TRANSFER PRICING AS A WAY OF MINIMIZING THE TAX BURDEN: INTERNATIONAL EXPERIENCE OF COUNTERACTION

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Abstract

The article analyzes transfer pricing used by a number of TNCs and MNCs as a way of minimizing the tax burden, which is often accompanied by significant social losses, especially sensitive for developing countries. In this context, the article focuses on the following issues: 1) historical aspects of development of transfer pricing; 2) economic evaluation of losses incurred by transfer pricing and a number of other methods of tax optimization; 3) new trends in the application of transfer prices in the conditions of digitalization of the world economy; 4) the logic of the development of international legislation in the field of transfer pricing. The article concludes with an analysis of a new order of normative regulation, called «BEPS» Action Plan, which is aimed primarily at solving the problems in the field of taxation of the digital economy which is also of great importance for Russia.

Keywords: transfer pricing, minimizing the tax burden, intangibles, BEPS Action Plan.

JEL code: G38, G35, H26

Historical background and research objectives

The relevance of regulation of transfer pricing as a way of minimizing the tax burden is due to the desire of economic entities to maximize profits in conditions, on the one hand, of deepening the processes of globalization, and, on the other hand, of heterogeneity of the tax systems of different countries. This encourages corporations to move capital and revenues to low-tax jurisdictions, using transfer prices as an effective tax planning tool from the point of view of private interests.

Historically, the problem of transfer prices arose in developed countries in the middle of the 20th century, due to the intensification of concentration processes and the specialization of production, which led to the formation of large transnational and multinational corporations (TNCs and MNCs). Intermediate products in the production process transferred between their divisions at intra-firm prices, which thus mediated the movement of intermediate products between the parent company and the subsidiaries.

The period of the late 1950s - early 1960s was marked by gaining independence of a number of countries located on the African and Asian continents. This led to the need for large business companies to change their strategies. Under the new conditions, TNCs intensified their efforts to lower the prices of raw materials supplied from developing countries to their own divisions located in «tax havens», and then resold it at market prices in international markets. Due to the implementation of such schemes, as experts say, some of the profits of corporations settled in «offshore» centers, and losses from understating of taxes were borne not only by developing but also by developed countries (Sultanova and Bagaytdinov, 2013, p.170).

During that period the transfer of capital from foreign divisions of TNCs and MNCs to the parent company was carried out mainly through the payment of dividends. However, the existence of government restrictions in the form of setting the upper limit of remittable dividends reduced the effectiveness of the use of this channel and forced companies to apply hidden methods of intercountry capital transfer (Zelenyuk, 2013, p. 50). In such a situation, an effective strategy for withdrawing funds from taxation was the application of transfer prices between associated companies located in different jurisdictions.

Over the past 30 years, the role of TNCs has increased significantly, which is due to the closer economic integration of the world's countries and scientific and technological progress, especially in the field of information technology and communications. According to the UNCTAD (UNCTAD, 2013) 80 % of international trade, estimated annually at 20 trillion US dollars, is administered within the framework of value chains connected with transnational corporations. In these conditions, despite the crossing of national borders of different countries, goods usually remain in the ownership of the group of associated companies.

Interdependence allows members of the TNC group to establish special conditions in the intra-group relations, which may differ from those that could have been formed if the members of the group acted as independent entities in the open market. Wherein, the existence of interdependence does not automatically mean deviation from the conditions formed in the open market (OECD, 2017a, p. 33). In many cases, income between divisions of TNCs located in different jurisdictions is distributed fairly and efficiently. At the same time, TNCs often abuse the rules for establishing fair prices with a view to separating the income from the activity which generates it.

For the analysis of such situations it is important to operate with clear concepts, including the basic concept of transfer prices. In the «OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017», transfer prices are understood as prices at which an enterprise transfers physical goods and intangible property or provides services to associated enterprises (OECD, 2017a).

In practice, both underpriced and overpriced transfer prices are used for the taxable base erosion. The selling to a foreign division of goods at an underpriced price facilitates the transfer of the taxable base to a jurisdiction with a more favorable tax regime. A similar situation occurs when the parent company purchases goods from a foreign division at an overpriced price. The underpriced transfer price is also used if there are the restrictions on the export of capital from the country of placement of the parent company, as well as when the foreign division is located in a low-tax or a zero-tax jurisdiction. Such transfer price is used in the case of presence of significant customs duties on imported products supplied to the associated enterprise, etc. The overpriced transfer price is applied if the parent company weakly controls the foreign division, and in the country where the division is located, the economic and political instability is observed. The consequences of applying of both types of transfer prices, underpriced and overpriced, are unfavorable.

Transfer pricing and its various aspects are of considerable scientific and practical interest for Russian and foreign researchers. Given the relatively long period of study of this phenomenon, currently in the foreign literature, publications predominate, in which special aspects of this problem are examined. These include the following: motives for applying transfer pricing (Gao L. and Zhao X., 2015); transfer pricing strategies and practices used by MNCs (Klassen, K. and Lisowsky, P. and Mescall, D., 2017); transfer pricing as a tool for tax planning and erosion of the taxable base (Hopland, Arnt. O. and Lisowsky, P. and Mardan, M., 2014; Rossing, Ch. Pl. and Cools, M. and Rohde C., 2017; Yolonen, M., 2016); arm's length pricing regime and alternative methods of allocating multinational income among taxing jurisdictions (Andrus, J. and Oosterhuis, P., 2017); transfer pricing as a mechanism for tax control (Baistrocchi, E, 2006); transfer pricing on intangibles (Blair-Stanek, A., 2016; Pankiv, M., 2016), etc. Experts from governments and non-governmental organizations are also involved in the study of this issue, particularly, from the OECD, the UN, the World Bank, «Tax Justice Network», «Global Financial Integrity», etc.

Preferential attention in the Russian literature is paid to the following issues: historical aspects of the development of transfer pricing (Sultanova, L. and Bagaytdinov, R., 2013); the essence and peculiarities of transfer pricing (Zelenyuk, A., 2013); tax control over transfer pricing of intangibles (Nagornykh, M., 2014); problems of measuring and scales of the tax base erosion in the Russian Federation (Milogolov, N. and Tserenova K., 2016); international cooperation in the field of taxation within the framework of the «BEPS» Action Plan (Shelepov, A., 2016; Yartseva, N. and Gorovoy, E., 2016), etc.

Considering the level of development of the problem in the literature, as well as a number of its topical aspects, the article will primarily provide estimates of losses associated with transfer pricing and other methods of optimizing the tax burden. To carry out this analysis, in turn, it was necessary to present the significance of a number of basic concepts and terms. In addition, we will study new trends in the application of transfer prices for the erosion of the taxable base, including the transition to the digital economy and the growing importance of intangible assets. Further, we will present the logic of the development of international legislation to prevent the use of transfer prices to minimize the tax burden. Special attention will be paid to the «Base Erosion and Profit Shifting» Action Plan (BEPS), published in 2013. Bearing in mind the accession of Russia to the «Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting» (June 7, 2017), we will highlight the most urgent tasks in this regard.

International losses from the use of transfer prices and other methods of optimizing the tax burden

The amount of budget losses from the use of transfer prices is difficult to estimate. To date, no organization investigating this problem can present a real picture of the damage from manipulating of foreign trade prices throughout the world economy, although some estimates are published on this score. These difficulties stem from, foremost, the insufficient interaction of states in the field of the exchange of financial information between Tax and Customs Administrations. Despite the efforts of the OECD, which resulted in the development of the «Standard for Automatic Exchange of Financial Account Information in Tax Matters», as of 2017, only 147 jurisdictions have joined the fight against tax evasion.

The non-governmental organization «Christian Aid», founded to support sustainable development and civil society, including research of the impact of TNCs' activities on the development of economies of different countries, believes that the budgets of developing countries annually lose about 160 billion US dollars due to insufficient control over transfer prices (Christian Aid, 2014).

According to the IMF estimates, the losses of the OECD countries' budget systems from the short-term effects of the erosion of the taxable base are 0,23 % of GDP, and for developing countries they are higher and reach 0.84 % of GDP (Milogolov and Tserenova, 2016, p. 7). As for Russia, according to experts, the losses that the country bears are comparable with the losses of developing countries.

Along with the transfer prices, other methods can be used for evading taxes and erosion of the taxable base. For example, «Global Financial Integrity», analyzing the amount of illicit financial flows from developing countries for the period of 2005-2014 (Global Financial Integrity, 2017), notes that most of the illicit withdrawal of funds (87 %) was carried out through trade misinvoicing, i.e. by distortion of the declared value of goods and services.

Manipulating the price, quantity and quality of goods or services on an invoice, the business shifted significant sums of money across state borders. Such misinformation pursues different goals with comparability of the consequences of their implementation. These goals include the following: illegal money laundering by criminal business representatives and public officials through corruption schemes; direct evasion from taxes and customs duties by underreporting of the value of goods during import; abuse in the form of overreporting of the value of goods exported abroad due to the generous tax incentives for domestic exporters; dodging from the state restrictions on the withdrawal of capital abroad, etc. (Global Financial Integrity, 2015). For the years between 2005 and 2014 the volume of illicit financial flows averaged from 14.1 % to 24 % of the total volume of trade of developing countries and increased annually by 8.5-10.1 % (Global Financial Integrity, 2017).

To assess illicit financial outflows from developing countries, «Global Financial Integrity» uses traditional and conservative approaches that allow forming a more complete picture of the scale of this phenomenon (Fig. 1).

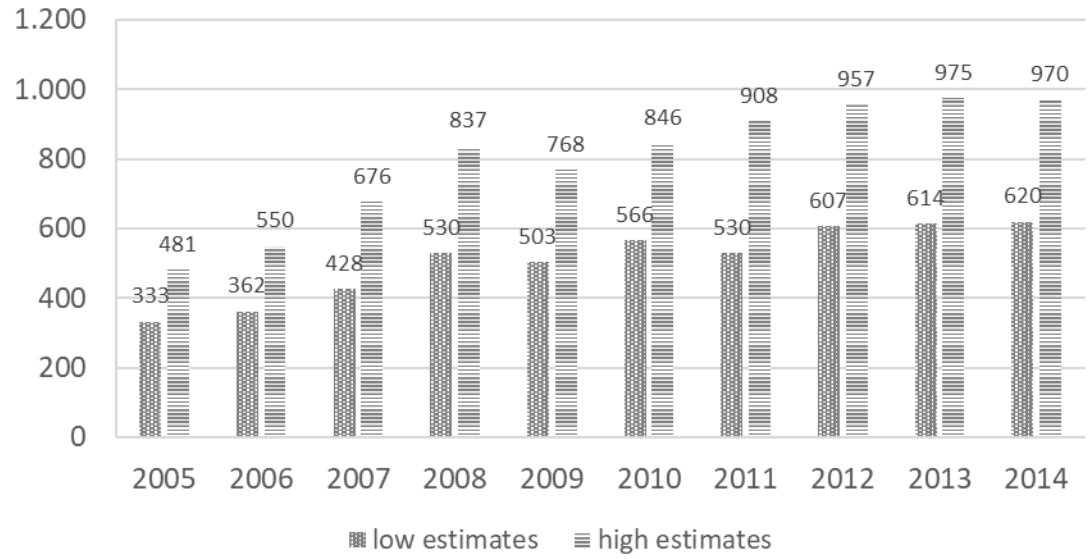

Figure 1. Estimates of Illicit Financial Outflows from developing countries, 2005-2014 (Millions of US dollars) (Global Financial Integrity, 2017).

Thus, the volume of illicit financial outflows from developing countries in 2014 was estimated at between 620 and 970 billion US dollars. Low estimates are based on data of bilateral trade between developing and developed countries only. When generating high estimates of the volume of illicit financial outflows, misinvoicing between developing countries is also accounted.

The fight against tax planning that minimizes the business tax burden applying by TNCs and MNCs is should be regarded as a separate problem compared to transfer pricing, and it requires the development of specific measures. Nevertheless, TNCs and MNCs do engage in trade misinvoicing and deliberately underreporting or overreporting the value of customs transactions for the purpose of illegal tax evasion, as in the case of applying of transfer prices (Global Financial Integrity, 2015).

The reduction of the taxable base by overpricing or underpricing of transfer prices is subjected to the thorough monitoring by the Tax Administrations of various states, which in turn change their national legislation for tightening the rules of transfer pricing. Large corporations, however, have some freedom in setting transfer prices because of the imperfect legislation of a country. Uncertainty increases significantly with the transfer of intangible assets, especially when transferring intellectual property rights to a foreign entity.

If earlier transfer pricing was often accompanied by manipulation of prices for tangible assets, the process of digitalization of the economy actualized the use of intangible assets in tax planning. This is due to the fact that in the digital economy there are significant difficulties in determining the jurisdiction in which creation of value occurs, as well as when tracking the value chain in connection with the modification of modern business models.

Indeed, if the transfer of tangible assets (industrial buildings, commercial premises) to another jurisdiction is accompanied by significant financial and material costs, the transfer of patent rights, rights on trademarks or copyrights is less expensive, and these transactions are implemented more quickly. In addition, many intangibles are unique, which causes difficulties in determining a fair transfer price that corresponds to the «arm's length principle». The «arm's length principle» is understood as the formation of such prices for intra-group transactions which correspond to prices established for comparable transactions between independent enterprises.

Transfer of the intellectual property right to an associated company registered in the offshore jurisdiction allows TNCs and MNCs to reduce their taxable base, primarily by setting high royalty payments for the use of intangible assets. The peculiarities of the legislation of a number of European countries for a long time allowed TNCs to use such schemes of minimizing the tax burden, which are inherently legal, but often unethical.

So, the work of American corporations Apple, Google, Facebook, Amazon and Starbucks in spring 2012 was criticized by the UK Tax Administration because of the use of «immoral» tax schemes, including «Double Irish», as well as «Dutch Sandwich».

In the same series, the example of the company Google, which having received in 2006-2011 almost 12 billion British pounds of revenue in Great Britain, paid only 10 million British pounds of taxes to the country's budget. Based on the findings of the report of the Permanent Subcommittee on Investigations of the US Senate of 2013, Apple, with the 74 billion US dollars profit received over the past four years, paid taxes at zero or minimum rates (Kozlovsky, 2013).

In 2012 the Facebook affiliate located in Ireland reported revenue of 1.79 billion euro. Its administrative costs, including license fees to Facebook Ireland Holdings, amounted to 1.75 billion euro, and the loss without taking into account the payment of tax - 626 thousand euro (Silonov, 2014).

The mechanisms for avoiding taxation in these situations were constructed as follows. The scheme for minimizing taxes, dubbed the «Double Irish», was based on the creation of two affiliated companies in Ireland - N1 and N2. The US parent company transferred the intellectual property rights to N1, which was controlled and managed from an offshore jurisdiction with a zero Tax rate. According to Irish law, N1 was a resident of the offshore zone and did not pay Corporate Tax in Ireland. Company N2, being a resident of Ireland, under the sublicense agreement with N1, conducted activities around the world and generated revenue. Most of the proceeds were transferred to N1 as royalty payments, while the rest was taxed at Corporate Tax at a rate of 12.5 % (Kozlovsky, 2013), which resulted in significant savings on taxes

Under the scheme of tax optimization, known as the «Dutch Sandwich», another Dutch company was added to the «Double Irish» scheme, what allowed to reduce payments in even larger volumes. Ireland did not tax the funds transferred by its residents to some EU countries, whereas when transferring profits immediately to the offshore zone tax was levied. To reduce payments, the Irish N2 transferred the profit not to the Irish N1, but to the Dutch company. The latter company was a «dummy», that is, it existed only on paper. Using the preferential tax regime of the Netherlands, it transferred the collected funds to an offshore company (Kozlovsky, 2013).

As reported by the Central Bank of the Netherlands, in 2010, for such purposes, 14.300 subsidiaries were registered in the country. According to some estimates, in 2012 the volume of funds transferred through the Netherlands amounted to about 13 trillion euro (Basmanov, 2013).

Due to the pressure of the European Commission, starting in 2015, the Irish government decided to eliminate the possibility of using a «Double Irish» tax optimization scheme for newly established companies. For companies that worked under this scheme earlier, a period until 2020 was established for switching to other taxation schemes.

Thus, today the regulation of transfer pricing on intangibles is a crucial aspect in the fight against illegal and legal tax minimization.

Imperfection of legislation and significant losses from the application of various schemes of tax optimization led to the development by the G20 and OECD countries of a document called the «Base Erosion and Profit Shifting» Action Plan (BEPS). The BEPS Action Plan provides for an analysis of the current taxation rules in terms of the ability to transfer profits from the country where it is generated to the low-tax jurisdictions, as well as eliminating of legal voids and gaps in the current transfer pricing rules. The adoption of this plan was the result of the development over several decades of international legislation aimed at preventing the use of transfer prices for minimizing the tax burden.

International legislation in the field of transfer pricing

The substantial financial losses associated with the transfer of the taxable base to foreign jurisdictions have contributed to the formation of special transfer pricing legislation both at the national and international levels.

The country that first adopted regulatory acts in the field of transfer pricing was the United States. Following the United States in the late 1960s the elaboration of tax regulation of transfer pricing was implemented by the United Kingdom, France, Canada, Japan, the Netherlands, and other states, whose companies were active in the markets of developing countries (Sultanova and Bagaytdinov, 2013, p. 170).

The first document regulating the issues of transfer pricing at the international level was the «OECD Draft Double Taxation Convention on Income and Capital» of 1963, which was the basis for concluding bilateral treaties on taxation of income between OECD countries and other states. It was revised, supplemented and published in 1977 under the title the «OECD Model Double Taxation Convention on Income and on Capital». In this convention, the definitions of transfer prices and associated enterprises were given, and for the first time the «arm's length principle» was formulated. It was described as an international standard-recommendation when establishing transfer prices.

The «arm's length principle» in modern tax practice is understood as follows: «Where conditions are made or imposed between the two associated enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits 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» (OECD, 2017a, p.38).

Further, a number of documents were drafted and adopted. Among them are the «OECD Declaration on International Investment and Multinational Enterprises» of 1976; the OECD report «Transfer Pricing and Multinational Enterprises» of 1979 (abolished by the OECD Council in 1995); the «UN Model Double Taxation Convention between Developed and Developing Countries», 1980; the OECD report «Transfer Pricing and Multinational Enterprises - Three Taxation Issues», 1984; the OECD report «Thin Capitalization», 1987 and others.

In 1995, based on the analysis of previous reports and additions, the «OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations» were approved, which were updated in 2010 and in 2017.

As can be concluded, the regulation of transfer pricing is mainly based on the conventions and recommendations of the United Nations and OECD, the provisions of which are taken into account in the legislation of developed and developing countries. The need to increase the transparency of international taxation, the existence of legal gaps and inconsistencies in the tax legislation of individual states led to the fact that in 2013 the OECD published the «Base Erosion and Profit Shifting» Action Plan (BEPS) (OECD, 2013), which includes 15 actions. In 2015, after numerous improvements and consultations, the final package of measures (BEPS Package) was published, which included materials on a number of areas of the BEPS Plan and seven updated reports. The final BEPS Package was approved by the leaders of the G20 at the Summit in Antalya in November 2015.

One of the key objectives of the BEPS Project was the development of international tax rules that would allow to tax transnational corporations where economic activities take place and where value is created (Yolonen, 2016, p. 34).

The main areas of work within BEPS in terms of regulation of transfer pricing are the following: the solving the problems in the field of taxation of the digital economy (Action 1), particularly, the analysis of various business models to determine the order of value creation; the development of a clearer definition of intangibles; proper enforcement of the «arm's length principle» in the transfer of intangibles and other mobile assets within TNCs and MNCs; ensuring the proper allocation of profits associated with the transfer and use of intangibles; re-examining the transfer pricing documentation, what requires that TNCs and MNCs provide the necessary information to all relevant governments regarding the global allocation of revenues, the taxes paid to each country and economic activity.

In 2015, the OECD presented the «Aligning Transfer Pricing Outcomes with Value Creation» Report (OECD/G20, 2015), which provides for changes to the «OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations». These changes are reflected in the updated version of the «Guidelines», published in 2017.

Changes in transfer pricing are aimed at taxing profits in those jurisdictions where real value creation occurs, i.e. emphasis is placed on ensuring «substance over form». The Report notes that when distributing profits on transactions related to intangibles, the legal title of the owner itself does not yet constitute a basis for obtaining all income (royalties) from the use of intangibles. The main attention in the Report is concentrated on counteracting the distribution of profits from intangibles disproportionately to the contribution of the parties to the creation of value. Associated enterprises performing important functions for creating the value of intangibles should receive not only compensation for expenses incurred for promotion, for example, a trademark in new markets, but also an appropriate remuneration, including a profit sharing element. In turn, associated enterprises which fund a project to create an intangible asset and assume the related financial risks but do not perform other functions can expect no more than a risk-adjusted return on its funding (FTS of Russia, 2015).

In February 2016, the OECD presented an Inclusive Framework for the participation of all interested countries and jurisdictions in the BEPS Project, developed on behalf of the G20. Under the new mechanism, not only G20 member countries and OECD countries can implement concerted measures to combat the erosion of the taxable base and profit shifting at the national level, but also all other states, including developing ones (Shelepov, 2016), by giving them the status of the key partners.

Participation in the BEPS Project is of particular relevance for the Russian Federation. This is due to the fact that domestic enterprises are actively applying tax planning schemes, covering also intangible assets, including by abusing the application of the «Double Taxation Avoidance Agreements» (DTAAs).

Thus, payment of royalties for the use of intellectual property rights for intangibles is included in expenses of the licensee, which reduces the taxable base of the enterprise and, accordingly, payments to the budget of the Russian Federation. The difficulties faced by the Federal Tax Service of Russia in challenging royalty payments in favor of non-residents, including difficulties in determining the fair transfer price due to the uniqueness of certain types of intangibles and the absence of DTAAs with the partner country, result in the transfer of significant financial resources to foreign jurisdictions.

According to the Central Bank of the Russian Federation, Cyprus, the USA, Ireland, Switzerland, Germany, Great Britain, the Netherlands, France, Korea and China were the largest partner countries that granted intellectual property to the Russian Federation in 2015. The amount of royalties in favor of countries with a ratio of incoming foreign direct investment to GDP more than 100 % (Cyprus, the Netherlands, Ireland, Switzerland) accounted for 44 % of the total payments for the use of intellectual property. In these countries are usually placed intangibles created in other jurisdictions for the purpose of tax optimization. In addition, for the Russian Federation, they are convenient conduit, not the ultimate recipients of royalty payments due to the presence of DTAAs (Milogolov and Tserenova, 2016, p.15). The presence of «Double Taxation Avoidance Agreements» with a number of states implies the application of the reduced withholding tax rate at the source when royalties are paid out from the Russian Federation. Then the conduit company located in such a state transfers the royalties to a low-tax or a zero-tax jurisdiction to the ultimate right-holder.

The Russian Federation, together with 69 other states, signed the «Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS» (OECD, 2017b) in July 2017, thereby documenting the intention to combat actively against the minimization of taxation and profit shifting, including in the field of abuse when applying Double Taxation Avoidance Agreements.

Ratification and entry into force of this Convention will be an important stage in the fight against taxation minimization both at the national and international levels within the framework of the implementation of the BEPS Action Plan.

Conclusion

The establishment of fair transfer prices is one of the most important tasks at the present stage of development of the world economy. The annual growth of international trade taking place between members of TNCs and MNCs, along with the digitization of the economy, leads to an expansion of the use of tax planning tools to reduce the overall tax burden, which undermines the economic potential of various countries. From the effects of tax base erosion, caused by applying of both underpriced and overpriced transfer prices, the largest losses are borne by developing countries, as well as by emerging markets, including Russia, due to imperfections in their tax legislation and other institutional constraints. At the same time, at the international level, legislation is constantly being improved to prevent the use of transfer pricing as a way of minimizing the tax burden. Only joint efforts of all countries will help limit the use of those tax optimization schemes which are implemented in the private interests of corporations.

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