Editorial

Transfer pricing: The break-down of consensus

Fred C. de Hosson, Caron & Stevens/Baker & McKenzie, Amsterdam

The significance of the transfer pricing issue hardly requires any explanation. At present, one-third to one-half of trade between developed market economies consists of intra-firm trade of transnational corporations. Such enormous flows of goods and services can, of course, by means of even slight price changes, substantially influence the geographic allocation of income within the transnational corporation.

With regard to the applied allocation methods it is more important for the concerned countries to agree on a joint application of any method than to determine which method will involve the most perfect results. In the post-war period, the developed countries agreed for quite a number of years that the preferable method was the comparable uncontrolled price method. Only in the absence of comparable prices in the market could other methods be applied (resale price method, cost-plus method or any other method). The bilateral tax treaties, often based on the 1963 and 1977 OECD Model Tax Treaties, also reflected this consensus on the priority of the comparable uncontrolled price method.

Particularly in the previous decade, however, the United States became more and more dissatisfied with the results of the established methods. Initially, the attention focused on the transfer of intangibles from U.S. companies to subsidiaries in low-tax countries. The often unique nature of intangibles rendered it virtually impossible to find any exact comparable uncontrolled price, whilst it was difficult to apply the other methods mentioned above. In a significant number of cases, it was established in hindsight that the proposed transaction price had been too low. The frustration of the U.S. government led to a 'Superroyalty' provision, added by the 1986 Tax Reform Act to IRS Section 482. The provision introduced the 'commensurate with income standard' for the transfer of intangibles. The new standard and its application in practice have been explained in the White Paper, the meanwhile famous consultative document which appeared in 1988.

In the past few years, in anticipation of the regulations which will have to execute in detail the provision set forth in Section 482, the transfer pricing problems have gradually become the subject of broader attention in the United States. Indeed, the problems have even become a political issue. The front pages of popular newspapers report allegedly massive manipulations of the profits of U.S. establishments of foreign groups, which would consequently withdraw billions in tax revenues from the U.S. Treasury and would lead to unfair competition towards U.S. companies.

Upon detailed examination, these allegations are often based on comparisons between the profitability of rather new foreign-owned subsidiaries and that of well-entrenched U.S. corporations. However, what is even more surprising to any tax professional: the concerned transnational corporations are accused of transferring income from the United States, where corporation tax is thirty-four per cent, to Japan, where the rate is fifty per cent, or to European countries, where the rates vary between thirty-five per cent and fifty per cent. They must, therefore, either be unwise or badly informed.

It is true that non-tax reasons may form an incentive to shift income back to the home country. In Japan, for instance, the financial community is pre-eminently interested in the parent-company earnings and ignores consolidation. Price-earning ratios on Japanese stock markets are, for instance, based only on the parent company's results. The new Japanese rules on consolidated group accounts, which became effective in 1989, however, should slowly but surely help investors to identify well-managed companies with strong group-wide earnings. Likewise, the pressure on Japanese management to inflate parent company's earnings should diminish.

For European companies, there are no significant proper tax or non-tax reasons to shift back income to the home country through the transfer price mechanism. However, the question as to whether profits are indeed shifted to a considerable extent is no longer of any

political relevance. There exists agreement across the U.S. political spectrum regarding the fact that new rules are necessary to fight the perceived abuse.

Although, strictly speaking, the White Paper and the published Proposed Section 482 Regulations leave some room for applying the comparable uncontrolled price method, the practical significance of this method has been virtually reduced to nil. There exists hardly any willingness to continue applying this method as a starting point and to achieve an acceptable result by means of adjustments.

The White Paper focused on the Functional Analysis, in which the total profits of the concerned group companies are allocated in proportion to their functional contribution. The theoretically correct transfer price of the intangibles involved is an outcome of this analysis. This price may in fact vary from year to year and thereby cause retrospective adjustments to the original price: a consequence, which is extremely difficult to conform to the arm's length principle. The Proposed Section 482 Regulations provide to a certain extent a liberalization from the White Paper proposals, basically by indicating that there may be more than one arm's length result. The currently proposed Comparable Profit Interval, which tries to find a comparison with profits of similarly situated taxpayers engaged in comparable situations with unrelated parties, allows a price range which can be accepted as being at arm's length. It is obvious that this concept shifts the problem to the question who the 'similarly situated taxpayers engaged in comparable situations' are and how the tax authorities and the taxpayer can gain access to the data necessary for answering this question.

In addition to the uncertainty regarding the content and practical applicability of the incredibly complicated new method, an element is missing which each international allocation method should have: acceptance by the developed market economies. It is practically inconceivable that intensive consultations in consultative bodies such as the OECD would not have led to any form of consensus in the six years following the inclusion of the 'Superroyalty' provision in Section 482.

For the first time since the rise of the truly translational corporation some decades ago and against the background of the further advancing integration of the world market, which has enhanced intra-firm trade to a record level, the applicable method of allocating income is currently subject to dispute. The Editorial Board of this journal considered the problems sufficiently significant to devote a special issue to this subject. This special issue contains not only the text of the Proposed Regulations and articles of US experts, in which the proposals are analyzed and explained, but also commentaries by foreign tax authorities and consultative bodies of international trade and industry. We hope it will contribute to the ongoing discussion and help to establish a new consensus.