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Back From the Dead:
How to Revive Transfer Pricing Enforcement

Reuven S. Avi-Yonah[1]

Transfer pricing enforcement is dead
Edward Kleinbard (2007)

In the six years since the then Chief of Staff of the JCT pronounced transfer pricing enforcement to be dead, numerous case studies have demonstrated the truth of his observation, starting with the JCTs own examination of six US based multinationals (MNEs) in 2010 and followed by the Senate Permanent Subcommittee on Investigations hearings on Microsoft, HP and Apple in 2012-13. There is little doubt that the current transfer pricing rules, in conjunction with the dysfunctional Subpart F rules, allow US-based MNEs to shift most of their profits to low tax jurisdictions. It is estimated that there are currently about 2 trillion dollars of such profits that benefit from deferral and cannot be repatriated because they are not subject to foreign tax and therefore would be subject to full US taxation upon repatriation under current law. Hence the push to adopt territoriality and allow the MNEs to distribute these trapped profits as dividends to their US parent, which can then in turn use them to pay dividends to its shareholders.

The OECD has recently come to recognize that the transfer pricing system does not work as intended. In its report on Base Erosion and Profit Shifting, the OECD recognizes that BEPS results in revenue losses that affect all states, especially poorer ones; that systematic tax avoidance by the richest and most powerful companies in the world undermines the general legitimacy of taxation; that it gives MNEs significant competitive advantages over purely domestic firms, resulting in inefficient allocations of investment and major distortions to economic activity; and that it skews the decisions of the MNEs themselves, resulting in overall economic welfare losses.

This article will contrast three approaches to dealing with the BEPS problem: adopting a unitary taxation regime; ending deferral; and adopting anti base erosion measures. It concludes that while the first approach is the best long term option, the other two are more promising as immediate candidates for adoption in the context of US tax reform and the OECD BEPS project.

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1. Unitary Taxation

Unitary taxation (UT) involves treating each MNES as a single unit, disregarding the formal distinctions among its constituent corporations, and allocating its profits to the various taxing jurisdictions by formula. This is the approach adopted by the US states and the Canadian provinces, and that is being considered for adoption by the EU as a Common Consolidated Corporate Tax Base, or CCCTB.

In principle, UT has two major advantages over the current system. First, it is a better fit for the way a modern MNE operates, since most MNEs are integrated units with no attention being paid to the formal distinctions among parent and subsidiaries except for tax and limiting liability purposes. Second, UT applies the same regime to all MNEs and does not rely on the increasingly unimportant question of where the parent corporation is resident.

But UT faces formidable obstacles to being adopted. First, it confronts considerable opposition from the OECD, which remains formally committed to the separate accounting method and the arms length standard (ALS). The OECD interprets its model treaty as forbidding the application of UT to parent subsidiary combinations, and has recently reinterpreted the model to apply similar rules to branches as well, including situations where a subsidiary can be deemed to be a dependent agent Permanent establishment (PE) of its parent. Second, in the absence of agreement on the allocation formula UT runs the risk of creating more double taxation. Third, a formula that relies on factors such as the location of assets or payroll risks driving MNEs to shift jobs to low tax jurisdictions.

I believe that in principle these objections can be overcome. I have argued elsewhere that the OECD interpretation of the treaties is not persuasive and that many treaties contain language that permits the application of formulas to subsidiaries that are considered dependent agent PEs of their parent, as long as the result is consistent with the arms length standard, which in the absence of comparables will be impossible to disprove. The double taxation risk is to some extent under the control of the MNEs, and is not more problematic than the reality of double non-taxation and the risk of double taxation under the current regime. The disagreement over the formula and the threat to jobs can be alleviated if the formula relies only on the destination of sales, since the costumer base is less subject to tax competition and states generally like to tax imports and exempt exports.

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Nevertheless, I think that in the immediate context of US tax reform and the BEPS project, UT is a bridge too far: there are too many technical details that need to be worked out for it to become a viable solution in the next couple of years. The best that can be hoped for is for the OECD to realize that the allocation of the residual profit under the profit split method, which is its preferred method for dealing with income from intangibles and other forms of income that are hard to source under the ALS, should be done under a formula and not left to each country to deal with as it pleases (the US allocates it to where R and D takes place, which favors its revenue interests but is irrelevant to the location of profits). Such a formulary approach to dealing with the residual would address the bulk of the problem while not violating the ALS, since the OECD agrees that in the absence of comparables any allocation of the residual is compatible with the ALS.

In the longer term, I do hope that even the OECD will be persuaded to move toward UT. If the EU adopts the CCCTB, this will give us a good working example in the context of high tax jurisdictions. Thus, I will continue to work on UT solutions, because these are the best outcome for a world in which integrated MNEs do not really belong to any jurisdiction. But this is a long term project.

2. Abolishing deferral.

It has also been realized for a long time that abolishing deferral deals effectively with the outbound transfer pricing problem for US based MNEs. In fact, Subpart F was enacted with the understanding that it will deal with the transfer pricing problem by subjecting all income that was likely to escape high foreign taxes to immediate US tax. The problem is that the world has changed in two ways since then: First, it is now possible to earn active income in many jurisdictions without foreign tax because of tax competition, and second, Subpart F has been undermined by the check the box regulations and the subsequent adoption of 954(c)(6).

The usual arguments against abolishing deferral are that it will put US multinationals at a competitive disadvantage, that it will lead to inefficient outcomes because less efficient foreign MNEs will obtain projects that should have been owned by more efficient US MNEs, and that it will lead to migration of US MNEs to other countries and to the establishment of new MNEs in other jurisdictions with more favorable tax rules.

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All of these arguments assume that abolishing deferral can only be done unilaterally. But the OECD BEPS project action plan envisages strengthening CFC rules, and I believe this presents the US with a golden opportunity to abolish or significantly restrict deferral while pushing other OECD members and large developing countries to follow the same route. As discussed below, option Y of Sen. Baucus' recent proposal is the best vehicle for achieving this goal.

If all the large jurisdictions in the OECD and G20 agree to severely curtail their deferral or exemption systems, this addresses all the arguments raised against doing so unilaterally. There will be no competitive disadvantage or inefficiency since the competition will be subject to the same rules, and it will not be possible to move to another jurisdiction since the likely headquarters jurisdictions will also follow the same rules.[2]

3. Base Erosion.

Abolishing deferral does nothing to address inbound transfer pricing abuse. Thus, I believe that it should be coupled with significant anti base erosion limitations. As suggested by Lowell and Wells, these should include an overall limit on deductible payments to related foreign parties, including cost of goods sold, interest and royalties. Such limits can be taken in conjunction with abolishing deferral and together these two steps will go a long way toward eliminating transfer pricing abuse.

4. The Baucus Proposal.

On the face of it, Sen. Baucus' proposal would seem to go in the opposite direction of what I suggest should be done, because it adopts territoriality as its base line. The main concern with territoriality is that it will encourage MNEs to shift even more profits overseas because they will no longer face constraints against bringing them back onshore. The proposal to tax the accumulated 2 trillion that are currently offshore at a lower rate of 20% would likewise seem to reward profit shifting.

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[2] Strengthening the exit tax provisions of IRC 7874 by imposing a deemed sale of all assets upon expatriation via merger and adopting a managed and controlled test for corporate residence would help prevent tax induced moves of corporate headquarters.

But Sen. Baucus' proposal also includes anti-shifting rules that go a long way toward mitigating these concerns. These come in two varieties dubbed options Y and Z. Under both options, income of CFCs from sales of goods and services into the US will be subject to immediate US tax. Income from foreign sales would under option Y be taxed at 80% of the US rate with a credit for foreign taxes. Under option Z, such income would be subject to full US tax unless it is connected with an active foreign business operation, in which case it will be subject to tax at 60% of the US rate with credit for foreign taxes.

I believe that the US sale rule is an important innovation because it means that we tax the CFC based on the ultimate destination of the sale of its goods or services regardless of whether it has a PE in the US and regardless of whether the sale is done through an unrelated conduit. This can be an important precedent for the kind of Unitary Taxation discussed above in which at least the residual profits of all corporations (not just CFCs) are taxed in the country they are sold into.

Of the two options, I strongly prefer option Y because it does not distinguish between types of foreign income and because the differential between the US rate and the rate applicable to foreign income is much smaller. Option Z relies on an antiquated distinction between active and passive income of MNEs that is very difficult to police in practice, as borne out by the experience of other countries that have similar rules. Moreover, this distinction has nothing to do with competitiveness, which is determined by the overall tax burden of the MNE.

If option Y is adopted, it will go a long way toward abolishing deferral. Assume that the US tax rate is 30%. Under option Y this will put the US tax rate on foreign income at 24%, which is about the OECD average. While there will still be a difference between US and foreign operations, the shifting potential would be significantly reduced.

If option Y is adopted by the US, the likelihood that the OECD would be willing to follow suit is quite high. The empirical data show that EU MNEs already bear an effective tax rate on their overall profits that is higher than 24% and higher than that borne by US based MNEs. Thus, other OECD countries that are currently under pressure to reduce the effective tax rates of their MNEs because of competition from the US but that also need the added revenue more than the US will be able to use the Baucus proposal as a reason to cut

back on their exemption systems and apply their tax rates, which are also about 24% on average, to the entire operation of their MNEs.

The history of international taxation is replete with examples in which unilateral moves by the US led other countries to adopt similar rules. The foreign tax credit, CFC rules, the transfer pricing methods, the branch profit tax and most recently FATCA were all American innovations copied by other countries. Unfortunately, the same is true for the portfolio interest exemption and the check the box rules, which led to a race to the bottom. It is time for the US to resume its natural position as leader in a race to the top.

5. Conclusion

The best way to kill transfer pricing abuse now is to adopt option Y of the Baucus proposal in conjunction with anti base erosion rules aimed at protecting the US tax base from foreign MNEs. If US based MNEs are to be taxed in full on their sales into the US, there is no reason not to apply the same rules to foreign based MNEs selling into the US. This can be done by adopting the anti base erosion rule and by using sales destination as the basis for allocating the residual under the profit split method.

In the longer run, I believe we should erase the distinction between US and foreign based MNEs by subjecting both to UT with formulary apportionment, which should in principle lead to a purely territorial system with no Subpart F or foreign tax credit needed. But we are not there yet, and in the immediate future curtailing deferral and base erosion are the best ways or the US to push the BEPS project forward.