



# DAILY TAX REPORT



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## The Misrepresentation of ‘Transfer Pricing’ in the Mainstream Media

BY DANIEL FALK

**T**he term “transfer pricing” has not exactly been household jargon in the United States since the U.S. Treasury Department issued updated final regulations under Section 482 of the Internal Revenue Code in 1994.

Certainly before that, one would have been hard-pressed to find anyone outside the tax world who understood what the term referred to. But recently transfer pricing has appeared in articles that were published by several mainstream online business portals, such as Bloomberg, and these stories were then picked up by even more recognizable media sources, such as ABC News and *Business Week* magazine.

Normally such references would be regarded as positive—after all there is no such thing as bad publicity—to tax practitioners. However, the recent stories have not only misrepresented what the term transfer pricing refers to, but essentially implicate all multinational firms that engage in transfer pricing as being complicit in “nefarious” or “evil” tax avoidance schemes.

This in turn implicates transfer pricing economists and practitioners and their employers as complicit in these activities as well.

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This has most recently been exemplified by an article originally published by Bloomberg with regard to Google’s ability to achieve a 2.4 percent effective tax rate (ETR) as reported in recent regulatory filings.<sup>1</sup> The article describes how Google has organized its international operations and legal entity structure to allow it to essentially report most of the profits attributable to its European business operations in low-tax jurisdictions such as Ireland. Subsequently these profits end up in what are essentially tax-free jurisdictions like the Cayman Islands, where they remain indefinitely deferred from the U.S. tax net.

The article describes how Google uses “transfer pricing” to shift those profits to the low-tax jurisdictions. Only a passing reference is made to a “secret pact known as an Advanced Pricing Agreement” that Google entered into with the Internal Revenue Service in 2006 with regard to its transfer pricing practices.

Nowhere did the article mention what other factors may have allowed Google to arrive at this ETR that would normally be considered in the calculations of its tax provision. However, this is not an effort to defend or repudiate Google’s tax planning strategies.

Another article published in the Monroe, La., *News Star* takes a political stance against Republicans by im-

<sup>1</sup> “Google 2.4% Rate Shows How \$60 billion Lost to Tax Loopholes,” Bloomberg.com, October 2010.

plying that they have blocked attempts by the Democrats to close the “transfer pricing loophole.”<sup>2</sup>

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In the early 1990s, transfer pricing was also in the news. However, at that time the focus was on foreign-based multinationals not paying their fair share of income tax in the United States. Then-Gov. Clinton’s presidential campaign released the following statement: “While American taxpayers are working harder for less, huge multinational corporations with billions of dollars in U.S. sales are using accounting gimmicks to pay outrageously low U.S. taxes. Foreign controlled companies in the U.S. are avoiding paying their fair share of U.S. taxes by inflating costs through transfer pricing.”<sup>3</sup>

This debate also reached the popular press, including a segment on ABC’s *Primetime Live* in 1992.<sup>4</sup>

The distinction between the recent articles and those earlier reports is that the latter described how companies were engaging in abusive transfer pricing practices by improperly determining the value of the goods imported into the United States.<sup>5</sup> However, the earlier stories did not engage in the same level of hyperbole and at least implicitly acknowledged that there is a need and a place for transfer pricing. The current crop of reports do not clearly describe what transfer pricing really is, including how and why firms engage in transfer pricing practices, how it is regulated, and how it is enforced by the tax authorities around the world.

### **What Is Transfer Pricing?**

The most troubling aspect of the articles is what the stories do not say, rather than what they do say. Transfer pricing is depicted in a manner that makes it seem as if multinational corporations (MNCs) have a choice of whether to engage or not engage in transfer pricing. What is not mentioned is the fact that companies with overseas operations are required to engage in transfer pricing based on accounting principles, such as those adapted under U.S. generally accepted accounting principles, and tax rules and regulations, including the guidelines issued by the Organization for Economic Cooperation and Development, to which most countries

<sup>2</sup> “GOP: Everything But the Facts”, Monroe, La., *News Star*, Oct. 23, 2010.

<sup>3</sup> PR Newswire, Sept. 29, 1992.

<sup>4</sup> *Primetime Live: No Yen for Taxes* (ABC television broadcast, April 9, 1992).

<sup>5</sup> Interestingly, the transfer pricing controversy of the early 1990s came on the heels of the 1980s anti-dumping crusades, which railed against foreign competitors that were pricing their goods to low.

subscribe. Transfer pricing is a fact of life for multinational corporations with multiple legal entities around the world.

Finally, transfer pricing is the means by which related entities within a multinational corporation transact business with each other. This is why intercompany transfer pricing accounts for the majority of the world trade activity.

Thus, from the perspective of the modern MNC, transfer pricing in its most basic form is simply an accounting exercise. Accounting principles require that expenses be recorded where the corresponding revenues are generated. A simple example of this is if an MNC sells its wares in a particular location, logic would imply that the revenues for the sale should be recorded at the location where the sale is made, assuming that the expenses required to sell the products were incurred in that location. The complications arise when the functions attributable to the sale are not performed in the location where the sale is made. The situation is further complicated when functions, risks, and ownership of intellectual property are spread out in various geographic locations where the MNC has operations.

This is where transfer pricing as an economic concept begins to form. How then, should the various affiliates of an MNC be remunerated for their respective functions, risks, and ownership of intellectual property? Basic economic principles require that these factors attract the appropriate level of profits, which admittedly is where the waters get muddied.

### **Arm’s-Length Standard and APAs**

In an effort to un muddy the waters, governments have enacted tax regulations to ensure that companies remunerate the aforementioned affiliates in an appropriate manner. The concept that ties these various rules and regulations together is the arm’s-length standard (ALS).

This is where the recent stories fail the reader once again. Nowhere is it mentioned that companies engaging in transfer pricing are bound by rules and requirements and subject to significant tax authority scrutiny. The reader is left thinking that governments are just now becoming aware of the problem when in fact it has been debated, regulated, and enforced for many years.

MNCs spend significant resources to comply with the regulations, assess their risk, and defend challenges by the taxing authorities. Oftentimes, there are competing taxes, including withholding taxes, customs duties, and value-added taxes that result in additional revenue if transfer prices are lowered or raised. Thus, it is disingenuous to imply that companies are simply evading taxes at every turn by “manipulating” their transfer pricing practices. Moreover, it is inappropriate to state that companies are taking advantage of a transfer pricing “loophole.”

This is not to say that companies with significant resources cannot apply complicated tax planning strategies and in some cases push the envelope or even engage in questionable tax practices. However, because of the subjective nature of the economics surrounding intercompany transactions, transfer pricing rules can be difficult to regulate and enforce. This is why countries invest a significant amount of resources in transfer pricing regulation and enforcement.

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In order to encourage more cooperation in this area, many countries engage in advance pricing agreements (APAs) that allow the taxing authorities and MNCs to negotiate prices governing various transactions. The agreements can be between one affiliate and its respective taxing authority or between multiple parties. This is known as a multilateral APA.

While it is true that the results of an APA are confidential, it is again misleading to suggest that this “secret pact” is yet another way that MNCs use transfer pricing in an abusive way. APAs require full disclosure by the MNCs of information that would normally never be voluntarily shared with a taxing authority and the results of an APA can allow both the MNC and the taxing authority to apply their resources in more productive ways. And frankly, if a company succeeds in gaining an advantageous position in an open process of negotiations, is that really being “evil”?

### **Viable Alternatives?**

It is certainly true that the current system is not perfect. Critics claim that the arm’s-length standard is inappropriate because companies will set up a related party to avoid having to deal with an unrelated party. Thus, enforcing a standard that requires them to act as if they are dealing with an unrelated party is illogical.

Furthermore, the arm’s-length standard is so subjective that enforcing it is too difficult.

Be that as it may, other options are far less promising and this is a subject, again, the recent discussion of transfer pricing in the media fails to adequately address. That is, what are the viable alternatives?

Formulary apportionment is often touted as the alternative to the ALS. However, formulary apportionment brings its own issues as it is not clear that a formula based on the commonly used factors of sales, employment, and tangible assets can adequately measure the contribution to value.

In addition, the Section 482 regulations and the OECD guidelines already have profit-split methods at their disposal. Profit splits are used most predominantly in cases where arm’s-length methods do not yield a reliable result or as methods for resolving disputes and controversies. Tax court judges routinely request profit-split analyses to be performed by litigators in helping them in their decisionmaking process. Thus it seems that there already is a system in place that accounts for any shortcomings of the ALS.

The motivation for implementing aggressive transfer pricing strategies would presumably be to shift income from higher-tax jurisdictions to lower-tax jurisdictions. If doing so gives rise to effective tax rates which we deem to be “too low,” perhaps the responsibility lies with these countries’ domestic tax laws rather than with the method by which their profits are allocated. Or perhaps it lies with the fact that U.S. tax law allows domestic corporations to defer taxation on their international income until their profits are repatriated. Finally, while many countries that are the biggest trading partners of the United States have lowered their corporate tax rates, the U.S. rate has increased.

Transfer pricing is not a wicked or immoral device that companies only use to perpetrate tax abuses. It is a system companies use to account for and value their intercompany transactions and it should not, by itself, be held responsible for any and all shortcomings in domestic and international tax laws.