WORLD BANK GROUP
Equitable Growth, Finance & Institutions

POLICY NOTE

TRANSFER PRICING REFORM

Few could have predicted, just a few years ago, the scale of reform taking shape in the OECD and Inclusive Framework's work on Pillars 1 and 2. Although much detail has yet to be finalised, the broad agreement at the Inclusive Framework's meeting on 1st July (with backing of G7 and G20) suggests that long-standing and cherished approaches to international taxation are being reassessed and revisited, and that internationally agreed, ground-breaking solutions, are indeed possible.

All this is very welcome, but we need to reflect that Pillars 1 and 2, with one minor (yet promising) exception, barely touch the long-standing and well-documented challenges associated with the practical implementation of transfer pricing rules. We suggest that the international community could now turn some attention to transfer pricing, an area crying out for reform, and apply the same innovation and ambition we are seeing in the work on Pillars 1 and 2.

Those of us working with tax administrations at the practical end of transfer pricing are aware of the chasm between theory and practice. The challenges faced by many developing countries (and, if truth be told, some OECD member countries) are manifold[1]. These days, the issue is probably not primarily a result of deficiencies in legislation; international and regional organisations, and aid agencies, have successfully supported many countries to adopt modern legislation. The problem lies largely in the application of those rules that have become so complex over the last years.

- Transfer pricing in practice needs a wide range of skills and experience that is hard for small tax administrations to acquire and sustain. Those countries that have had some success in enforcing their rules have built teams of specialists (often supported by lawyers and economists) to create a sustainable institutional capacity. Most small countries simply do not have the resources to build this capacity.
- At the same time, tax administrations struggle to obtain information about the business operations of MNE taxpayers required for applying transfer rules. An asymmetry of information between taxpayers and tax administrations continues, despite the advances resulting from BEPS Action 13[2].
- More fundamentally, tax administrations struggle to acquire the market data necessary to apply the arm's length principle. Transfer pricing needs financial data derived from transactions between unrelated entities to inform the 'arm's length' on which legislation relies. For many countries, especially developing countries, such data may be non-existent

[1] Documented, for example, in OECD Report to G20, A Report to G20 Development Working Group on The Impact Of BEPS
In Low Income Countries. www.oecd.org/tax/part-1-of-report-to-g20-dwg-on-the-impact-of-beps-in-low-income-countries.pdf

[2] The strengthened common approach to transfer pricing documentation found in Action 13 is largely beneficial to developing countries. Most such countries, however, have not had access to country by country reports.

or inaccessible. Even where some data can be found, it is often absurdly unreliable, frequently drawn from businesses operating in different continents.

- At the same time, the subjective nature of transfer pricing also sits uncomfortably for many countries. Transfer pricing analyses, whether carried out by a taxpayer or a tax administration, rarely arrive at anything like an exact answer – the data often doesn't allow it. And the complex web of facts and circumstances often encountered in a transfer pricing audit allows for multiple interpretations and for subjective judgement. This means that the larger economies routinely settle their enquires by means of negotiated settlements with taxpayers. This is workable in tax administrations that have the skills and confidence to negotiate with large well-advised MNEs, but problematic for smaller low capacity administrations that lack the experience, confidence or culture to negotiate, even if they can find a knowledgeable counterpart to negotiate with.
- Finally, effective dispute resolution procedures in some countries are lacking, providing little incentive for taxpayers to come to the negotiating table.

None of this is welcomed by businesses, as these factors create uncertainty, delay and expense. Indeed, an army of expensive advisors has developed to negotiate around, and sometimes exploit, the complexities and subjectivities of transfer pricing. A recent leader in the Economist observed that 330 000 people list 'transfer pricing' on their LinkedIn profile and referred to their 'running circles around tax authorities'[3].

For a long time NGOs, academics and others[4] have called for reform, especially in relation to developing countries. This has historically been resisted, but the development of Pillars 1 and 2 suggests that larger economies and the OECD have become willing to revisit long-held sacred principles.

What reform options are available? For our part, we see advantages to the arm's length principle – it attempts to replicate the market in related party transactions, therefore creating some objectivity and minimising economic distortions. But there is no benefit to the arm's length principle unless it works. Solutions need to be found to allow the arm's length principle to apply in practice, while recognising that any solution will provide at best an approximation of the theoretical (but unknowable) arm's length price, and remembering that, in reality, current transfer pricing practices very rarely result in anything close to an exact, well defined or intellectually robust outcome.

A number of solutions could be considered, all of which involve the use of more formulaic or simplified approaches, and many of which were discussed in a 2019 World Bank discussion paper[5].

One option, discussed amongst academics and NGOs for many years, is Global Formulary Apportionment. At a high level, this would involve allocating, on a formulary basis, MNEs group (or segmented) global net profit between the jurisdictions in which they operate. It would remove the need for traditional transfer pricing rules. Designing and agreeing a mechanism for implementing this approach would be fraught with practical difficulties. We suggest, however, it should be considered seriously in international fora (perhaps even in the Inclusive Framework), to explore if an

[3] Economist, 15th May 2021.
[4] Including the Economist, 15th May 2021, which argues for 'bolder reform' of the 'broken 'arm's length' transfer pricing approach'.
[5] Colin Clavey, Jonathan Leigh Pemberton, Jan Loeprick, Marijn Verhoeven: International Tax Reform, Digitalization and Developing Economies, October 2019

international consensus might be achievable[6]. Unilateral attempts would only add more complexity to the system.

Another formulary approach could involve allocating an MNE's residual profit between tax jurisdiction according to the types of factors available for global formulary apportionment (e.g. assets, employees, sales). Coupled with fixed margins (which are available to determine routine returns, and therefore residual profit) this would represent a major simplification. The current design of Pillar 1 adopts elements of this approach in that it redistributes part of MNE residual profit according to a formulaic manner, and, in 'Amount B', moves towards a fixed margin approach.

Fixed margin approaches, which determine a return to specified categories of business activity, although less ambitious than formulary methods, can simplify transfer pricing in practice, most obviously by eliminating the need to find market comparables in every case. Amount B, a component of Pillar 1, (but which could stand alone), for example, would streamline the application of the arm's length principle for basic sales and distribution functions. The same approach could be extended to cover other routine activities such as some manufacturing and the provision of services.

The international community could explore whether international consensus on such a mechanism is possible, noting that the development of Amount B suggests that such an internationally agreed approach to fixed margins has become palatable even at the OECD. Fixed margin approaches currently come in many forms, including Brazil's approach and some mandatory safe harbours. Perhaps most ambitious would be to seek an international consensus on fixed margins for several categories of business functions, perhaps according to geographic region. Such an approach could significantly improve the implementation of the arm's length principle, create more certainty for business, and mitigate double taxation.

To mitigate against double taxation, any formulaic approach should (where possible) be formulated bilaterally or multilaterally, and fall within scope of MAP. Taxpayer options to propose alternative margins, where they can demonstrate that they better accord with the arm's length principle, could usefully be considered.

The above is far from an exhaustive list of possible solutions. Others have been discussed by Mike Durst and others[7], and the 'Sixth Method', already adopted by many countries, represents another path. No doubt, further possibilities are waiting to be revealed. If fundamental reform is not possible at this time, further work is needed to improve access to 'comparables' data by developing countries, following up on proposals found in the PCT paper, 'Difficulties in Accessing Comparables Data for Transfer Pricing Analyses'[8], including the possibility of harvesting data available to tax administrations (perhaps regionally) in a way that maintains taxpayer confidentiality.

The authors wonder whether the massive global transfer pricing industry is really an efficient use of the world's resources. Given that formulaic and simplified approaches to international taxation are

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[6] The EU's Common Consolidated Corporate Tax Base attempts to create such a formulary apportionment approach. The EU has announced plans to revisit formulary approaches by 2023.

[7] See, for example, proposals developed by Mike Durst, and discussion in 'Taxing Multinational Business in Lower-Income Countries: Economics, Politics and Social Responsibility' (Mike Durst, 2019). https://opendocs.ids.ac.uk/opendocs/bitstream/handle/20.500.12413/14336/Durst_Book_Final.pdf?sequence=1&isAllowed=y

[8] https://www.oecd.org/tax/toolkit-on-comparability-and-mineral-pricing.pdf

firmly on the current international agenda, now seems the right time for international and regional organisations, NGOs, aid agencies and others to turn the international spotlight on to the realities of transfer pricing.

ABOUT THE AUTHORS

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ABOUT WB's SUPPORT ON INTERNATIONAL TAX

The World Bank Group (WBG) has been supporting countries on their efforts to strengthen their international tax framework since 2011. Areas covered include: transfer pricing, tax treaty policy, exchange of information, preferential tax regimes, anti-avoidance rules, dispute resolutions, and taxation of the digital economy. WBG technical assistance engagements typically include assistance with a comprehensive review of international tax risks, advice to strengthen legislation, establishment of an effective risk assessment and administrative processes, advice on implementation of transfer pricing/international tax audits, technical assistance to effectively implement global standards on tax transparency (on request and automatic), support to build risk assessment systems to identify sources of risky transactions that could be vehicles for tax avoidance, tax evasion and illicit flows.

Most WBG's technical assistance on international tax in developing countries is financed by the **Global Tax Program** (GTP). The GTP seeks to strengthen the tax systems of developing countries by facilitating the design and implementation of evidence-based tax reforms. The GTP provides an umbrella framework for tax support and leads an ongoing program of activities at both international tax and country levels focused on strengthening tax institutions and mobilizing revenues at the international and domestic levels. The GTP is supported with generous financial contributions from Australia, Denmark, France, Japan, Luxembourg, Netherlands, Norway, Switzerland and United Kingdom.

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