax administrations in the member states. It is also a guideline on which documents are expected from the company and what the administrators shall

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[104] OECD, "*Transfer Pricing Guidelines…"* section 5.2

[105] UN, "*Practical Manual on Transfer Pricing for Developing Countries"* section 3.6.1

[106] OECD, "*Transfer Pricing Guidelines…"* section 5.2

[107] OECD, "*Transfer Pricing Guidelines…"* section 5.4

[108] OECD, "*Transfer Pricing Guidelines…"* section 5.9

pay attention to when evaluating the taxation responsibility.[109] The creation of EU TPD was considered necessary since the national legislations were not always cohesive with OECD guidelines and this created confusion for middle and smaller MNE entering the international market.[110] The EU TPD is not only applicable to MNE situated within the region, but rather function as a complement to the OECD Guidelines. This guidance is developed as optional and will not be implemented via a directive.[111]

The Pacific Association of Tax Administrations (PATA), consisting of Japan, Canada, Australia and the United States, has also developed a combined regulation for concerning transfer pricing. This regulation is said to be optional and consistent with the OECD Guidelines. The regulation is a package of all four members national regulation regarding document requirements. Since it meets the national regulations on transfer pricing documentation the MNE has to regard it as national legislation and therefore in reality not optional.[112] There are three functioning principles that make up the core of the PATA Documentation Package.

Firstly, the MNE has to try to set a transfer price within the arm's length principle. This means they have to search for comparable transactions that are controlled by two separate companies.[113]

Secondly, the MNE needs to keep all documentation to verify that they have taken necessary steps to find a transfer price within the arm's length principle. The national tax authority shall evaluate this documentation when deciding on taxation level for that specific MNE. They shall also regard other relevant facts like the availability of relevant data and the importance and complexity of the issue.[114]

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[109] EU "*Report on the activities of the EU Joint Transfer Pricing…*" p. 22

[110] EU "*Report on the activities of the EU Joint Transfer Pricing…*" p. 6-7

[111] EU Council Resolution 2006/C 176/01

[112] PATA, "*Transfer Pricing Documentation Package*" section I

[113] PATA, "*Transfer Pricing Documentation Package*" section II.A.

[114] PATA, "*Transfer Pricing Documentation Package*" section II.B.

Thirdly, the MNE has an obligation to provide documentation to the requesting taxation authority if the transfer involves the jurisdiction of that authority.[115]

4.2 UN manual for Developing Countries

With the OECD Transfer Pricing Guidelines as inspiration, UN has published "*Practical Manual on Transfer Pricing for Developing Countries*". It aims to give a practical guidance for developing states when analysing transactions of MNE. It is important that the developing states get the information they need to handle tax issues that arises when companies do internal transaction. Without information of how to prepare national legislation there is a risk profits appear to be earned in a low tax jurisdiction instead. [116]

4.2.1 Practical Manual on Transfer Pricing

As 30 percent of the world trade is between related parties UN has defined transfer mispricing as a growing tax issue. Many of the transfers that are made between a developing state and a developed state, results often in an unfavourable position for the developing state.[117]

UN gives clear guidance on the documentation that should be demanded from the MNE and how to classify different documents that are required. Basic *enterprise-related* documents that give information about the owners and includes profiles that estimate the company sales shall be submitted when establishing a new corporation. *Transaction-specific* documents unveil information of similar, comparable international transactions and provide functional analyses of the enterprise when setting a transfer price. *Computation-related* documents that give detailed information of the reason for selecting the price, which method used, factors and assumptions that influenced the decision shall also be submitted by a MNE when performing an internal transaction.[118]

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[115] PATA, "*Transfer Pricing Documentation Package*" section II.C

[116] UN, "*Practical Manual on Transfer Pricing for Developing Countries*", Foreword

[117] UN, "*Practical Manual on Transfer Pricing for Developing Countries"* section 1.1.3

[118] UN, "*Practical Manual on Transfer Pricing for Developing Countries"* section 1.6.3

The guidance aim to give the developing states assistance on how to handle these issues, but also to give clear advices on which transfer pricing method should be used when transferring different assets. For intangibles with no comparables UN suggests the PSM or CUP method in order to find an arm's length price on these assets. When intra-group services are provided between subsidiaries the guidance suggest the CUP method if an external enterprise could provide the service or C+ method if there are no comparables.[119]

In the manual, UN stresses the fact that TP regimes should be part of domestic law. It is of importance that each state formulates or adapts their tax regulation so it is cohesive with international tax guidance and TP treaties.[120] UN do not state how implementation of the regulation should be done, but offers suggestions such as Controlled Foreign Corporation (CFC) rules or "Safe Harbour rules" to ease the process. CFC rules have been developed to prevent MNEs' use of foreign subsidiaries to avoid taxation. The domestic company is taxed on income of subsidiary units profit. States are usually not allowed to demand tax by companies established in other jurisdictions. This principle is different and if certain specific conditions are met, states can be allowed to tax subsidiaries in low tax jurisdiction.[121] Safe harbour rules exempts profits, that are within a specific range, as percentage of overall sales or under a certain amount, from ALP method. Instead the profit will be taxed with a specific rate and the MNE do not have to comply with the complex and expensive procedure surrounding the arm's length methodology. This type of regulation is a simplified mechanism that UN suggests for developing counties mainly because it provides predictability and ease for tax administrators. The UN believes safe harbour regulation would help in small-cases where there are difficulties to collect information. There is always a risk that the collection of analytical data is too extensive. The effort made by the tax authority to evaluate is not always in proportion to the controlled transaction.[122] It should, however, be noted that OECD discuss safe harbour regulation in their guidelines but do not suggest it as an alternative in developed states. The disadvantages, such as the high risk of double taxation, tax avoidance and difficulties to implement mutual

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[119] UN, "*Practical Manual on Transfer Pricing for Developing Countries"* section 1.6.6-9

[120] UN, "*Practical Manual on Transfer Pricing for Developing Countries"* section 1.7.2

[121] UN, "*Practical Manual on Transfer Pricing for Developing Countries"* section 1.7.8

[122] UN, "*Practical Manual on Transfer Pricing for Developing Countries"* section 3.8.3

agreements, weights heavier than the small amount tax revenues it will bring in rich states.[123]

UN has presented different methods to use when implementing TP regulations, regarding approaches and which effects they have on the national system. The tax regulation can either refer the burden of proof to the authorities or base it on a self-assessment system. The manual presents pros and cons of both approaches to help states find a way adapted to their system.[124]

4.2.2 Challenges in India

The UN practical manual gives presentations on four individual states: Brazil, China, South Africa and India. The presentations, which have been written by the states themselves, aim to present their experiences as information to readers. They do not represent the view of the UN Subcommittee.

India is a big country that offers a large labour force and attracts many manufacturing MNEs. They have used the arm's length principle since 2001 to control TP issues. India presents a timeline-issue that appears when collecting data. Even though the states believe that comparability analysis is the key to determine arm's length price, there are difficulties with the market volatility. The international markets volatility complicates and limits comparable assets since the price set two years ago is not necessarily the price that would have been set today.[125]

A second issue India faced when implementing ALP was the importance of risk assessment. The general consensus, that risk only can be controlled by the parent company and subsidiaries in India are exempted from the responsibility, is not correct according to the Indian transfer pricing administration. They mean the Indian subsidiaries exercise control over operational manufacture and other risks. Therefore, India believes subsidiaries should have the same right to returns on functions performed, including strategic decisions and control on risk related to their operation.[126]

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[123] OECD, ”*Transfer Pricing Guidelines…”* chapter IV

[124] UN, ”*Practical Manual on Transfer Pricing for Developing Countries”* section 3.2.4

[125] UN, ”*Practical Manual on Transfer Pricing for Developing Countries”* section 10.3.3

[126] UN, ”*Practical Manual on Transfer Pricing for Developing Countries”* section 10.3.4

Some complications appears when a state implement ALP and with these reports the states help each other towards a more transparent system where the roles are set by the states and not by the MNE.

4.3 Analysis

The responsibility to control TP issues lies upon the states. Neither states nor anyone else can legally demand higher tax revenues or responsibility from MNEs than what is legally required. It is within the states right and responsibility to legislate on matters within its jurisdiction.

In general, very few want to pay tax, but everyone wants to enjoy the benefits. If one company were to be exempted from taxation it would not inhibit the development. The governmental budget will not increase because one MNE chooses to transfer their profit out of the state. However, if every individual would be given the same possibility to transfer taxable income, the state would stagnate. Therefore the tax system has to be applicable to everyone and MNE should not be an exception. It is within the states interest to regulate MNE. States need to create a regulation that is transparent so that the MNEs know what is expected of them.

States also need to bear in mind the long-term effects tax avoidance has on the development of the state. They need to create a sustainable system strong enough for market volatility. MNEs might in the future request engineers, economists and other educated workforces. Today developing states welcome MNEs' demand of large labour forces but if the market change they will not have enough educated workforce and unemployment will increase. States have to be proactive in their actions and that include regulating MNEs.

It is important that states implement a clear regulation that demands qualified documentations from the MNEs. States should carefully note and evaluate the actions done by MNE and objectively review their transfers. States should also demand to have an open dialogue with the MNE and the other states the MNE is functioning in. If states open up to each other, MNEs would not be able to play the states against each other. If states openly work together in specific MNE-cases, both have an interest and both will benefit of more information.

5 Corporate responsibility

"There is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud".[127] – Milton Friedman 1963

5.1 Guidelines for MNE

The general guideline for MNE formulated by OECD is fund in "*OECD Guidelines for Multinational Enterprises*" and the 5th edition was published in 2011. Chapter XI that gives a general advice on how member states and MNE shall regard taxation.

OECD encourages companies to follow the spirit of national law and comply with the levels on taxations without negotiation. Companies shall not feel obliged to pay any excess tax for being multinational if not legally required. MNE are encouraged to treat tax compliance as an important factor in its management strategies so that tax risks can be identified and evaluated. The company shall have a clear awareness of the tax responsibility and evaluate their actions to comply with international and national regulations.[128]

OECD emphasises the importance of considering tax payment when doing a transaction. The underlying economic reasons for a transfer shall not be to modify tax payments. It is important that the company has solid documentation as a basis for the transfer even if the burden of documentation requirement and the tax relevance shall be balanced. Risk management, structures and policies shall all reflect the enterprises' commitment to tax compliance and law. MNEs shall actively develop strategies, concerning the entire enterprise. These policies on taxes shall handle internal tax controls so that the overall operating tax supervision is consistent with the views of the company's board of directors. With a solid

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[127] Rugmand, Alan & Brewer, Thomas "*Oxford handbook of International Business*" p. 597, Milton Friedman, as quoted in Vernon (1998:131)

[128] OECD, "*Guidelines for Multinational Enterprises*" p.60

risk strategy MNE will be able to avoid financial losses and reputation degradation.[129]

OECD considers transfer pricing to be of particular importance since it determines the tax bases' between counties. The arm's length price is considered to be the international used method to adjust profits.[130]

5.1.1 Investors guide

In May 2013 the international NGO ActionAid published an investor-guide regarding tax responsibility. They aim to assist companies when they wants to make taxation as one of their responsibilities. They list three steps companies should consider when implementing taxations in their policies.

Firstly, the MNE need a clear tax policy. They should identify risk management and what the company approach should be in negotiations with tax authorities and business partners. It is important to have a clear policy so every unit in the MNE chain knows how to relate to tax in their state. The policy should preferably be detailed and rule out aggressive tax practices.[131]

Secondly, the MNE need to take measures for implementation of the policy because without them the tax policy is of no use. The policy needs to be communicated and their employees need to be informed. Compliance mechanisms are suggested to simplify the procedure for the employees and provide a mechanism to identify measures that are not in compliance with the tax policy.[132]

Thirdly, the MNE need to publish reports of their tax responsibilities in the states where they are stationed. This is especially of importance since it shows if the company practice is in compliance with the policy.[133]

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[129] OECD, *"Guidelines for Multinational Enterprises"* p. 61

[130] OECD, *"Guidelines for Multinational Enterprises"* p. 62

[131] ActionAid "*Tax responsibilities – an investor guide"* p. 12

[132] ActionAid "*Tax responsibilities – an investor guide"* p. 13

[133] ActionAid "Tax responsibilities – an investor guide" p. 13

5.1.2 UN guidelines

UN launched the '*UN Global Compact'* in 2011 as a strategic policy initiative where businesses are asked to embrace universal principles. The Global Compact focuses on human rights, labour, environment and anti-corruption and how companies shall comply with the set goals.[134] Acts connected to these areas has been discussed frequently within the Global Compact but so far has taxation not been suggested as a responsibility for businesses.

UN has also published '*Transfer Pricing Manual for Developing Countries'* as guidance for developing states. The manual does not contain any specific guidance for MNE and how they shall comply with TP. They do, however, state that the manual is developed in consistency with the OECD TPG, which offers guidance for both state and MNEs.[135]

5.2 Social responsibility

The definition of MNE unveils that they are situated in more than one state and therefore subjected to more than one legal system. State A might have a different legal system than State B and the principle of sovereignty prohibits State B to create regulations that intrude on State A's jurisdiction. The regulation, in the developed State B, might be consistent with international legal recommendations regarding taxation, human rights and the use environmental hazard substances, while developing State A is struggling to get a functioning legal system. A problematic situation arises when a company from State B take advantage of the weaker legal system in state A to get a more profitable position. MNE have the possibility to use different legal systems that is suitable for them in different areas and this has created a debate regarding the MNEs' social responsibilities when functioning in several states.

According to Milton Friedman the only responsibility for MNE is to follow the national legislation.[136] Then again, one has to understand that the world

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[134] Global Compact, "*Overview of the UN Global Compact*"

[135] UN, "*Practical Manual on Transfer Pricing for Developing Countries"* Foreword

[136] Rugmand, Alan & Brewer, Thomas "*Oxford handbook of International Business*" p. 597, Milton Friedman, as quoted in Vernon (1998:131)

has changed and national law is no longer the only regulation companies have to comply with in order to be a good citizen. A step to widen the responsibility for the MNE as well as to exercise some pressure upon the MNE to pay fair amount of taxes is the development of CSR reporting.

5.2.1 Taxation and CSR

The term 'Corporate Social Responsibility' was introduced 1953 in the book '*Social Responsibilities of the businessman'* by R.H Bowen but did not come into use until the 1960's. It is important to recognize that even if academics, corporations and media all use the same term, CSR, as a generic name for the same phenomena, the functioning differs depending on which point of view they have.[137] Traditionally the CSR-focus has been on human rights, environmental sustainability and labour rights. Recently some debaters suggested that every act that influences the traditional areas, such as taxation, should be part of CSR.[138]

The European Commission published a new policy on corporate responsibility in 2011 where they give a new definition on the term CSR: "*the responsibility of enterprises for their impacts on society*".[139] Today CSR is a way for companies to manage their business and not only as a description of the responsibilities they have to comply with. When establishing a subsidiary in another state the MNE has to choose an approach that they will comply with. This approach has to include the domestic regulation as well as the CSR aspect of their activities. For instance, if accepting the workers human rights as an area within the responsibility of the company, it should not be limited to specific concerns like working conditions and payments. Instead, they should see the broader picture, accept responsibility, and pay a fair amount of tax to the tax authority. Tax revenues will in return build schools that educate the work force and hospitals that cure them. This means that the company has to balance the tax responsibility for those they have a responsibility for.[140]

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[137] Carroll, Archie B. "*Corporate Social Responsibility: Evolution of…*" p. 269 also Freeman, R. E. & Reed, D.L. "*Stockholders and Stakeholders: A new Perspective…"* p. 90

[138] Corporate Watch, "*The evolution of CSR*"

[139] EU COM (2011) 681 final, p. 6

[140] KPMG, "*Tax and Corporate Social Responsibility*" p. 11

Many of the CSR concerns are connected to commercial decisions such as choice of supplier or areas for establishment. As residents in a state the MNE is subject to national legislation and taxation is not an optional cost for companies or individuals. It cannot be compensated by charity work for the community. The obligation to pay tax is not negotiable, even though many states make agreements on taxation levels and which taxation regulations that should be applicable on particular companies.[141]

It should be noted that including taxation in the CSR would not demand any active action by the MNE. In fact, an acceptance of a taxation obligation would result in the company not putting recourses on tax avoidance and tax planning. The only responsibility would be to give confidence to the tax authorities ability to give a fair taxation level to the company.[142]

5.2.2 Expectations on tax in CSR

When including taxation as a CSR issue, it is important to give a clear indication on what is expected of the company. Even if the states are in control of taxation rates, there are still different actions a MNE can do to affect their tax liability.

Firstly, when a company decides on establishing in a state, there will often be a negotiation with the tax authority on taxation levels and how the regulation should be applicable to the MNE. A big and influential company will choose to establish where they believe it will be most profitable for them. MNEs have the possibility choose a state, but a state never has the possibility to choose MNEs to establish in their state. MNEs are therefore in a strong position when negotiating with the state. They have little to loose if the authority denies any tax relief but much to gain when keeping a strong position in a negation.[143] A MNE with a desire to comply with their CSR will have to exercise some restraint when negotiating with the authority. This would not be any different than MNEs restraining from the use of toxic chemicals or trying to convince the government to allow child labour. In many areas the MNE has accepted the fact that they should not use their power only because they can. Including taxation in CSR does not have to be

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[141] KPMG, *"Tax and Corporate Social Responsibility"* p. 14

[142] KPMG, *"Tax and Corporate Social Responsibility"* p. 14

[143] KPMG, *"Tax and Corporate Social Responsibility"* p. 26

complicated, since they only have to refrain using their economic 'muscles' against the state.[144]

Secondly, the companies choose if they want to avoid taxation or not. The tax planning procedure can be applied even if the MNE has been given tax advantages by a state. There risk is then that the government might withdraw the given benefit and this will not be profitable for the MNE. Even if it is not an illegal approach it might be frowned upon by the governments and the company might risk losing any tax relief given by the tax authority.[145] MNE are recommended to explain their position on tax avoidance in their CSR.

If MNEs are situated in developing or developed states the CSR-expectations are different. A developed state does not need to negotiate on taxation levels to the same extent as a developing state. They are therefore in a stronger position in a negotiation against the MNE. For a developing state other beneficial contributions from the MNE might outweigh tax revenues.[146]

5.3 Tax is not Corporate responsibility

The main critique of CSR as a concept regards the lack of obligation and the voluntary nature. There is no obligation for MNE to establish a CSR and those who do not wish to commit to responsibilities cannot be legally forced. It is therefore argued that CSR only attract those already enlighten.[147] The lack of obligation and follow-ups by independent organizations gives MNEs the freedom to promote their CSR as a marketing tool when associated with voluntary acts to create a better society.[148] The concept of CSR is therefore not a sustainable solution for the goal to reach a uniform tax responsibility for MNEs.

In many areas is it easier to show what a MNE does for the community or which chemicals they abstain from using. Today a variety of organisations

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[144] KPMG, *"Tax and Corporate Social Responsibility"* p. 29

[145] KPMG, "*Tax and Corporate Social Responsibility"* p. 26

[146] KPMG, "*Tax and Corporate Social Responsibility"* p. 26

[147] Corporate Watch, "*What's wrong with Corporate Social Responsibility?"* p. 11

[148] Corporate Watch, "*The arguments against CSR*"

have created procedures for companies to comply with when handing in their CSR report. Bodies like the Global Reporting Initiative[149], Social Accountability International[150] and the Institute of Social and Ethical Accountability International[151] have developed framework for reporting but since it is not a legal document there cannot be any sanctions for those who do not participate.[152]

If including taxation in CSR reports the assessor also have make a valuation of each subsidiary contribution to the MNE. Otherwise the assessor cannot determine if profit-transfers is considered as tax avoidance or commercially justified. The MNE could easily to give a clear motivation of establishing subsidiaries in low tax jurisdictions.

David Henderson, former head of the OECD (1984-1992) in Paris, wrote the book "Misguided Virtue: False Notions of Corporate Social Responsibility" in 2001. In the book he discusses whether or not MNEs' economic profitability shall be incorporated when assessing the companies ability to 'give back to society'. Henderson states that a definition of 'society' needs to be made before including it as a responsibility for the MNEs.[153] Through traditional CSR objects, such as human rights and environmental issues, MNEs give back to the community. Through taxation MNEs only contributes to the state. Some say that the state acts as a surrogate for the community since they have responsibilities to all citizens. A problematic situation arises when the priorities made by the government do not comply with the CSR of the MNE or even international human rights.[154] Therefore, it has to be determined to whom MNEs have responsibilities to – the state or the citizens? In most cases this might this not be a contradiction, but shall it be within the MNEs responsibility to ensure that their tax revenues do not end up financing a corrupt government that abuses the citizens? If the responsibility is towards the citizens in the community some MNE will

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[149] Global Reporting Initiative

[150] Social Accountability International

[151] Institute of Social and Ethical Accountability International

[152] KPMG, "*Tax and Corporate Social Responsibility*" p. 8

[153] Henderson, David "*Misguided Virtue: False Notions of…*" p. 157-158

[154] KPMG, *"Tax and Corporate Social Responsibility"* p. 12

claim they can do more good with charitable giving and specific welfare systems for employees and their families.[155]

CSR issues often result in a demand of 'fair' contribution by the MNE. There is however not a uniform definition on what is considered to be fair and this creates confusion. Who shall the company compare with to determine what a fair contribution should be? Companies in their home state, domestic or other foreign companies in the host state or should a separate determination be done based on their ability to contribute? Politics will play a role in determining the fair contribution by a MNE. Many left wing governments tend to promote higher taxation levels or have a wider taxation base. A MNE establishing in state A might have to pay lower taxation on profit, royalties and VAT but have pay higher salary to their workers since they have a high income tax. Many factors need to be taken into consideration when determining the fair contribution by the MNE.[156]

5.4 Analysis

MNEs have the responsibility to comply with national legislations and BTTs. By avoiding taxation they act within the legal sphere and are therefore complying with their legal obligations. Just because MNEs have the legal possibility to avoid taxation does not mean all of them take advantage of it. They are also allowed to cut down rain forests and use child labour sin some states but the moral obligation stops some MNEs to act unethical. As part of a state the population expect every member to contribute. Regarding the situation of Starbucks[157], they would not have gained this amount of profit if it were not established in a rich and developed state as the United Kingdom. MNEs need states and their citizens, but they do not always consider their responsibility to contribute. MNE needs their costumers and bad publicity can result in the loss of customers.

The social responsibilities should be based on actions taken to support the people or the environment. If MNE were to include taxation into CSR, there is a risk that it would also result in contradictions. Many developing states

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[155] KPMG, *"Tax and Corporate Social Responsibility"* p. 12

[156] KPMG, *"Tax and Corporate Social Responsibility"* p. 27

[157] Section 2.4.1

suffer from dictatorship and corruption and by paying more tax it might contribute to governmental abuse of the population. To determine if the tax revenue paid benefits the population or not, would be too much responsibility for MNE.

MNE are however encouraged by OECD to develop internal policies on taxation. Develop taxation policies similar to CSR would be beneficial not only for the state and consumer, but also for the MNE and its subsidiaries. It would give guidance on how the subsidiaries shall act. The problem with tax policies would be the same problems as faces CSR reports today. Only those who are already enlightened in the area will comply. Others might formulate the policy in a vague manner that would make tax avoidance possible. Even if not ideal solution, when creating a policy it would make MNEs reflect on their taxation responsibility.

MNEs main responsibility is towards their stockholders. They are expecting the MNE to act as profitable as possible within the legal boarders. Effective responsibility for MNE can only be enforced through regulating MNEs actions on a national level.

6 Conclusions

Tax avoidance is a problematic issue for states and their citizens. When profits are transferred from developing state to developed states, it misallocates the capital and profit distribution in the world. When not receiving tax revenues developing states experience difficulties to improve their society. They have fewer resources to educate the population, as they otherwise would have done. The state will consequently have problems to contribute with innovation and the globalisation process will be negatively impacted. The gaps between rich and poor states increases and this is damaging for everyone.

Even though developing states are suffering from tax avoidance, they are also in strongest need of MNEs. They need MNEs to expand and continue to help with the state's development. The tax revenues might be small, but it is still revenues they would not have received unless the MNE had established in the country.

A reason why the TP issues have been highlighted in the past decade might be since it has now started to hurt the developed states. With the Starbucks and Amazon examples, we could see how effectively they transferred profits between some of the world's most developed legal systems. Once the problem started to occur in developed states it got more attention in media. It resulted in dissatisfied customers and citizens. Developed states are also in a better position to enforce a change.

PT is today the mechanism used to control the split of profits. There are many problems with the methods and it has shown not to prevent MNEs who wants to avoid taxation. Therefore it cannot be regarded as a successful tool. It does contain a successful functions such as it ensures payment to workers in subsidies.

The problem with transfer pricing is that the governments has limited regulation to ALP. ALP has on the other hade become so wide that there is plenty of room for MNEs to find a suitable comparable asset. Governments have little possibility to make MNEs stop avoiding tax when using ALP. OECD have recognised ALP as the best solution for regulating the division

of profit. OECD also presents the alternative method GFA. With this method states gets better control of MNEs.

State has the responsibility to control MNE and therefore is it important that the regulation is clear and transparent. To create such a regulation the states need to share experiences, but most of all they need to collaborate. If one state creates a clear and firm regulation for MNEs situated within the state, the MNEs will move their business to another state. It is therefore of crucial importance that states work together and decide on similar regulation in every state. OECD states in their critique of GFA that the implementation of a common regulation would be too complicated and states have not jet shown the willingness to cooperate.

There have been suggestions that taxation should be included in a MNEs CSR. When avoiding tax in a state, it will ultimately hurt the citizens and therefore is it a matter for CSR. MNE shall regard every act and be aware of the consequences. The idea of CSR is that it shall start where the law stops. If there is no tax regulation, states shall declare a tax policy of their own. A tax policy would be a reasonable demand, but to include tax into CSR would be to give the MNEs to much responsibility. MNEs would have to defend establishment in corrupts states and be aware of how the government distribute tax revenues. It is a risk that the CSR becomes contradictory because of acts committed outside of the MNE's control.

A tax policy that shows how the board of directors relate to taxation could be a useful tool for the subsidiaries. The policy should not be too detailed nor contain specific acts that should be taken to comply with the policy. The creation of the policy would be voluntarily and too much responsibility might make MNEs hesitate. One shall not forget that MNEs' responsibility is to the stockholders. If they have nothing to gain, they are unlikely to commit to a policy.

In situations that lack regulation, it is important that every party take responsibility of their actions.

Supplement A

Article 9 – Associated enterprises

OECD adopted "*Articles of Model Convention with respect to taxes on income and on capital*" in January 2003 where article 9 concerns '*Associated Enterprises'*. This convention is applicable to all 34 OECD member states.

1. *Where:*
    a. *an enterprise of an Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or*
    b. *the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,*

    and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profit which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

2. *Where a Contracting State includes in the profits of an enterprise of that State – and taxes accordingly – profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are the profits which would have accrues to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which have been between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein those profits. In determining such adjustments, due regard shall be had to the other provisions of the Convention and the competent authorities of the Contracting State shall, if necessary, consult each other.*

In 2011 did the Department of Economic & social Affairs of United Nation adopt this article 9 and added a third paragraph in the United Nations "*Model Double Taxation Convention between Developed and Developing Countries*". This double taxation convention is applicable to all 193 UN member state.

3. *The provisions of paragraph 2 shall not apply where judicial, administrative or other legal proceedings have resulted in a final ruling that by actions giving rise to an adjustment of profits under paragraph 1, one of the enterprises concerned is liable to penalty with respect to fraud, gross negligence or wilful default.*

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