

Transfer Pricing Regimes for Developing Countries

The authors, in this article, discuss challenges in designing and administering transfer pricing regimes in less developed countries and outline administrative and policy options to address these issues.

1. Introduction

Comprehensive anecdotal and academic evidence reveals that multinational enterprises (MNEs) transfer income from high-tax countries to low-tax jurisdictions to reduce their corporate tax burden. Political and public debates on the topic were recently reignited by the “Paradise Papers” scandal, where leaked electronic documents on offshore investments, among others, of large MNEs, such as Apple, Nike and Siemens, were made public. The documents also provide information on significant income transfers from developing countries to tax havens, thereby underpinning the prevalent notion that developing and emerging economies are equally, if not more, vulnerable to profit shifting by MNEs than their developed country counterparts.¹

Political and public concerns regarding income shifting by MNEs relate to the implied revenue losses for high-tax countries, potential distortions of product market competition and adverse distributional consequences.² These concerns are of particular relevance for less developed economies that often suffer from high levels of income inequality and low-tax raising capacity – with the latter resulting in small revenue-to-GDP ratios, which hamper the provision of much-needed public goods and services in these economies.³

Recent years have seen comprehensive unilateral and multilateral efforts by governments worldwide to contain international profit shifting. As empirical evidence suggests that much, if not most, of profit shifting relates to strategic distortions of intra-firm transfer prices,⁴ partic-

ular attention has been paid to the implementation and design of transfer pricing laws that are intended to limit strategic mispricing. Such transfer pricing laws commonly follow the OECD’s Transfer Pricing Guidelines⁵ and prescribe that the transfer prices of MNEs must adhere to the arm’s length principle, i.e. must correspond to prices that would have been set between unrelated parties. In recent decades, many countries have combined such rules with contemporaneous documentation requirements, prescribing that taxpayers must document intra-firm prices and their conformity with the arm’s length principle by demonstrating that price choices are aligned with those of similar uncontrolled entities and transactions. While industrialized countries fostered the emergence of existing transfer pricing regimes and multilateral initiatives to coordinate and tighten these provisions, most prominently the OECD’s/G20’s Base Erosion and Profit Shifting (BEPS) initiative, many developing economies followed suit in an attempt to protect their corporate tax base.

In this article, the authors consider the particular challenges encountered by developing countries and emerging markets in designing and implementing transfer pricing regimes as well as potential instruments to deal with these issues. Next to the general conceptual and practical problems of the arms-length system, developing countries face three particular challenges. First, uncontrolled comparable transactions to construct arm’s length prices are often difficult to find in these economies, due to, among other things, a limited number of formal firms and less stringent public reporting requirements. Second, given the complexity of modern transfer pricing regimes, administering transfer pricing systems imposes high demands on the resources of tax authorities, both in terms of the number of staff required and in terms of staff ability and education, which are often not met in less developed economies. Third, the fact that transfer pricing involves significant discretion on the side of tax auditors, with transfer price studies yielding acceptable price ranges rather than “true” transfer prices, gives rise to the possibility of corruptive behaviour in environments where governance systems tend to be weak.

A number of adverse implications can follow. Most importantly, developing countries may be particularly prone to outward profit shifting, a notion which is supported by empirical evidence (see previously in this section). Simul-

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1. For systematic empirical evidence supporting this notion, see C. Fuest, S. Heubous & N. Riedel, *International Debt Shifting and Multinational Firms in Developing Countries*, 113 *Econ. Ltr.* 2, pp. 135-138 (2011) and E. Crivelli, R.A. de Mooij & M. Keen, *Base Erosion, Profit Shifting and Developing Countries*, 72 *Finanzarchiv: Pub. Fin. Analysis* 3, pp. 268-301 (2016).
2. See OECD, *Action Plan on Base Erosion and Profit Shifting* (OECD 2013), International Organizations’ Documentation IBFD.
3. See, for example, T.J. Besley & T. Persson, *Taxation and Development*, CEPR Discussion Paper 9307 (2013).
4. See, for example, D. Dharmapala, *What Do We Know About Base Erosion and Profit Shifting? A Review of the Empirical Literature*, CESifo Working Paper No. 4612 (2014) and J.H. Heckemeyer & M. Overesch,

Multinationals. Profit Response to Tax Differentials: Effect Size and Shifting Channels, 50 *Can. J. Econ.* 4 (Nov 2017)

5. Most recently, OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD 2017), International Organizations’ Documentation IBFD [hereinafter: the “*Transfer Pricing Guidelines* (2017)”].

taneously, the high tax compliance, and often also bribery, costs related to transfer pricing may deter investment activities of MNEs and have negative employment effects.

Against this background, the authors discuss potential remedies for the transfer pricing challenges faced by developing countries. First, the article addresses “direct” responses, i.e. countering the lack of comparables data by permitting arm’s length prices to be constructed from indirect comparables, for example, uncontrolled transactions in different industries or different countries, and countering deficiencies in tax authority capacities by capacity building measures, such as knowledge transfer programmes. In the authors’ opinion, such “direct” responses are, however, in themselves, unlikely to solve the transfer pricing challenges faced by developing countries and may raise their own issues. Another, potentially more viable, option may, therefore, be to deviate the transfers pricing systems of developing countries from the arm’s length principle and thereby help to reduce compliance and administration cost as well as the scope for corrupt behaviour.

The article is structured as follows. Section 2. provides a general background to the current international corporate tax system and transfer pricing laws. Section 3. discusses the specific challenges faced by developing countries when it comes to international taxation, in general, and transfer pricing laws, in particular. Section 4. considers policy responses. Section 5. concludes the article.

2. Transfer Pricing Systems and the Arm’s Length Principle

Before turning to the specific challenges of transfer pricing systems in developing countries, the authors briefly describe the principles that govern the current international tax system. The system primarily relies on two pillars: (1) source country taxation, implying that corporate income is subject to corporate taxation where it is “earned”; and (2) separate accounting principles, implying that taxable income is determined separately for every group affiliate based on intra-firm transfer prices set according to the arm’s length principle, with the latter prescribing that intra-firm prices must correspond to the price setting of uncontrolled parties. The system hence aims to align the allocation of taxable income with value creation and the allocation of real activity within multinational groups.

Most countries follow the OECD’s Transfer Pricing Guidelines, which permit the use of five methods to determine whether prices for intra-firm transactions are in line with the arm’s length principle. There are three traditional transaction methods, which compare intra-firm transactions with prices or gross margins agreed by independent parties (the comparable uncontrolled price method, the resale price method and the cost-plus method), and two transactional profit methods, which compare the profit of related parties to the profit earned by comparable uncontrolled parties (the transactional net margin method and the transaction-based profit split method).

Implementing the arm’s length principle thus requires identifying comparable transactions between uncontrolled parties. These comparability analyses are the Achilles heel of the current international tax system and are difficult to implement in practice.⁶ First, firms can choose between different methods to determine arm’s length prices and between different entities and transactions, which may serve as potential “comparables”, thereby offering room for discretion. Second, a significant fraction of the income earned by modern MNEs relates to intra-group services and intangible property, such as patented technology or trademarks, which are firm-specific in nature and thus imply that arm’s length prices by their very definition do not exist. The share of these goods in overall trade is high in modern MNEs and will plausibly further grow in the future, which questions the suitability of the arm’s length principle as a mechanism to internationally allocate corporate income. Third, modern MNEs tend to be highly integrated and complex, which makes it challenging, if not impossible, to trace back functions to affiliates when value drivers, risk taking and entrepreneurial functions are spread across entities in different tax jurisdictions.⁷

The objective of aligning the location of taxable income with corporate value creation and the location of corporate real activity, therefore, appears to be impossible to meet under the current international tax system. In line with this notion, anecdotal as well as empirical evidence suggest that MNEs distort the location of profits towards low-tax countries and have considerable scope in disentangling the location of real activity and income.⁸ The recent OECD/G20 BEPS initiative is intended to counter some of these profit shifting channels, for example, by internationally aligning corporate tax laws to eliminate mismatch arrangements or by facilitating the identification of high-risk cases for transfer pricing audits by requiring taxpayers to undertake country-by-country reporting. However, the effectiveness of the agreed measures in limiting international profit shifting remains to be seen.

And even if these modifications were to be effective in eliminating some profit shifting activities, this would not resolve the conceptual shortcomings of the system. Specifically, the arm’s length principle adopts the concept that prices charged in uncontrolled transactions are suited to identify the unobserved “true” prices for trade within MNEs. It is well established, however, that MNEs systematically differ from their national counterparts. Most importantly, they are more productive and have higher bargaining power against suppliers, which affects pricing behaviour and implies that the true unobserved multinational transfer price deviates from the arm’s length price

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6. See, for example, J. Vidal, *The Achilles’ Heel of the Arm’s Length Principle and the Canadian Glaxo-SmithKline Case*, 37 *Intertax*, 10, pp. 512-528 (2009) and L. Luckhaupt, M. Overesch & U. Schreiber, *The OECD Approach to Transfer Pricing: A Critical Assessment and Proposal*, in *Fundamentals of International Transfer Pricing in Law and Economics* pp. 91-122 (W. Schön & K. A. Konrad eds., Springer 2012).
 7. See, for example, B. Knoll & N. Riedel, *Transfer Pricing Laws*, CESifo DICE Report, 12(4), pp. 22-26, Ifo Institute, Munich (2014).
 8. See, for example, Dharmapala, *supra* n. 4 and Heckemeyer & Overesch, *supra* n. 4 for surveys of the empirical academic literature.

constructed based on trade between standalone entities. Consequently, there are options for profit shifting, even with the correct application of the arm's length principle.⁹ Incentives to distort transfer prices for tax purposes moreover also hamper other internal functions of transfer prices, for example, in relation to management incentives.¹⁰

What is more, arm's length taxation involves significant compliance costs for corporate taxpayers. In particular, firms must document their intra-firm transfer prices and demonstrate that their price setting adheres to the arm's length principle as defined by national tax laws. The related compliance costs have been labelled as "absurdly" high by commentators.¹¹ Durst (2010) notes that large MNEs spend millions of US dollars on transfer pricing studies annually.¹² It is, therefore, not surprising that around half of the tax managers in MNEs consider transfer pricing to be the most important tax issue for their group.¹³ The arm's length principle also imposes significant enforcement costs on tax authorities, which have to assess compliance with transfer pricing regimes and may have to engage in mutual agreement procedures with regard to transfer pricing disputes.

3. Transfer Pricing Regimes and the Challenges for Developing Countries

Despite the shortcomings of the arm's length principle outlined in section 2., many developing and emerging countries have introduced transfer pricing laws into their tax legislation in an attempt to protect their domestic corporate tax base. Corporate taxes are in general an important revenue source in the developing world where compliance with direct personal taxation is hampered by limited enforcement capacity and an unfavourable information environment with little scope for third-party reporting. Many developing countries, therefore, tax corporate profits at comparably high tax rates, making them potentially vulnerable to outbound profit shifting by MNEs.

Conditional on a given tax rate differential and a given design of anti-profit shifting legislation, it is theoretically unclear as to whether more or less income is being shifted from the developing world. The following four factors are relevant here.

First, a significant fraction of the exports of developing countries is agricultural goods and natural resources as well as standard manufactured products, for which arm's length prices do exist and the scope for tax-motivated mispricing is, therefore, rather limited. On the other hand,

developing countries also import complex goods and services, including the right to use intangible firm-specific assets and headquarter services, which present considerable scope for profit shifting by way of strategic mispricing.

Second, transactions between unrelated parties and standalone firms that could act as comparables in respect of transfer pricing may also be difficult to come by in less developed countries and/or information regarding such entities may not be publicly available, due to weak public reporting requirements. This complicates the application of the arm's length principle and hampers compliance by corporate tax payers, as the setting of prices is based on less comparable transactions. Such a situation increases the scope for strategic mispricing and related income shifting to low-tax countries, as well as the risk of transfer pricing adjustments following tax audits.

Third, recent years have seen an explosion of complexity of transfer pricing regimes, which is partly related to the OECD/G20 BEPS initiative and the resulting adoption and adaption of transfer pricing laws.¹⁴ There is a strong view that tax authorities of developing countries often lack the resources to appropriately administer and enforce such complex transfer pricing regimes, both in terms of the number of individuals who are available to carry out these tasks and in terms of staff education. As the strictness of transfer pricing regimes not only depends on the underlying legal provisions, but also on the application of the provisions by the tax authorities, lax enforcement may undermine the effectiveness of such rules in terms of limiting income shifting to low-tax countries. Given the discretion in applying the rules, with comparability studies deriving a range of acceptable transfer prices rather than a "true" transfer price, transfer pricing regimes also give rise to scope for corrupt behaviour on the part of tax auditors in the presence of weak governance rules. Whether developing countries are more or less prone to income shifting is, therefore, an empirical question. To date, evidence on this issue is limited. Three notable exceptions are work undertaken by Fuest, Hebous and Riedel (2011),¹⁵ Crivelli, De Mooij and Keen (2016),¹⁶ and Johannesen, Torslov and Wier (2017),¹⁷ which indicate that there are more profit shifting activities in developing economies and emerging countries.¹⁸

Fourth and finally, transfer pricing regimes in developing countries must be evaluated against potentially different objectives of these economies. On the one hand,

9. See C. Bauer & D. Langenmayr, *Sorting into Outsourcing: Are Profits Taxed at a Gorilla's Arm's Length?*, 90 J. Intl. Econ. 2, pp. 326-336 (2013).
 10. See, for example, S. Nielsen & P. Raimondos-Moller (2012), *Multiple Roles of Transfer Prices: One vs. Two Books*, in Schön & Konrad eds., *supra* n. 6, at pp. 25-46.
 11. R.S. Avi-Yonah, *Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation*, 2 World Tax J. 1 (2010), Journals IBFD.
 12. M.C. Durst, *Making Transfer Pricing Work for Developing Countries*, Tax Analysts, pp. 851-854 (13 Dec. 2010).
 13. See, for example, Ernst & Young, *Precision under Pressure – Global Transfer Pricing Survey 2007-2008* (2007).

14. The OECD has initiated an Inclusive Framework, which permits all interested countries to work jointly on the implementation of measures proposed as a result of the OECD/G20 BEPS initiative (see OECD, *Background Brief: Inclusive Framework on BEPS* (OECD 2017)).
 15. See Fuest, Hebous & Riedel, *supra* n. 1.
 16. See Crivelli, De Mooij & Keen, *supra* n. 1.
 17. N. Johannesen, T. Torslov & L. Wier (2017), *Are Less Developed Countries More Exposed to Multinational Tax Avoidance? Method and Evidence from Micro-Data*, mimeo (U. Copenhagen 2017).
 18. It should also be noted that the corporate incentives to transfer income from developing countries may not be limited to taxation, but may also relate to weak governance in less developed economies, with entities wishing to transfer funds from countries that have a perceived increased risk of expropriation.

countries have an incentive to counter income shifting by MNEs and increase corporate tax revenue. However, on the other hand, an equally important objective may be to attract foreign direct investment and the related employment opportunities to a country. Raising effective tax rates by tightening a country's transfer pricing regime could hamper the latter objective. Decisions on corporate tax rates and on the strictness of transfer pricing regimes must, therefore, balance these countervailing objectives.¹⁹ In any case, private investment may, however, also be deterred by compliance costs and tax uncertainty, which both offer no revenue gains in return. Countries should, therefore, unambiguously design their transfer pricing regimes to minimize the two.²⁰ This is of particular relevance for developing economies where a lack of direct comparables implies that costs to comply with transfer pricing laws tend to be high. In addition, a lack of comparables may result in a wide range of supportable transfer prices, which exceed acceptable price ranges in developed countries. As tax authorities can adjust arm's length prices within these ranges, taxpayers in developing countries may encounter significant variations in post-tax income. Risk-averse firms²¹ account for this type of risk, both in developed and developing countries, though developing countries are likely to be more exposed to behavioural responses for two reasons. First, the inadequate administration of transfer pricing regimes (for example, relating to a lack of tax officer knowledge or corruptive behaviour), increases the range of possible transfer prices in these countries, thereby imposing an additional tax risk. Second, investors in developing countries are furthermore exposed to various non-tax risks which are absent in developed countries, for example, related to poor governance institutions and a lack of stability in respect of regulatory environments. As the cost of corporate risk plausibly increase convexly in a firm's aggregate risk exposure, additional variation in after-tax income added by the tax system could have a greater detrimental effect on investment activity in developing countries than in developed countries.

4. Transfer Pricing Regimes for Developing Countries

4.1. Introductory remarks

Following on from the discussion on the objectives and challenges of designing and implementing transfer pricing regimes in less developed countries that are outlined in section 3., the objective of this section is to consider viable options to address these challenges. The authors start with direct responses, i.e. with proposals to resolve the lack of resources on the part of tax authorities by capacity build-

ing measures and to counter the absence of comparable data by permitting the use of indirect comparables (see section 4.2.). However, the authors do not consider that these measures are sufficient in themselves to resolve the transfer pricing challenges of developing countries. Consequently, the discussion moves on to the role of advance pricing agreements (APAs) as a potential mean to address the transfer pricing challenges of developing countries (see section 4.3.) and to assessing proposals for modified transfer pricing rules in developing countries that relax the arm's length principle and thereby realize a reduction in taxpayer compliance costs and the administrative burden of tax authorities, namely safe harbours (see section 4.4.) and a more formulary apportionment of income (see section 4.5.).

4.2. Direct responses: Capacity building and indirect comparables

The most direct response to counter the lack of tax authority capacity in many developing economies is to institute capacity building measures, for example, the knowledge transfer programmes introduced within the OECD's Inclusive Framework or the Platform for Collaboration on Tax (PCT), initiated by the International Monetary Fund (IMF), the OECD, the United Nations and the World Bank, which provide toolkits to assist developing countries in implementing transfer pricing regimes. While such measures are useful, it is unclear whether they give rise to capacity changes that are sufficiently large for the tax authorities of developing countries to successfully administer increasingly complex transfer pricing cases. This is especially true given the fact that staff numbers in the transfer pricing units of many developing countries' tax authorities are low and cannot readily be increased given the scarcity of skilled labour in local labour markets. Even if feasible, it implies moving highly skilled labour from productive tasks to tax administration work, which may involve non-negligible opportunity costs.

In the same vein, the most direct response to the lack of data on uncontrolled comparable transactions is to permit the use of indirect comparables, i.e. uncontrolled transactions of third parties that have different business strategies, business models or otherwise slightly different economic circumstances, or to look for transactions in the same industry but in other geographical, perhaps foreign, markets or for uncontrolled transactions taking place in the same geographical market but in other industries as advised by the OECD and the United Nations.²² This pragmatic solution is a necessity to be able to administer transfer pricing regimes based on the arm's length principle in environments where direct comparables or access to information on such comparables is missing.

The disadvantage of the use of indirect comparables is that it further complicates compliance with the arm's length system and raises the already high corporate compliance burden related to transfer pricing legislation. Specifically,

19. It should be noted that the social and economic returns in respect of corporate investment in developing countries could also outweigh that of investment in developed countries. For instance, technology spillovers from MNEs to host countries increase in the technology gap.

20. The nature and sources of tax uncertainty and its effect on business decisions are considered in IMF and OECD, *Tax Certainty*, IMF/OECD Report for the G20 Finance Ministers (IMF Mar. 2017).

21. The risk aversion of firms may, for example, stem from the imperfect diversification of corporate ownership.

22. OECD, *Transfer Pricing Guidelines* (2017), *supra* n. 5. Another direct option would be to strengthen public reporting requirements.

firms must search for transactions in markets and industries, they are unfamiliar with and access to foreign (commercial) data may be expensive and/or not permitted.

In addition, while arm's length systems, in general, fail to identify the "true" underlying transfer price for a given multinational transaction (see section 2.), the arm's length prices obtained from indirect comparables could further deviate from the "true" underlying price, given that the MNE transaction and the control transaction then differ in more observed dimensions. By definition, the five criteria that determine comparability according to OECD Transfer Pricing Guidelines, i.e. the characteristics of the property or service transferred, the functions performed by the parties, the contractual terms, the economic circumstances and the business strategies pursued, are not simultaneously satisfied when imperfect comparables are used. This issue is especially relevant where data on "comparable" entities is derived from developed countries (for which a large pool of firm information is typically available), but which significantly differ in their economic environment and business models from developing economies. Using data from other developing countries with similar economic structures and circumstances could, therefore, be preferable, but is, in turn, often hampered by poor data availability on potential comparables that is no better than in the entity's host country.

Consequently, permitting the use of imperfect comparables can give rise to significant compliance costs and conceptual problems. In addition, the fact that taxpayers may deviate from comparable transactions in many dimensions, for example, turning to different countries, different industries or different transactions, plausibly increases the range of supportable arm's length prices. This may on the one hand increase income shifting from developing countries and, therefore, reduce effective corporate tax rates, but on the other hand also increase corporate tax revenue, if tax authorities successfully adopt aggressive transfer pricing positions in their favour. In any case, the application of indirect comparables raises the probability of disputes between taxpayers and tax authorities and increases the associated compliance costs (for example, legal and court costs), as well as transfer pricing risks for taxpayers. Moreover, the increased level of tax auditor discretion with respect to the choice of indirect comparables could encourage corrupt behaviour within developing countries' tax authorities. Given these shortcomings, the application of indirect comparables in developing countries should, in the authors' view, be limited as much as possible.

4.3. APAs

A complementary option that could deal with problems relating to the application of transfer pricing regimes in the developing world can be seen in fostering the availability and use of APAs between one or more taxpayers and one or more tax administrations. APAs prescribe in advance the transfer pricing methods, comparables and appropriate adjustments thereto, critical assumptions, etc.

for a set period of time for in-house transactions carried out in the future, or in past years ("rollback").

APAs have gained significant importance in recent years.²³ Opinion polls among firms suggest that concluding APAs helps to avoid double taxation and reduces tax risks relating to audit adjustments and transfer pricing disputes. Becker et al. (2016), on top, emphasize the role of APAs in addressing hold-up problems in corporate investment decision-making. APAs may, therefore, increase tax certainty and encourage investment.²⁴

On the downside, setting up APAs tends to be resource-intensive for both taxpayers and tax authorities. During the negotiation of an APA, significant capacities may be bound in setting up the agreement, while during the application period and, potentially, the renewal period, capacity savings emerge related to reduced or no tax audit requirements and a lower probability for disputes. Whether APAs reduce overall compliance and administrative costs, therefore, depends on the relative size of these costs and savings.

In practice, the tax authorities of developing countries should, at least, have some experience with the transactions under consideration before initiating an APA programme. Negotiating an APA with sophisticated tax representatives of MNEs could be very demanding and potentially result in unfavourable results if the knowledge of the tax authorities regarding mispricing in the relevant industry is still limited. Developing countries should, therefore, start their APA programmes with a few and limited duration APAs to gain experience.²⁵

The negotiation stage of an APA may also have benefits for the tax authorities, as MNEs are expected to make proposals on suitable transfer pricing methods and must document the adequacy of price choices. This may provide valuable access to information on prices and business practices of specific MNEs and sectors in question, which may increase the efficiency of transfer pricing audits.

In conclusion, APAs increase tax certainty and may thus increase investment levels. However, APAs are unlikely to effectively reduce administration and compliance costs. The complexity of transfer price determination and conflict resolution is only transferred to the negotiation stage of an APA. While APAs may serve as a meaningful element of transfer pricing regimes in developing countries, they are unlikely to provide effective solutions to all of the challenges noted in section 3. Section 4.4. on safe harbours and section 4.5. on formulary apportionment, therefore, consider more far-reaching reforms of transfer pricing regimes.

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23. See, for example, J. Becker et al. (2016), *Das Verfahrensrecht der Verrechnungspreise: Grundlagen, Erfahrungen und Perspektiven*, PwC-Studien zum Unternehmens- und Internationalen Steuerrecht p. 5 (Springer Gabler 2016).
 24. Id. The beneficial effects for taxpayers tend to be enhanced when APAs are negotiated on a bilateral or multilateral basis, especially where tax treaties and mutual agreement procedures do not exist.
 25. See also *United Nations Practical Manual on Transfer Pricing for Developing Countries*, UN Department of Economic & Social Affairs (United Nations 2017).

4.4. Safe harbours

In the authors' opinion, developing countries should, conditional on adhering to the arm's length principle, implement comprehensive safe harbour provisions into their transfer pricing regimes. Safe harbours, as defined by the OECD, are:

circumstances in which eligible taxpayers may elect to follow a simple set of prescribed transfer pricing rules in connection with clearly and carefully defined transactions.²⁶

If these rules are followed, the related transfer price choices are accepted by the tax authorities and taxpayers "may be exempted from the application of [all or part of] the general transfer pricing rules".²⁷ Safe harbours, therefore, imply deviations from the arm's length principle. From the authors' perspective, this is a limited shortcoming though, given the conceptual and practical problems relating to the arm's length system (see section 2.).²⁸

Safe harbour provisions may take different forms. They may, for example, state that transfer pricing choices are accepted by the tax authorities if they are based on a pre-specified transfer pricing method connected with an associated level or range of financial indicators for a defined category of transactions, for example, the cost-plus method with a not less than 5% net profit margin. Alternatively, safe harbours may be a specification of a transfer pricing process,²⁹ which, when applied to a defined category of transactions, is considered to produce results that fulfil the requirements of the relevant transfer pricing regime. Documentation requirements and transfer pricing studies can be waived under safe harbour provisions. Safe harbours are, moreover, elective provisions coupled with opt-in or opt-out clauses, which permit taxpayers to choose the standard arm's length system in cases where opting for safe harbour rules would result in double taxation.³⁰

26. OECD, *Transfer Pricing Guidelines* (2017), *supra* n. 5, at para. 4.101.

27. Id. Safe harbours are combinations of, clear-cut, legal rules and, interpretable, legal standards that ensure that if the taxpayer complies with these rules and standards, no penalty results. The reverse set of legal rules and standards would be 'sure shipwrecks', which, if met, would never be accepted and would always result in the adjustment of reported taxable income and, potentially, penalties (see S.C. Morse, *Safe Harbors, Sure Shipwrecks*, 49 UC Davis L. Rev. 4, pp. 1385-1430 (2016)).

28. In addition, while OECD has historically opposed any deviation from the arm's length principle, this position was relaxed in OECD, *REVISED SECTION E ON SAFE HARBOURS IN CHAPTER IV OF THE TRANSFER PRICING GUIDELINES* (2013) which replaced Section E on safe harbours in Chapter IV of the OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010), International Organizations' Documentation IBFD and OECD, *Transfer Pricing Guidelines* (2017), *supra* n. 5, which include sections on safe harbour provisions.

29. In this case, the safe-harbour does not specify a particular transfer pricing method or range to be realized, but rather the steps in a benchmarking process, for example, the search criteria to be used in a search for comparables.

30. It should be noted that choosing opt-out or opt-in clauses may change which party bears the burden of proof with regard to the correctness of a given transfer price. Specifically, under opt-out clauses, it may not be the tax authorities that have to prove that the reported transfer prices outside the safe harbour regime do not meet the arm's length principle. However, the burden of proof may be redirected to the opting-out entity, which may be beneficial from the perspective of the tax authorities, as it saves on the associated administrative resources.

Safe harbour rules have a number of advantages. First, they save taxpayers from undertaking costly comparables searches and may, therefore, significantly reduce compliance costs. Safe harbours also remove the risk of transfer pricing adjustments and litigation relating to, potentially aggressive, transfer pricing audits. In addition, tax authorities save the administrative burden of auditing the covered transfer pricing cases and can redirect the freed administrative resources to higher risk cases, i.e. those involving non-standard transactions, intangibles, business restructurings, electronic-business and/or connections with tax havens.

The overall effect on corporate revenue is, however, unclear and depends on the design of the safe harbour rules, for example the choice of the permitted financial indicator ranges relative to price choices under a "standard" transfer pricing regime and corporate behavioural responses to the introduction of safe harbours. In order to mitigate potential negative revenue implications, the application of safe harbours could be restricted to low-risk taxpayers and transactions, for example, taxpayers with assets and trading volumes below given thresholds and with no connection to tax haven entities.

It should, however, be noted that countries have an incentive to deviate the safe harbour threshold from the arm's length price such that additional tax revenue is raised. For exported goods and services, there are, for example, incentives to choose safe harbour rates that are higher than the true underlying transfer price – resulting in higher tax payments if the firm opts for the safe harbour.³¹ From the perspective of the tax payer, this may result in double taxation if the partner country applies an arm's length price that corresponds to the "true" price in calculating the corporate tax base as well as if it operates a safe harbour regime and strategically sets its price range to maximize corporate tax revenue.

In the presence of such double taxation, taxpayers may wish to opt out of a safe harbour regime to avoid the associated double tax costs.³² Interestingly, this is not always the case though, as opting out of the provision also gives rise to additional compliance costs in the form of the requirement to document and defend transfer pricing choices. As long as the implied additional tax costs do not exceed the transfer pricing compliance burden in case of an opt-out, taxpayers choose the safe harbour provisions and accept the implied double taxation. The introduction of safe harbour provisions thus permits countries to replace socially wasteful transfer pricing documentation costs with socially beneficial additional corporate tax revenue.

There may, however, be concerns that this implies that countries have an incentive to maximize the strictness of their transfer pricing regimes and the related compliance

31. It should be noted that, in many existing safe harbour regimes, it is not uncommon to find that financial indicator ranges differ in respect of inward and outward transactions.

32. For this reason, it is typically advised to introduce safe harbour regimes on a bilateral basis.

costs outside the safe harbour to maximize the acceptable double taxation of taxpayers under the safe harbour provision and the related tax revenue. Such adverse incentives are, however, effectively counterbalanced by the fact that the associated increases in compliance and tax costs would imply that mobile MNEs would relocate real investment from the country in question.

It should, moreover, be noted that the arguments so far implicitly assume homogenous MNEs and transactions, thereby implying that the safe harbour provisions are set assuming a common “true” underlying price among the entities affected. With heterogeneous entities, safe harbours must, in turn, be chosen against the background of a distribution of “true” underlying prices for a given transaction. Consider, for example, a safe harbour provision, where export transactions are stated to fulfil the arm’s length standard if the reported net profit margin exceeds 5%. As argued previously in this section, countries have an incentive to strategically deviate from the “true” net profit margin in the setting of this threshold, thereby exploiting the fact that taxpayers are willing to accept additional tax costs in exchange for reductions in compliance costs. The corporate benefits obtained from such a safe harbour regime inversely correlate with the “true” underlying profitability of entities. Entities with a small “true” productivity and profitability, resulting in net profit margins significantly below 5%, may not find it beneficial to opt for the safe harbour regime as, for such entities, the implied additional tax costs outweigh the additional compliance burden related to transfer price documentation. Entities with “true” net profit margins in a given range just below 5% may find it attractive to choose the safe harbour regime despite the additional tax costs involved, as these additional tax costs fall short from the compliance burden savings. Entities with “true” net profit margins of over 5% benefit the most and obtain a two-fold benefit from choosing the safe harbour. As they opt for the safe harbour, they, firstly, benefit from reduced compliance costs as transfer pricing documentation is waived. Secondly, they can reduce their effective tax burden by declaring a 5% net profit margin, which is less than their “true” underlying profitability and results in under taxation. Such rules thereby imply that especially large and profitable MNEs benefit from these provisions, while the tax and compliance burden of smaller MNEs remains unchanged.

To the extent that investment made by large and productive entities is more mobile than that of smaller entities, this type of discrimination may be socially optimal, as it helps in retaining mobile investment in a country.³³ On the downside, it may give rise to distributional concerns and may also distort product market competition.³⁴

33. See, for example, N. Riedel & M. Simmler, *Large and Influential: Firm Size and Corporate Tax Rate Choice*, mimeo (2017).
 34. This can be countered by exempting small taxpayers from taxation altogether or by granting reduced rates, which follows the literature regarding the optimal design of taxation and regulation rules in the presence of administrative costs (see D. Dharmapala, J. Slemrod, & J. Wilson, *Tax Policy and the Missing Middle: Optimal Tax Remittance with Firm-Level Administrative Costs*, 95 *Journal of Public Economics* 1036 (2011)).

Finally, it should be noted that the introduction of a safe harbour regime also affects the incentives of MNEs to engage in profit shifting by strategic trade mispricing. Specifically, MNEs may refrain from tax-motivated price distortions outside the safe harbour regime as freed and redirected audit resources may increase the propensity that such mispricing activities will be detected and penalized. In the foregoing example, the entities may hence reduce or eliminate mispricing that results in a net profit margin of less than 5%. The related revenue gains must, however, be compared to potential revenue costs relating to the fact that entities with a “true” net profit margin of more than 5% would now start to report the 5% safe harbour threshold.

In conclusion, safe harbour rules that waive transfer pricing documentation requirements and the need to undertake transfer pricing studies or permit simplified procedures have several important advantages for developing countries. First, safe harbours foster tax simplicity and permit a reduction in administration and compliance costs. Second, safe harbours also eliminate tax uncertainty for taxpayers relating to inconsistent decision making of tax authorities in respect of transfer pricing, whether due to inability, incapacity or corruption. Consequently, corporate investment may increase. In addition, targeting the freed tax audit resources on high-risk cases may reduce profit-shifting. On the downside, the benefits from safe harbours may be unequally distributed among MNEs, thereby potentially giving rise to concerns regarding equality and distortions of product market competition. These issues can, to some extent, be countered by a non-linear corporate tax schedule that, for example, exempts small businesses from taxation, or by applying safe harbour provisions to homogenous subgroups of entities.³⁵

Finally, it should be noted that the real-world prevalence of safe harbours in transfer pricing is still limited today. Only ten countries,³⁶ mostly in the developed world, have implemented some form of safe harbour rules, which mainly address routine or low-risk services and low-value adding services, such as intra-group loans and guarantees.³⁷ Very few countries use safe harbours for manufacturing or high value services, with India being a recent exception in that it introduced safe harbour provision into its legislation for, among others, software development, information technology enabled services, knowledge process outsourcing services, contract research and development services in relation to software and phar-

35. Morse, *supra* n. 28 notes the vulnerability of safe harbours to interest group influence. This may be particularly relevant if safe harbours are defined for narrow sub-groups of transactions and entity characteristics.
 36. The ten countries are Australia, Austria, Brazil, Hungary, India, Mexico, the Netherlands, New Zealand, Singapore and the United States. See also the EU Joint Transfer Pricing Forum (JTTF) and OECD state safe harbour rules (see PCT, *A Toolkit for Addressing Difficulties in Accessing Comparables Data for Transfer Pricing Analyses*, Prepared in the framework of the Platform for Collaboration on Tax (PCT) under the responsibility of the Secretariats and Staff of IMF, UN, OECD and WBG app. 19 (PCT 2017)).
 37. See, for example, Becker et al, *supra* n. 24.

maceuticals in 2009.³⁸ The still limited prevalence of safe harbour provisions may relate to difficulties in designing the provisions, most importantly in setting the relevant safe harbour thresholds, which requires detailed knowledge of arm's length prices in the considered category of transactions.³⁹

4.5. Formulary apportionment

Finally, as systematic evidence on the effectiveness of transfer pricing regulations in limiting tax-motivated income shifting is still scarce⁴⁰ and the conceptual problems of the current international transfer pricing system (see section 2.) are unlikely to be resolved in a satisfactory manner, this may call for a more profound reform of the international corporate tax system. The most prominent reform proposal involves a switch to (global) formulary apportionment, where income is consolidated at the level of the multinational group and apportioned to group affiliates based on fixed allocation keys. The keys serve as a proxy for corporate economic activities in the relevant countries and include factors such as the value of assets, total payroll, the number of employees, turnover and sales.

The major advantage of formulary apportionment is that it abolishes all profit-shifting incentives and, therefore, removes the requirement for transfer pricing laws and associated administrative and compliance costs. In this way, formulary apportionment also eliminates all

38. The example of India also provides anecdotal evidence for design incentives when it comes to safe harbour provisions. The provision for software development services (IT services) is, for example, limited to low-risk transactions with a transaction value of less than INR 500 crores (approximately, EUR 60 million). The operating margin set in the safe harbour laws, of not less than 20%, was also considered to be very aggressive and exceeds the true underlying profitability margin of many entities, which is in line with the concept that safe harbours may serve as an instrument to transform compliance burdens into tax revenue. The Indian safe harbour rule, however, was, in fact, so high that many firms refrained from choosing the safe harbour regime, as the additional tax costs outweighed the compliance burden costs saved. This resulted in a downward adjustment of the threshold value in June 2017. (See Deloitte, *Indien veröffentlicht neue Safe-Harbour-Regelungen bzgl. Verrechnungsspreisen*, 26.11.2013, (2013), available at <http://www.deloitte-tax-news.de/transfer-pricing/indien-veroeffentlicht-neue-safe-harbour-regelungen-bzgl-verrechnungsspreisen.html> (accessed 22 Nov. 2017) and KPMG, *CBDT notifies the much awaited revised Safe Harbour Rules*, KPMG Tax Flash News (9 June 2017).

39. Economies of scale imply that determining arm's length prices in a centralized way by the tax authorities is superior to individual taxpayers constructing arm's length prices in a decentralized manner. It should also be noted that another viable option to address the transfer pricing challenges of developing countries is the implementation of the 'Sixth Method' or 'Commodity Rule'. This relates to the fact that a significant fraction of the export trade of a developing country is commodity trade in agricultural products and natural resources. One particularity of such goods is that they are traded in commodity exchange markets and, therefore, imply the option that the quoted price is taken as the arm's length price. The rule is used as a simplification for the arm's length pricing of trading outside such commodity exchange markets, where prices may depend on the particularities of a transaction and the trading partners involved. It has the benefit of reduced compliance costs and lower administrative burdens for the tax authorities, thereby freeing resources for high-risk audit cases. The transparency inherent in the rule also makes corruption and arbitrariness in relation to the tax administration less likely.

40. See, for example, N. Riedel, T. Zinn & P. Hofmann, *Do Transfer Pricing Laws Limit International Income Shifting? Evidence From Europe*, mimeo (2016) and S. Beer & J. Loeprick, *Profit Shifting: Drivers of Transfer (Mis) pricing and the Potential of Countermeasures*, 22 Intl. Tax & Pub. Fin. 3, pp. 426-451 (2015).

problems inherent in the current international transfer pricing systems, above all the stand-alone fiction of entities belonging to the same multinational group, or quick fixes of it (see section 2.).

Formulary apportionment, however, comes with its own problems. First, while profit shifting incentives are eliminated, MNEs have an incentive to strategically distort the location of the apportionment factors so as to transfer income to low-tax jurisdictions. Empirical evidence, however, suggests that such activities, while existent, tend to result in less tax-motivated distortion in the international income allocation than under current separate accounting principles.⁴¹ This concern can be further mitigated by placing high weight in the apportionment formula on destination-based sales, as the latter can hardly be distorted by MNEs (which plausibly have limited influence on the location of customers), thereby further reducing the related efficiency losses.

One practical problem, however, is the international political consensus that would be required to implement such a formulary apportionment system. Given that a move to such a system would give rise to winners and losers (in terms of corporate tax revenue and, potentially, also corporate investment), it can be assumed that such a consensus would be difficult to reach. This would relate to the adoption of the regime in general and the choice of apportionment factors and the weights assigned to these factors in particular as each country has an incentive to argue for high weights on factors that are characteristic for its economy.

While formulary apportionment systems have been implemented at a sub-national level in a number of countries, notably Canada, Germany, Switzerland and the United States, attempts to introduce formulary apportionment at an international level have been hampered by political obstacles. The European Commission has, nevertheless, recently renewed its proposal to implement formulary apportionment in the European Union ("Common Consolidated Corporate Tax Base (CCCTB)"). Developing countries lack the resources to start own initiatives for an international formula apportionment system, but could join other initiatives like the one proposed by the Commission for the European Union if this proves to be successful. In the light of this discussion, a move towards formula apportionment might be a beneficial step for less developed countries as the operation of formulary apportionment systems, if appropriately designed, would most likely reduce administrative and compliance costs and limit tax risk and the scope for corrupt behaviour on the part of tax officers. By being part of a multilateral formulary apportionment system, developing countries could furthermore adopt the definition of the tax base of other (major) countries, which would further enhance tax simplicity and exert a positive effect on FDI and trade. Whether developing countries win or lose in terms of cor-

41. See, for example, J. Mintz & M. Smart, *Income Shifting, Investment, and Tax Competition: Theory and Evidence from Provincial Taxation in Canada*, 88 J. Pub. Econ. 6, pp. 1149-1168 (2004).

porate tax revenue would depend on the design of the formulary apportionment system, primarily on the choice of the apportionment formula.

Given that an international introduction of formulary apportionment appears to be unlikely in the near future, one viable short-term option could also be to make the assignment rules in the current arm's length system more "formula-based". The idea is to modify the current transaction-based residual profit split method, which follows a two-step procedure. First, each associated enterprise is compensated for routine contributions based on the returns that unrelated parties would earn. The remaining "residual profit" is split on an economically valid basis that corresponds to the division between unrelated parties, thereby acknowledging the relative values of deployed assets, skills, and intangibles.

The major difference between the distribution of profit in the second step of the residual profit split method and formulary apportionment is thus simply the case-specific formula in the former and the pre-determined formula in the latter case. One sensible reform option within the current transfer pricing system is, therefore, to stick with the "residual analysis", but distribute the residual income based on fixed allocation keys. The appeal of such an approach is that the arm's length principle is retained where it is easy to apply in situations involving limited administration and compliance costs, i.e. with regard to the pricing of standard goods, services and tasks, but formulary apportionment would be used for transactions where applying the arm's length principle would result in absurd and unresolvable complexity, such as in the presence of intangibles, skill-intensive services and core competencies. This would reduce administration and compliance costs and would also limit the scope for aggressive transfer (mis)pricing behaviour by sophisticated MNEs, as well as the risk of the adoption of aggressive tax positions by the tax authorities and the potentially related negative effects on investment by MNEs.

5. Conclusions

The objective of this article was to identify particular challenges faced by developing countries in designing and administering transfer pricing systems. Next to the general conceptual and practical shortcomings of the arm's length principle, developing countries encounter the specific difficulties that: (1) comparables data from uncontrolled transactions is often hard to locate; (2) tax authority resources tend to be limited; and (3) tax auditor discretion relating to transfer pricing choices may provide opportunities for corrupt behaviour in weak governance environments.

The authors discuss potential remedies for these challenges. They firstly assess "direct" responses, namely permitting the use of indirect comparables as a response to the lack of comparables data and engaging in staff training and other capacity building measures as a response to the lack of resources on the part of the tax authorities. In the authors' view, it is, however, unlikely that such provisions, in themselves, would be effective in resolving the transfer pricing issues of developing countries, and both measures, on top, would also come with their own issues and problems.

This article, therefore, argues for the diverging of the transfer pricing regimes of developing countries from the arm's length principle in return for reduced administration and compliance costs. The authors primarily consider the introduction of safe harbour provisions and a more formula-based international allocation of the income of MNEs. While both proposals may have complex efficiency and equity consequences, they come with decreased administration and compliance costs and have the potential to exert positive effects on FDI in developing countries and to reduce profit shifting and corrupt behaviour.