PhD THESIS

CSABA LÁSZLÓ

KAPOSVÁR

2019
PhD Thesis

KAPOSVÁR UNIVERSITY

FACULTY OF ECONOMIC SCIENCES

Doctoral School of Management and Business Administration

Head of Doctoral School
Prof. Imre Fésű

Professor, Doctor of the Hungarian Academy of Sciences

Supervisor
Tamás Bánfi

Professor, DSc, Hungarian Academy of Sciences

TRANSFER PRICING IN LIGHT OF INTERNATIONAL TAX COMPETITION AND TAX AVOIDANCE

Prepared by:

CSABA LÁSZLÓ

Kaposvár

2019
1. Background and goals of research

1.1. Choice of topic

More than 60 percent of global trade takes place within multinational companies.\(^1\) We still often hear this estimate made by an OECD expert 15 years ago. According to the WTO’s World Trade Statistical Review 2016, global merchandise exports totalled USD 16.2 trillion while exports of services totalled USD 4.68 trillion in 2015.\(^2\) And the majority of this huge volume of transactions takes place between companies that are in some way related to one other, either by ownership or management. Since there are many other regulatory differences between countries, in addition to taxes, it makes sense for companies to structure their cross-border trade relations involving two or more countries in a manner that is most advantageous for them in every respect. The most obvious method, of course, is to exploit tax advantages. In today’s world of taxation, the profit generated on an international transaction can incur tax of 40 percent, but also tax of zero percent, if a company takes advantage of the opportunities presented by tax havens.

It follows from all this that if someone wants to venture into the field of international tax planning, tax optimisation, tax avoidance or tax fraud, then the most obvious solution is to shift their profits from a high-tax country to a low or zero-tax country with the help of transactions between related (controlled) companies. The contractual terms and conditions of these transactions form the basis of transfer pricing: first and foremost the pricing

---

\(^1\) Neighbour [2002] p. 29
conditions, but there are also a good number of other terms determining the final price and the assumed risk which fall under the scope of transfer pricing.

Ten to fifteen years ago, even in the most developed of OECD countries, transfer pricing was a niche field for only a very narrow band of tax professionals. In recent years this domain has grown in significance for tax authorities, companies and tax advisers alike, but also for politicians. Today, a huge number of countries have detailed transfer pricing policies. The process also started in Hungary, albeit with a slight delay, and was accelerated with a decree comprising detailed transfer pricing rules issued by the Ministry of Finance in 2003.\(^3\) According to a global survey by Ernst & Young in 2010, large multinational companies labelled transfer pricing as their most important tax-related problem.\(^4\)

I first encountered the field of transfer pricing on the regulatory side – as the person in charge of tax policy at the Ministry of Finance – and then on the client side, as a partner at a large advisory firm. The worlds of business and politics have given rise to countless misconceptions about this area. It is mentioned as the primary source of risk for the budget, a prime example of an excessive administrative burden for businesses, one of the key domains of international tax competition… and the list goes on. There are many truths in these statements, yet further research is needed to make transfer pricing and its impact on international tax competition, on profits in individual countries and on the levels of paid corporate tax more understandable. My thesis aims to contribute to this research.

\(^3\) Ministry of Finance [2003].
\(^4\) Oosterhoff [2011] p. 159
1.2. Purpose of research

In my paper I would like to analyse in detail the extent to which transfer pricing rules can fulfil this role, and what regulatory changes would improve the opportunities for regulation and international cooperation. Based on an examination of the hypotheses put forward in the analysis, I want to explore how much the opportunities provided by transfer pricing offer an effective solution, and how much we need to push through substantive changes in other areas regarding legislation and international cooperation. Apart from a review of literature, I want to conduct a detailed analysis of the workings of transfer pricing rules, the correlations with tax competition and the evolution seen with administrative burdens. It is important to broaden the scope of research to include correlations of international taxation that fundamentally determine the framework of international taxation. These include bank secrecy, cross-border data exchange, as well as examinations of the public nature of company registers and the cooperation of tax havens. In the research I had to look at how the possibilities and opportunities of international tax harmonisation could improve the efficiency of tax collection, and what level of harmonisation could be achieved. The combined use in the paper of theoretical research and practical experience helped me accomplish the objectives of the research.

I formulated the following hypotheses in connection with the set goals. 

**HYPOTHESIS 1:** The international system of transfer pricing that has emerged in recent decades provides increasingly less support for promoting efficient internal systems of accounting at corporations, and does not prevent tax avoidance and tax fraud via international tax planning.

My most important assumption is that international transfer pricing rules determine the internal systems of accounting at large corporate groups, and
these internal systems primarily facilitate compliance with the rules instead of focusing on presenting the real added value between the group members. Despite the pressure to comply with regulations, transfer pricing today is unable to prevent income flowing around the world for tax optimisation purposes. Tax authorities find it very hard to fault controlled transactions established using sophisticated transfer pricing methods.

HYPOTHESIS 2: Formal approaches to procedures dominate in transfer pricing rules.

Owing to the overly formal approach, the pricing system for transactions between related companies is not determined by the actual substance, while the approach taken by tax authorities can also be described as formal. Despite basic principles emphasising actual substance being the norm in many countries, the formal approach is considered most widespread in everyday practice. And in spite of transfer pricing essentially being based on the logic of economics and financial analysis, tax authorities and courts mainly focus on transfer pricing documentation because of their asymmetric information deficit, and they are unable to effectively manage the pricing systems that distort actual added-value ratios.

HYPOTHESIS 3: Preparing transfer pricing documentation is one of the most bureaucratic burdens for a group of companies.

The complexity of international business relations is constantly rising with the liberalisation of the international regulatory environment over the last decade or so, and with capital, labour, goods and services moving more freely. The European Union in particular is leading the way in this process, for whom one of the most important principles in economics is the freedom of economic organisation. It is virtually impossible to review complex business models with
the traditional methods of transfer pricing documentation. In the meantime, the magnitude and the complexity of the documents have steadily risen, and they are no longer transparent for either the companies affected or for the tax authorities – especially if we are talking about the multi-level subsidiary systems of large multinational companies with hundreds or thousands of entities.

HYPOTHESIS 4: The most promising field in the fight against international tax avoidance and tax fraud is not found in transfer pricing. Politicians are often inclined to label the transfer pricing system as one of the scapegoats for international tax avoidance and tax fraud. Transfer pricing is just one example of a method which emerged within the international economic system over previous decades that is no longer capable of fulfilling the requirements of tax authorities effectively in a radically changed economic environment. Tightening the transfer pricing system, and even applying tools of criminal law, could bring some partial successes, but solving the problem of international tax avoidance and tax fraud primarily means looking beyond the bounds of transfer pricing.
2. Material and method

2.1. Introduction to transfer pricing

The globalisation of international financial processes, the explosive development of global trade and the massive waves of migrants triggered by international conflicts and wars have created opportunities and demands prompting many countries to construct enticing legal systems and financial institution frameworks in which substantial tax advantages, secrecy, anonymity, stability and security are offered to companies and private individuals who are looking for places conducive to tax fraud or tax avoidance, or for stashing their assets. It was in this new world that shifting tax bases between different countries and thereby realising significant tax benefits became possible. If a country has a reliable legal environment and banking secrecy is watertight, then the low risk means there is a real temptation to avoid tax at international level.

Countries offering favourable tax conditions, otherwise known as tax havens, do not have any substantive real economic activity for the most part. Most of the head offices, development divisions and production units in the main economic sectors are still found in developed OECD countries today, and from an economic perspective, the profit is also generated in these high-tax countries. According to Christensen et al [2004], “at least half of all world trade appears to pass through tax havens, even though these jurisdictions account for only about 3 per cent of global GDP.” (p. 3)

If someone – maintaining a semblance of legality – wants to transfer their profit from high-tax countries to low-tax countries, then they are compelled to shift their tax base within the group via transactions that do not affect the basic production structure, but which do move a high proportion of profits at low
cost. In order for these transactions to achieve the desired effect, the prices of transactions between related companies have to be set so that the profit appears in the country that is most beneficial from a tax perspective. Financing transactions as well as the purchase and sale of intangible assets are perfect for this, but even goods trading does not necessarily mean the goods have to physically move. In a legal sense, any goods can travel halfway round the world on paper whilst physically remaining in the same warehouse. Yet profits or losses can arise at the various stages of the purchase procedure, decreasing or possibly increasing the tax base in the targeted countries.

Transfer pricing rules attempt to curb these opportunities, and channel the pricing of transactions within company groups into controlled and regulated frameworks. The first transfer pricing regulation was created at the end of the 1960s in the United States.\(^5\)

When devising the transfer pricing system the regulator assumed that related companies belonging to a “family” cannot be expected to conduct themselves in the same way with related clients as they would if they were independent parties. What matters within a group are the ultimate owners and the interests of the head office; the profitability of the individual subsidiary firms is always secondary to this. The purpose of transfer pricing rules is to force groups to apply the “arm’s length” principle for taxation purposes in transactions between related parties.

The essence of the arm’s length principle is that the parties involved should structure their mutual business relations as if they were independent from one another, and there was no hierarchical structure between them. Companies within the group are entitled to set prices freely between each other, but for tax accounting purposes, transfer pricing rules will only accept prices that independent parties would use in similar transactions. If a seller sets an

\(^5\) Kéri [2008] p. 359
excessively high price in a controlled transaction based on the arm’s length principle, then the seller is obliged to reduce its tax base and the customer has to increase its tax base with the difference to the arm’s length price. What one country wins with the tax base, the other loses exactly the same amount. But the tax impact, in most cases, is asymmetric.

Often the tax surplus of the winning country is nowhere near in proportion to the tax lost by the country on the losing side. Compared to the pre-2018 corporate tax rate in the United States of around 35 percent, the tax rate in tax havens could even be 1-2 percent. And this ten or twenty-fold difference can amount to millions or billions of dollars or euros for large multinational businesses. The aggregate impact for the budget in the United States, France or Germany for example can range from ten to one hundred billion dollars/euros, and these are amounts where losing countries will do everything in their power to avoid missing out on this tax.

The complexity of the problem is well illustrated by the fact that the “Bible” of the profession, the OECD Transfer Pricing Guidelines, takes more than 400 pages to elaborate on the OECD’s recommendations for member countries.⁶ Alongside OECD countries, a whole host of other states rely on these guidelines, while the OECD countries themselves do not necessarily adapt them in the same way.

Transfer pricing rules only appeared in Hungary just over 10 years ago. The first detailed regulation at Ministry of Finance level, approved by this author, entered into force in 2004. This decree made it mandatory for documentation to be prepared regarding transactions between related companies. In the early years the tax authority mainly examined compliance with formal requirements, but nowadays they also look at substance. The inspection guidelines issued every year by the tax authority always treat

⁶OECD [2010a].
transfer pricing inspections as a priority, and the tax authority’s (APEH/NAV) 2008–2012 strategy specifically highlighted the importance of transfer pricing inspections.

2.2. Definition of a related party

The entire transfer pricing issue starts with who or what qualifies as a related party. It is not always easy to define this. Relevant legal rules clearly cover the majority of the cases. Related parties are those between whom there is a significant ownership relationship. If this also means control by owners, then the fact of the related party relationship is not up for debate. Accordingly, this relationship is clear-cut with ownership of anywhere between 50 percent + 1 vote and 100 percent.

This is why, based on the principle of substance over form, the internationally accepted rules set forth that companies are also considered related parties even if the ownership ratio is less than 50 percent + 1 vote, but they still exert a decisive influence on each other’s operations from a management perspective.

2.3. Where is the profit generated?

Even with goods and services that are seemingly the same, a great number of factors need to be assessed that can very much influence prices. Quantitative, qualitative and delivery conditions, deadlines, level of risk, type of business relation – these are just some of the aspects based on which independent parties negotiate prices. These factors mean it is necessary to collect an extensive amount of information and conduct serious analysis to even approximate an arm’s length price.
This is because, disregarding regulated prices, arm’s length prices evolve as a result of market processes, supply and demand as well as other business factors, and so here it is rather economic and financial analysis that take precedence. The starting point for transfer pricing regulation is to search for a benchmark that is understandable and acceptable to the tax authorities examining the transaction, and on which basis the transfer prices can be determined. This benchmark is comparability.

The OECD [2010] defines five factors as important from the perspective of comparability:

– characteristics of property or services,
– functional analysis,
– contractual terms,
– economic circumstances,
– business strategies.  

2.4. Transfer pricing methods

The characteristics of the various business transactions are different, and the information available on the market can also differ, so several methods have evolved in recent decades to determine transfer prices. Prior to 2010, the OECD Guidelines favoured three methods.

– comparable uncontrolled price method,
– resale price method,
– cost plus method.  

---

7 OECD [2010a] p. 49–57
8 OECD [2001].
Following the most recent amendment in 2010, transactional profit methods are now also perceived in a similarly favourable manner:

\[\text{– transactional net margin method,}\]
\[\text{– transactional profit split method.}^{9}\]

**Comparable Uncontrolled Price Method (CUP)**

“The comparable uncontrolled price method compares the price charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances.”\(^{10}\)

The price lists available to anyone very rarely give information on detailed business conditions and on bulk discounts available. If someone does have detailed information on the pricing of competitors then it might be easier to determine transfer prices, but this can give rise to anti-trust concerns at the competition authority. Is it realistic for someone to have so much information on competitor prices? Perhaps they discuss them in detail?

**Resale Price Method**

“The resale price method begins with the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise. This price (the resale price) is then reduced by an appropriate gross margin on this price (the “resale price margin”) representing the amount out of which the reseller would seek to cover its selling and other operating expenses, and, in the light of the functions performed (taking into account assets used and risks assumed), make an appropriate profit. What is left after subtracting the

---

\(^{9}\) OECD [2010a].
\(^{10}\) OECD [2010a] pp. 69–70
gross margin can be regarded, after adjustment for other costs associated with the purchase of the product (e.g. customs duties), as an arm’s length price for the original transfer of property between the associated enterprises. This method is probably most useful where it is applied to marketing operations.”\textsuperscript{11}

**COST PLUS METHOD**

“The cost plus method begins with the costs incurred by the supplier of property (or services) in a controlled transaction for property transferred or services provided to an associated purchaser. An appropriate cost plus mark up is then added to this cost, to make an appropriate profit in light of the functions performed and the market conditions. What is arrived at after adding the cost plus mark up to the above costs may be regarded as an arm’s length price of the original controlled transaction.”\textsuperscript{12}

There can be two pitfalls to the cost plus method. The cost and the mark up. The majority of tax authority inspections focus on the mark up, and less so on the cost. Yet using a common mark up of 5–10 percent, the cost makes up 90-95 percent of the final arm’s length price, which is often taken as given, even though the cost side can comprise elements that do not really comply with the arm’s length principle. This can particularly be a problem where business activity with independent parties accounts for a significant share alongside controlled transactions. In such cases, by allocating the internal cost, more or less than the actual cost can be allocated to controlled transactions, depending on whether they want to increase or decrease the profitability of the enterprise.

\textsuperscript{11} OECD [2010a] p. 72
\textsuperscript{12} OECD [2010a] p. 78
as a whole. In comparison to this, it is often unimportant whether the mark up is 1 or 2 percent higher or lower.

The mark up part of this method is not simple either. Rarely do we find transaction-level market data for mark ups, and therefore taxpayers, or more commonly their consultants, tend to rely on aggregated figures to find “comparable” data that they can use to calculate mark ups on the market.

With the companies that are ultimately selected, the data that falls outside the upper and lower quartiles is not usually taken into account. At the end of this complicated and time-consuming process, the data most frequently falls in the range between the upper and lower quartile, between 3-5 percent and 8-10 percent.

**Transactional net margin method (TNMM)**

“The transactional net margin method examines the net profit relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer realises from a controlled transaction. Thus, the transactional net margin method operates in a manner similar to the cost plus and resale price methods. This similarity means that in order to be applied reliably, the transactional net margin method must be applied in a manner consistent with the manner in which the resale price or cost plus method is applied.”

It follows from the definition that similar problems arise here as with the cost plus method. The transactional nature of the method as derived from its name is very hard to ensure in practice since reliable databases on transactional data are few and far between.

---

13 OECD [2010a] p. 85
TRANSACTIONAL PROFIT SPLIT METHOD

“The transactional profit split method seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transaction by determining the division of profits that independent enterprises would have expected to realise from engaging in the transaction or transactions. The profits are split between the associated enterprises on an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm’s length.” 14

In the business structures that have taken shape over recent decades, it is increasingly difficult to separate individual functions and the associated risks and incomes in connection with complicated production and service processes. According to Hellerstein15, formulary apportionment rests on the belief that cross-border economic activity is becoming increasingly integrated, and that efforts to identify the source of the income is “theoretically questionable and practically inadministrable”. In the long run, this is why Hellerstein believes that formulary apportionment will be the preferred method of income allocation in the 21st century.

The added value chains of large multinational companies simply do not exist at individual, independent enterprises. Yet with the expansion of globalisation we are seeing an increase in the number of industries where the concept of a comparable uncontrolled enterprise is meaningless because such companies have not existed in the given sector for a long time. In response to this problem, Fris–Gonnet16 recommend that the large groups should not be rejected, on the contrary, the figures consolidated at group level should be used in the analysis.

14 OECD [2010a] p. 103
15 Hellerstein [2005] p. 111
16 Fris–Gonnet [2010] p. 102
OTHER METHODS

In addition to the methods defined in the OECD guidelines, in many countries it is also possible to apply other discretional methods if the methods presented above are not appropriate. These can be applied in special transactions. The valuation methods commonly used for acquisitions are taken into account for intra-group purchases and sales. The discounted cash flow method is used most frequently, and if this conforms to the normal approach in such transactions between uncontrolled parties, then the tax authorities accept its use.

PROBLEMS OF USING TRANSFER PRICING METHODS

One of the main problems is that the figures in publicly available databases comprise aggregate financial information, and in no way can this be broken down to cost, revenue, income and mark up data for individual transactions. This means there is no way to ensure the “transactional” nature\textsuperscript{17} if we rely on these databases.

Another problem is that only available information can obviously be taken into account for transfer pricing decisions, which means using data from at least 12–18 months before. A further risk for enterprises is that while detailed data on their rivals is not public, the tax authority can gain access to the data of any company during an inspection, even transactional data. Yet how can you defend against findings where their detailed background is unknown. Probably one of the most ancient principles of law is that regardless of who is accused of what, the accused has the right during their defence to access all of the information underlying the charge based on the principle of “equality of arms”. The Constitutional Court has confirmed this rule in several cases.\textsuperscript{18}

\textsuperscript{17} Fris–Gonnet [2010] p. 102
\textsuperscript{18} Constitutional Court (2002)
SELECTING THE TRANSFER PRICING METHOD

Selecting the transfer pricing method that best suits the individual transactions is by no means an easy task, and is generally the result of several steps. Large international companies devise centralised transfer pricing policies, taking account of the largest transactions in the most important countries. This is why the practice adopted by head office is often then followed for decisions made on methods used for smaller transactions, without conducting any detailed analyses.

2.5. Documentation

It is probably apparent by this point that transfer pricing is a seriously bureaucratic process. Designating the methods needed to determine the arm’s length price as well as carrying out detailed calculations and analyses require major effort from all those involved. This work essentially targets two goals. According to Cools¹⁹, transfer pricing is a significant element of internal management at groups. First and foremost, this system has to facilitate the precise measurement of performances in individual areas and the operation of incentive systems. The other, and in practice increasingly important, function of transfer pricing is serving the needs of tax authorities.

“Taxpayers should make reasonable efforts at the time transfer pricing is established to determine whether the transfer pricing is appropriate for tax purposes in accordance with the arm’s length principle. Tax administrations should have the right to obtain the documentation prepared or referred to in this process as a means of verifying compliance with the arm’s length

¹⁹ Cools [2003] p. 139
principle. [...] Moreover, the need for the documents should be balanced by the costs and administrative burdens, particularly where this process suggests the creation of documents that would not otherwise be prepared or referred to in the absence of tax considerations. Documentation requirements should not impose on taxpayers costs and burdens disproportionate to the circumstances.”

In most OECD countries and in many other states, mandatory provisions regulate the deadlines by which taxpayers have to prepare certain documents. The requirements regarding the form and substance of this documentation are defined in laws.

### 2.6. Safe havens

The ultimate outcome of what the majority of the profession deem to be an excessive and disproportionate documentation burden is that a lot of transactions produce the common mark up of between 3-5 and 8-10 percent, which meets the arm’s length principle. Fris-Gonnet [2010] levelled the criticism that

“Comparability, and the arm’s length principle deserve more than standardised comparables search processes and hazardous outcomes.”

The safe harbour option was invented in response to this unsettling situation. The essence here is that if the mark up on transactions defined in relevant regulations falls into a pre-determined range, then the transaction is

---

20 OECD [2010a] p. 211
deemed accepted from a transfer pricing perspective without the need for any further administration, analysis or calculation.

The fact a favourable solution is created for parties seemingly with contrasting interests probably played a role in the introduction and growth of safe harbours. The predictability which sets the maximum amount of tax payable by the taxpayer also offers a guarantee to the tax authority on the minimum tax to be collected. Moreover, checking transfer prices and handling any legal disputes does not require substantial resources on either side. After all, the excessive volume of documentation is not just a burden for the taxpayer, because the tax authority has to wade through the same documents too. In the end there is rarely any substantive difference between the opinions of the taxpayer and the tax authority regarding the mark up range, and so there is no point in nit-picking. The resources of the tax authority are tight, and there are other areas where inspection capacities can be put to more efficient use.

2.7. International implications (APA, MAP)

An increasing number of large multinational companies approach transfer pricing from a global perspective. The other approach is to shape transfer pricing with the help of local management. Yet setting up structures to minimise taxes is only one part of global tax planning. Risk management is also a factor. Risk factors have to be taken into account when allocating tax bases. If a tax authority adopts a very aggressive approach, then disclosing several tax bases in the country can be a rational strategy.
**Mutual Agreement Procedure (MAP)**

During mutual agreement procedures the competent bodies in the countries concerned strive to reach an agreement on allocating the disputed tax base with a view to avoiding double taxation.

“According to the OECD guidelines, mutual agreement procedures affect corresponding adjustments, and the most significant concerns expressed in connection with the procedures are discussed separately below:

1. Time limits under domestic law may make corresponding adjustments unavailable if those limits are not waived in the relevant tax treaty;
2. Mutual agreement procedures may take too long to complete;
3. Taxpayer participation may be limited;
4. Published procedures may not be readily available to instruct taxpayers on how the procedure may be used; and
5. There may be no procedures to suspend the collection of tax deficiencies or the accrual of interest pending resolution of the mutual agreement procedure.”

Yet Biçer [2014] levelled similar criticism too, also broaching the fact that taxpayers frequently being left out of tax authority consultations is a serious problem for them, or at least questionable, given that only they have all the information and they bear the potential consequences.

**Advanced Pricing Agreement (APA)**

Owing to the uncertainties regarding transfer pricing, both the authorities and taxpayers rightly want more reliability, transparency and manageable risk. So authorities and taxpayers have a mutual interest in adopting methods that facilitate a decrease in unpredictability and risk. Binding rulings have long

---

23 Biçer [2014] p. 84
since been common in normal tax matters, and are used by taxpayers to request an official opinion (resolution) from the competent authority (most often the Ministry of Finance or the tax authority) prior to implementing transactions and structures they consider important. If the conditions set forth in the issued resolution are complied with, the taxpayer knows in advance exactly how much tax to pay and when. What is frequently even more useful with such resolutions is that if the event takes place in accordance with the conditions contained therein, the tax authority may not object.

*Advance Pricing Agreements (APA)* were created by analogy with this system. Taxpayers can request an official opinion on transactions with related enterprises. If they follow the resolution issued by the authority, then it is clear how much tax they have to pay, and the tax authority cannot object to the transaction.

International correlations mean there are various types of advance pricing agreement. **Unilateral** advance pricing agreement (*unilateral APA*) – the taxpayer can only request an opinion from an authority in its own country. **Bilateral** advance pricing agreement (*bilateral APA*) – such a request is submitted if the taxpayer would like protection in two countries. The two authorities involved have to issue a joint resolution in this case. **Multilateral** advance pricing agreement (*multilateral APA*) – this must be requested if the taxpayer wants assurances in more than two countries. With complicated cross-border financing transactions and commercial transactions, the impact of a business process can span more than two countries.

There is another important issue with mutual agreement procedures (MAP) and advance pricing agreements (APA). One key element in both processes is that authorities with differing interests seek an agreement on taxes
to be paid into their national budgets. Consequently, bargaining constitutes a significant component of the negotiating procedure and the final outcome. Where a compromise is reached, it is easy for professional arguments and considerations to be pushed into the background, meaning that the final outcome of the two procedures in question does not always comply with the arm’s length principle. This problem raised by Monsenego [2014] is difficult to remedy. If all of the authorities involved and the taxpayer are satisfied, then why do we have to stick to the arm’s length principle in a “pure” sense? One of the main obstacles to the spread of advance pricing agreements is that they often take a very long time.

2.8. Special transactions

Based on a decade of experience in transfer pricing inspections, the tax authorities have now worked out which transactions they love to examine, and what the suspicious signs are that attract their closer attention and interest. In special transactions, large amounts are moved with the help of transactions for which there is no comparable market price. This is primarily typical for financial transactions, royalty transactions, and commercial deals that “move” on paper.

The main difficulty with monitoring financial transactions and the supply of goods and services on paper is that – because of the minimal transaction costs – there are no restrictions regarding frequency, size and the countries used. Money and products can be “moved” anywhere, at any regularity and in any way.

---

24 Monsenego [2014] p. 22
Tax inspectors love management fees. Since management really is the crucial activity of a company, there is not really any market equivalent for this function. It is easiest for the management to destroy a company and then help it flourish now and again, which means even extreme pricing is conceivable. Despite this, due to tax authority procedures they apply some form of cost-based approach, which does deviate from the arm’s length principle.

Aside from the types of transaction, these characteristics can attract the attention of the tax authority to unusual transactions.

– Incomplete or missing documentation is in itself cause for suspicion. In the Hungarian system, incomplete documentation can give rise to painful penalties. Without documentation it is difficult for the tax authority to judge whether or not a controlled transaction meets the arm’s length principle. This is why it is not surprising that controlled transactions are assessed more stringently if the documentation is missing.

– Large and long-term losses will always catch the eye of the tax authority. This is particularly the case if there are high-value transactions within the group. At independent companies, a long-term loss will sooner or later lead to economic steps in order to eliminate the source of the loss, or it will result in bankruptcy/liquidation. Owners do not normally tolerate losses for a long time. This is exactly why it seems suspicious if a controlled enterprise generates losses year after year. The tax authority assumes that this “irrational” situation is only tolerated by the owner because the profit is shifted into another country with the help of transfer pricing. And if this suspicion arises, then the taxpayer can expect a tough inspection.

– Questions can be raised if the profit of a related company falls significantly short of the industry profit levels on a sustained basis. If everyone else is capable of operating at a much higher level of profitability,
then why is this company the exception? It is possible that the answer to the question lies in transfer pricing, and we can expect a rigorous tax inspection.

– One of the most difficult transfer pricing phenomena to explain is if a company adopts different pricing policies for controlled and uncontrolled partners. Transfer pricing regulations as a whole are based on comparisons. The best example of this is if a given product or service is sold to independent and related parties. This provides a basis for comparison, and makes it very easy to judge the accuracy of the transfer pricing procedure applied. By contrast, if the pricing is different then the taxpayer has to come up with very strong and founded arguments since otherwise the tax authority will definitely call into question the transfer prices used.

– The trust displayed by the tax authority will not be reinforced if high-value transactions are conducted with tax havens and with countries that have no transfer pricing regulations. The internationally recognised regulation of transfer pricing is conspicuous by its absence in these countries so they can attract the most “activities” along with the associated tax base and business advantages. Transfer pricing is one of the most “enticing” tools to achieve this. Investigations by the tax authority can be held back by the fact that these countries are not famous for their speed and for efficient exchanges of information. This is why the OECD is pushing ahead with varying degrees of success to involving tax havens in the international exchange of information.

– Large and irregular transfers can be interesting for tax authorities too, especially if there is no perceivable business event lurking behind the cash flow. Without credible, expert and realistic explanations, there is a good chance a thorough inspection will be launched.

– Significant year-end “adjustments” between related parties are not too popular either, especially if they reduce the tax base of the given year. The
tax authority can easily begin to think that when an enterprise’s estimated profit and tax base can be approximated well, then the adjustment took place in the interests of avoiding an “excessive” tax payment. Again, this emphasises the importance of credible, professional and realistic explanations. Without these, you can expect a tax authority inspection.

– If we are looking for an obvious candidate for suspicious transactions, then free services or product exchanges are sure to catch the eye. After all, free supplies of products or services are not common between independent parties under normal market conditions. It is not realistic for such business events to take place on a market basis. You can bank on a rigorous tax authority inspection in these cases too.

– Finally, “round numbers are always suspicious” – I learned this from an old colleague at the Ministry of Finance (thanks to Róbert Láng). He’s right. If the value of a transaction has to be determined based on complicated analyses and calculations, then at the very least it is hard to believe that this value is exactly HUF 1 billion or USD 10 million. During normal business negotiations it can happen that an agreement is reached on a rounded number somewhere between the two extreme viewpoints. It can easily happen that between a sales offer of EUR 4.462 million and a purchase offer of EUR 5.781 million the negotiating parties agree on a figure of EUR 5 million. Despite this, the final outcome of the detailed calculations and analyses underlying connected transactions can only be a rounded number in exceptional cases and by chance.

The “special” business events discussed above do not just take place individually, yet the tax authority can become even more suspicious if things start to accumulate.
2.9. Transfer pricing as a large profit pump

Sikka–Willmott [2010] rightly states that “Since costs and overhead allocation mechanisms are highly subjective corporations enjoy considerable discretion in allocating them to particular products/services and geographical jurisdictions.”\(^{25}\) The details of the background need to be understood in the interests of succeeding in the fight against abuse. The corrupt oligarchs, businessmen, politicians and bureaucrats of Russia, China and many other developing countries often strive to embezzle as much money as possible and smuggle it out of the country. For them, transfer pricing as a tool creates a semblance of legality. Via complicated corporate networks comprising intermediary companies, and by underpricing or overpricing high-value transactions, profit ends up at a company where the money is “in good hands”. In cases like these it matters how much the tax rates are, but what is more important is that the smuggled money be tucked away from the authorities and from the eyes of the public. Sure-fire banking secrecy and a company register enabling the anonymity of beneficial owners are much more important than the tax rate. And there are countries where the “holy trinity” of banking secrecy, anonymity and low taxes can always be found. Nobody should entertain the thought that harmonising tax bases and tax rates can be successful in combating this phenomenon. Action taken to prevent the manipulation of transfer prices just to save on taxes can be beneficial, but there is no way it will reduce embezzlement by itself.

According to a study written by Sikka with another author, transfer pricing was originally just about optimal resource allocation, but today it has

\(^{25}\) Sikka–Willmott [2010] p. 3
become a tool for shifting profits between different countries, which generates major losses for some states.26

There has been talk about harmonising corporate tax bases in the European Union for more than ten years, but there has yet to be a proper breakthrough. Harmonising tax rates is not even an option. And let’s not even talk about other parts of the world. In fact, the fall in corporate tax rates observed over the last ten to fifteen years is probably largely attributable to fears about losing business owing to high tax rates. And many countries are trying to entice more investors with low tax rates. This kind of “harmonisation” is really accidental, and does not properly address the outlined problem.

2.10. Link between taxation and profit shifting

Clausing [2003] also believes27 that the tax rate has a major impact on profit before tax. Using the Amadeus database and taking general corporate tax rate trends into account, Dischinger [2007] outlined the following correlation. “The results suggest a decrease in pre–tax profits of about 7% if the tax rate difference of a subsidiary to its immediate shareholder increases by 10 percentage points.”28 He also noted that profit shifting is not just apparent within the EU, but looking at the trend there is a massive outflow of profit from the EU.29 Of course, in today’s liberalised global economy based on an international system of trade and financial institutions, this comes as no surprise. If we can see a tax-driven allocation of profits within the EU, then why should this phenomenon stop at the EU borders?

---

26 Sikka–Haslam [2007] p. 2
27 Clausing [2003] p. 2208
28 Dischinger [2007] p. 20
29 Dischinger [2007] p. 19
“We show that corporate tax rate changes give rise to adjustments in the project location as multinational firms have an incentive to locate high-profitability projects in countries with a low corporate tax rate while labor-intensive projects tend to be located in high-tax economies.”

The characteristic of loan financing that reduces the tax burden is commonly referred to as a “tax shield”. If a company is burdened with a sufficiently large volume of loans, then its interest expenditure can exceed its profit, with the direct result that there is no profit before tax and therefore no corporate tax. It is no coincidence that many countries adopt *thin capitalisation* systems, where the goal is for the tax regime to take action using regulatory tools to combat extreme increases in leverage. The essence here is that the interest on debt that exceeds a pre-defined level can no longer be accounted for as expense – and hence as a deductible for corporate tax purposes.

Huizinga et al [2007] along with Dischinger et al [2010] clearly showed that the higher the tax rate, the higher the leverage. According to Dischinger et al [2010], the risk level of subsidiaries has a significant impact on leverage. High-risk subsidiaries are less inclined to get into debt, while low-risk ones take on greater levels of debt. This correlation also shows that other factors impact on the size of leverage, not just tax.

Most tax havens around the world have sprung up in smaller countries. What is common about these countries is that they are less reliant on income taxes. Hines–Summers [2009] revealed that a ten percent smaller population is associated with a one percentage point fall in income tax.

The higher profitability at corporate head offices can be due to special reasons that balance out the impact of higher taxes.

---

30 Becker – Fuest - Riedel [2010] p. 18
– The majority of head offices are found in the country where the entire corporation started. This is the market they know the best. Home advantage is probably not just reserved for sports, it is also evident in business life. There is probably a better chance of achieving a higher profit at home.

– The most important profit-generating factors tend to concentrate around the head office. Management functions, R&D, marketing, sales and the management of intangible assets are often carried out at a key location in terms of the operation of the company, at the heart of the company, thereby determining where the highest profit within the group will be.

– Another key factor is that the loyalty of the company management to the home country and any fears about rigorous tax authority procedures in that country collectively contribute to higher profits at the head office. In my experience, this aspect can also be crucial if the tax burden at subsidiaries is substantially lower.

The head offices of large multinationals are still often found in the local market, where the company started. Most head offices of the large US banks are still located in New York. Coca Cola is still based in Atlanta. Ford, Chrysler and General Motors have their head offices in Detroit. And the list could go on, across all five continents.

Of all the factors generating profit, one of the first mentioned is always intangible assets. What is more, the transaction cost and time factor for trading in intangible assets are probably the smallest. With the help of a good lawyer, any intangible asset can be transferred from one company or country to another in a matter of hours. In comparison to this, transferring money is much more cumbersome.

It is not by chance that the most common examples of transfer pricing used to demonstrate wrongful use are related to intangible assets.
The purpose of the favourable taxation on R&D activity is to increase the proportion of high-profit, value-added activities in a given country. Another benefit of purchasing intangible assets is that just moving the asset is not necessarily enough. For “credibility” there needs to be some substance too, i.e. functions and resources need to be allocated to these assets.\textsuperscript{34} This partly means additional tax income and there can be beneficial spill-over effects for other parts of the economy.

\textsuperscript{34} Dischinger–Riedel [2008] p. 20
3. Conclusions, proposals

The first three proposals concern tax avoidance and the “holy trinity” of banking secrecy-anonymity-low tax rates enabling money laundering. It is important to emphasise with these proposals that individual countries are not capable of achieving any substantial success by themselves. Since tax avoidance and the related transfer pricing are international phenomena, only with international cooperation and regulatory harmonisation can we be successful.

1. LIFTING OF BANKING SECRECY IN DEALINGS WITH TAX AUTHORITIES. Banking secrecy is one of the vital conditions for any major tax fraud or tax avoidance. There is of course a whole range of reasons arguing why it should be retained. Companies and citizens are entitled not to make their own banking affairs public for anyone. Yet the fight against international tax fraud is impossible if tax authorities are not able to access the banking data of potential tax evaders abroad, outside of their own “national territory”. Making the international exchange of data more widespread has picked up pace in recent years, but the changes to date are nowhere near sufficient. There are still too many countries that have not committed to exchanging data, and where it does work in theory, the exchange of information is extremely slow and bureaucratic.

2. MAKE IT IMPOSSIBLE FOR COMPANY OWNERSHIP TO BE ANONYMOUS. Company registers enabling owners to be anonymous mean that money laundering, tax fraud and embezzlement – which often go hand-in-hand – can stay hidden. The countries that have such reliable systems offering anonymity are not scared of these clandestine owners committing a crime in their countries that they would need to prosecute.
For other countries, the anonymity makes it a virtually hopeless endeavour to track the path of the money across borders. It makes no difference that they know the money arrived at a specific enterprise with an unknown owner if they cannot monitor the money’s movements thereafter. If they knew the owner, and said person could be found by the investigative authority, then a proper investigation could be conducted. If a company with an unknown owner transfers the received money, probably to another company with an equally inaccessible owner, then the chances of tracking the route of the illegal money are very slim.

Of course, this anonymity is not just exploited by the mafia and by drug barons. There can be many business reasons as to why people shy away from publicity, and use this anonymity opportunity for completely legal business activities. In a normal business relationship it is also useful if the contracting parties know the actual ownership background of their business partners. I don’t think there would be very cogent reasons arguing in favour of maintaining a system where nominees appear to be owners, but in fact they are neither the actual managers nor the beneficiaries of a company. And these solutions cannot even be considered legal based on the principle of substance over form. From a formal, legal perspective, everything is ok, everything is “documented”, but the reality is quite different.

International cooperation and international constraints are necessary, but with this, company registers could be made fully public. Of course, this means that in addition to the tax havens, developed OECD countries such as the United States and the United Kingdom have to lead by example. If only companies whose ownership structure is public can take part in international trade and money transactions, then this per se would force the abolition of anonymity. If someone wants to run a restaurant anonymously on Barbados or the Seychelles, they can quite happily do so because this will not upset the
international financial system. It does seem quite a brutal move of course, and technically speaking difficult to implement, but if the international banking system does not execute transfers from countries where common forms of international data exchange and the rules on transparent company registers are not enforced, then significant money laundering and money transfers almost become impossible. It is entirely possible that international cash transactions would increase as a side-effect of such a move, but the really substantial movements of funds would be very difficult to handle in cash owing to the technical constraints.

3. THE THIRD, AND PERHAPS MOST DIFFICULT, STEP IS INTERNATIONAL TAX HARMONISATION. If there were a consensus to eliminate the opportunities for international tax fraud and tax avoidance, then the most obvious solution would be the strict harmonisation of tax rules determining the levels of the main tax types in international taxation (upper rates of corporate tax, personal income tax, value added tax). In line with what was presented earlier, the average rate of personal income tax does not trigger significant movements in labour and tax bases, so harmonisation is not needed either.

There is no realistic chance of resolving this in the near future for various reasons. First of all, it would not be accepted even in some of the countries expected to gain from it (for example the United States). This would involve relinquishing national sovereignty to such a level that currently has no political support. There would likely be vociferous resistance particularly from the countries that lose out. Those currently winning in terms of tax competition would certainly not want to give up their competitive advantage, putting their budget revenues at risk.

A further argument approaches the issue from the fiscal angle of national sovereignty. If we harmonise the main taxes, and thereby determine the
majority of the incomes, then we also define how much we can spend. Consequently, the scope for budgetary policy would narrow in spending policy too. At present, and in many respects, the spending side of the budget determines how much revenue is required, and as a result what tax rates are needed. This approach is not fool-proof of course, but what is certain is that large differences on the spending side would become unsustainable.

This explains why it is not realistic to expect international harmonisation covering the most important taxes in the next 10-15 years. Much better results are likely from steps that seem to be much less ambitious but which do at least hold out the prospect of genuine achievements.

4. INTRODUCTION OF THE OECD’S BEPS RECOMMENDATIONS IN ALL COUNTRIES TAKING PART IN THE INTERNATIONAL FINANCIAL SYSTEM AND TRADE. The initiative against base erosion and profit shifting (BEPS) is much less spectacular, but produces practical results. In this framework it would be possible to eliminate the hybrid structures and organisations that are treated differently by different countries. One of the most important tools of international tax avoidance today is that the same organisation can be treated as a separate taxpayer in one country, while in another country it is transparent and passed-through from a tax perspective. Yet the same can be said for example of transactions where a cash flow is deemed to be a loan in one country and capital in another.

In practice, these organisational structures only serve tax avoidance purposes, while it is clear that the same organisation or transaction cannot be treated two ways at the same time in an economic or business sense. Different legal traditions and the various legal systems can of course have created diverging structures over time, but today these are rather anachronistic and offer excellent tax planning opportunities.
5. **MAKE INTERNATIONAL TAX STRUCTURE TRANSPARENCY THE NORM.** For those affected it would most certainly be an unpopular suggestion if companies had to be fully transparent in their tax affairs above a certain threshold. All tax treatment deviating from the normal rules would need to be presented, regardless whether it is a tax benefit, a special tax incentive or a tax planning structure.

From a business perspective, this level of transparency could harm interests. Rivals would be quick to copy the best structures, meaning that the competitive advantage of innovative tax planning could quickly be lost. That said, if we assume that companies have to compete not on a tax innovation basis but based on product and service innovation, on efficient cost management and on creative marketing, then the criticism of transparency is less of an issue.

This step would have one more important impact. Here I need to refer to the basic principles of the Texas Instruments’ code of ethics: the company should not carry out any measure that would cause the company’s management, owners or employees to feel uncomfortable after it is made public, or which would clearly have an adverse impact on PR. For many enterprises this would be a significant barrier, although the large IT companies in the United States, despite repeated criticism over the years, still pay tax on a large part of their profits overseas, thereby avoiding the corporate tax rate in the USA which could even amount to 35 percent up until 2018.

The question is whether this transparency should be extended to transfer pricing as well. The transfer pricing system very often contains information that has a huge impact on competition. Publishing this could indeed be detrimental from a business perspective. Instead of this, the rule could be that structures differing from normal approaches must be made public.
6. USE OF SAFE HARBOURS. One of the main regulatory developments in recent years was the appearance of safe harbours. Despite clearly being in opposition to the basic arm’s length principle, it is still popular among the companies and state authorities affected. A substantial decrease in documentary requirements not only reduces the administrative burdens for companies, but also makes inspections much simpler, which can free up state resources in the field of tax inspections.

The other main advantage is the predictability, which for companies, in addition to the “how much” question, also replies to the issue of which country and which subsidiary. The predictability of payments equally makes it clear for the budget how much revenue it can expect.

Finally, one of the parts of transfer pricing regulations that is most difficult for people to accept is that clearly, the majority of the complex documentation work relates to transactions where the arm’s length price is somewhere between the lower and upper quartile, between 3-5 percent and 8-10 percent, and almost anything between these two points can be defended during a tax inspection. Furthermore, the tax revenues related to these transactions are negligible compared to the profits that can be shifted with the genuinely important transactions. After all, there are far more controlled transactions of USD 1 million than there are USD 100 million or billion transactions. Owing to the complicated internal division of work that is common at large multinationals, the majority of administration services are increasingly centralised, and offered to individual member firms by “service centres”.

It follows that, although less relevant from a budget perspective, the majority of the administration carried out by companies and tax authorities goes on a large number of small transactions. Despite the fact that safe harbours
probably do not satisfy the principles of pure transfer pricing, their broader adoption would reduce bureaucratic burdens and leave more resources for documenting and inspecting the genuinely important transactions.

For standardised administration services offered on a broad scale, even ones easily available on the market, the use of safe harbours does not jeopardise budgetary revenues and does not really distort the distribution of profits and taxes between individual countries.

7. **Principle of Substance over Form in Taxation.** This principle used widely in many countries is very easy to anchor in legislation, but is extremely difficult to enforce in practice. Furthermore, rarely in taxation do we find situations that are very “black and white”. Based on the broadly accepted principle of the freedom to conduct business, almost any goods or services can be freely bought and sold between independent parties in today’s liberalised financial and commercial world. The same right cannot be denied among related parties either. Genuinely high-value transactions are always special, complex and not very transparent. The place of performance for services is uncertain in today’s online world in particular. What is more important? Where the service provider is located, which channel is used to make the sale, or where the user of the service is located.

The BEPS initiative of the OECD against base erosion and profit shifting seeks answers to these questions among others. Based on the principle of substance over form, a kind of “reality test” should be applied, but this is much easier to declare in theory than it is to implement in practice. Despite this, the “reality test” can really help in understanding complex transactions, and there is no need for a complicated set of conditions when applying the “reality test”. Only the usual transfer pricing question has to be asked: would the transaction
take place between uncontrolled parties in exactly the same way, under the same conditions and at the same price?

8. EXTENDING THE PRINCIPLES OF COMPETITION REGULATION TO TRANSFER PRICING. One interesting development is that the EU is trying to take up the fight with a new weapon outside the scope of taxation to combat the special tax structures of the large IT companies referred to earlier. Proceedings have been launched against Apple for the distorting effect on competition caused by prohibited state aid that is the result of its structures in Ireland. It seems that they viewed there was less of a chance of forcing Ireland and Apple to change their very favourable tax circumstances when addressing the issue from a tax perspective.

With the current level of tax sovereignty in the EU, it is virtually impossible to force any Member State to its knees in tax matters from a Community perspective. What is more, the regulatory reforms are progressing at a snail’s pace, primarily because of the fierce resistance of the stakeholders. The powers of the competition authority established based on the incontestable principle of the free movement of goods and services can offer Brussels a much more effective weapon. After all, the low tax rates and the profit shifting on account of attractive tax structures impact on competition conditions, alongside the losing countries missing out on budget revenue. Lower tax burdens qualify as prohibited state aid since they clearly provide a competitive advantage and thus distort competition. The “attack” on Apple was noticeably just the first step in rolling out this new weapon. If Brussels succeeds in breaking this symbolic player in the information technology industry, then similar proceedings will be launched against other IT firms or even pharmaceutical enterprises, one after the other.
And this is a development that could radically restructure the international practices of large multinational companies. In tax matters it is not necessarily easy to gain assurance about the long-term perception of a structure either. Yet so far it was often enough to obtain a *binding ruling* from one or two countries and/or an advance pricing agreement (APA). And winning countries were always happy to issue these documents quickly. In the future though, the risk has to be managed with due consideration of international connections and EU competition aspects. If I mentioned a number of times before in relation to transfer pricing transactions that subjective factors and the uncertainty of economic and financial analysis play a key role, then this is even more the case when examining the distorting effect on competition of prohibited state aid. The situation of those involved is exacerbated by the fact that while the countries that came out on top in tax optimisation were “accessories” in helping to legalise even the most aggressive of structures, they cannot expect even close to the same treatment from supranational competition authorities. Tax structures need to be designed in hostile territory, under much more uncertain circumstances.

Of course, anyone could easily say just let the “evil” multinationals deal with it, but we should not forget that transactions and controlled transactions primarily help to raise the efficiency of business processes, and not every transaction is designed to avoid tax. Obtaining provisional opinions and issuing resolutions is a theoretical solution for eliminating the uncertainty, and this is an option available to competition authorities as well. Beyond tax procedures, preliminary consultations and issuing resolutions are not alien topics for the competition authorities either. Asking for the opinion of competition authorities in advance is quite a traditional approach with large mergers that influence market competition. The question is whether or not the regulatory, material and personal conditions for competition proceedings taking tax
aspects into account can be created. In this new setting, every stakeholder (taxpayer, tax authority, consultant) has to adapt to the principles of competition regulation as well.

9. **Problem of Differences Based on Legal Regulation of Substance and Form.** One of the gravest problems for the tax authorities is when the substance and the form clearly and legally differ from one another. Satisfying the previously mentioned requirement of transparency is made more difficult if it is possible for the owners or beneficial owners to hide behind so-called “nominee” owners or managers. *Trusts* can work on this basis in Anglo-Saxon law for example, and foundations in German-speaking countries. But in a good number of countries, the owners or managers of companies registered and operating in a perfectly normal manner can hide behind anonymity.

As part of international cooperation, the banking system has more or less broken through this constraint in the interests of compliance with money laundering rules. At banks, clients now have to make an unambiguous declaration about who the beneficial owner is, who the *final beneficiary* is. This change provides little consolation for the tax authorities because the information is still difficult for them to gain access to because of banking secrecy rules.

Legal provisions dating back a hundred years would need to be changed, and logically speaking, this change would have to be pushed through with a lot of opposition. Without it though, the tax authorities will continue to find it difficult to follow and understand large international tax structures.

10. **Profit Allocation Based on Pre-defined Formulae.** Another option is to create an opportunity to allocate profits between countries based on pre-defined formulae. The EU has been dealing with this proposal for more than
ten years. The concept of the Common Consolidated Corporate Tax Base (CCCTB) has yet to be endorsed in the EU, and since all Member States have to lend their support to a change of such a magnitude, there is no hope for now of it being fully introduced in the near future. By contrast, there is a good chance of the countries that support the CCCTB rolling out this method of profit and tax base allocation for their mutual relations.

Based on the CCCTB approach, companies operating in more than one country would first have to calculate their profit and tax base on a consolidated basis, then divide this amount between the individual countries based on predefined formulae. The first criticism of this proposal could be that “this is another new method that ignores the tried and tested arm’s length principle”. This probably worries the companies and those responsible for tax policy the least. As with so many things, the devil again is in the detail. The proposed distribution rates would be set based on some combination of the headcount, wage cost, sales revenue and asset value.

We can confidently declare that regardless of which rates are used for the distribution, it would immediately trigger a huge international game of chess. Who can modify and manipulate the indicators underlying the distribution rates, and how, to ensure an optimal distribution from a tax perspective. I previously went into detail on the different tax implications of principal and debt ratios in corporate financing. But think about the opportunities to optimise headcount or sales revenue. And the answer of course, is that yes, there are opportunities. Sales revenue can be gross, but some kind of net commission revenue can also be disclosed. Headcounts can be flexibly optimised too. Where is there a standard that says how many people have to be employed, or what the ratio of temporary staff should be?

What is more, regardless what system of formulae is introduced, if it is overly simple then the specificities of individual industries may distort the
distribution results. The principle of transparency becomes impaired if the formulae are complex and complicated, giving rise to even more opportunities for “optimising” indicators.

There would be winners and losers to such a change. The losers would find it difficult to accept the losses incurred as a result of the change, while the various systems of indicators would affect the countries fulfilling different roles in the international division of labour in completely different ways. Financial centres, contract work locations, concentration of R&D-intensive industries, general wage level, industrial structure – the list of features that would influence the distribution of tax bases in any system is a long one.

This proposal is a good example of the frequent design faults of ideas devised behind a desk. Designs and models nicely formulated on paper are not necessarily efficient in practice. The common consolidated corporate tax base would strive endlessly to simplify overly complicated systems, which would harm too many interests and result in a tax base distribution running counter to real business logic. New horizons would open for “tax planning” too. Owing to the manipulation of indicators, actual results would likely differ substantially from those estimated in advance, leading to more and more regulatory fine-tuning, exceptions and “more accurate” indicators, until the entire system and its actual impact become completely non-transparent. In light of the above it is no surprise that I do not believe allocating tax bases using pre-defined rates is a good idea, and in the long run it would definitely generate more problems than it is capable of resolving.

11. DISCLOSURE OF FINANCIAL REPORTS. An important proposal that is seemingly not directly related to the subject matter of this paper is that the public nature of company registers should be extended to cover financial reports. Listed companies almost everywhere around the world have to comply
with significant transparency requirements, but there are many companies that are not obliged to publish financial information on account of their size or ownership structure. A common feature of tax havens in particular is that the companies registered there do not even have to prepare financial reports. An obligation to make information public cannot even arise.

Bringing tax havens and other “recalcitrant” countries to heel should involve bookkeeping obligations for companies registered there and public financial reports in line with international standards. In addition to the most popular share companies (like Ltd. firms), the international structure could accommodate a range of other organisational forms for business activity, and this being public would be important not just for the tax authorities but also for other business partners. Consequently, these obligations should be extended to include essentially every organisational type, such as trusts, foundations, funds, partnerships – and the list could no doubt go on.
4. New scientific results

My research was based on the assumption that transfer pricing markedly influences international tax relations, and I explored several problems that impair the efficiency of large groups, and distort the competitiveness of individual countries. The most important issue is that via transfer pricing it is possible to make international profit transfers where there is no genuine economic basis for them. This jeopardises the budgetary positions of countries on the losing side, while the cut-throat battle for investment provides incentives to endlessly cut tax rates.

The most important events are summarised below.

1. COUNTER-PRODUCTIVE OPERATION. The common arm’s length approach that has emerged in the system of transfer pricing has created a strange, and in many ways counter-productive, framework for the companies involved and their consultants, as well as for regulators and inspectors. The primary criterion for companies in relation to transfer pricing is how to comply with official requirements. It is ever rarer to encounter a company that has its own, independent approach keeping it clear-sighted within the group.

For lack of public and relevant information enabling real comparisons, the necessity for comparisons prescribed by regulators and inspectors has brought about the application of backstop solutions that can only lead to a genuinely arm’s length price by chance.

There are essentially two main problems with large database comparisons. Only in the rarest of scenarios can companies that are really relevant and “worth” comparing make it into the set of comparables, but what probably distorts the whole approach even more is that transactional data is not available in the databases used. So we compare apples with pears. We compare
the transactional data of an examined company with the non-relevant, aggregated data of a non-relevant set of corporates. Based on the law of large numbers of course, the averages nicely gloss over these problems. The averages typically fall between 3 and 10 percent – if the transfer price is squeezed into this range, then you’re more or less safe.

And for pricing the majority of special transactions (M&A, royalty transactions) it is utterly impossible to find a methodology suitable for making proper comparisons.

2. **FORMALISM DOMINATES OVER THE PRIMACY OF SUBSTANCE.** For lack of any other adequate option, those involved examine whether the regulatory requirements were formally met, yet there are often no resources or intentions to analyse the actual substance. In terms of risk, taxpayers can stray onto dangerous ground if they prepare analyses even for internal purposes that differ from official documentation. It can never be ruled out that such a document will eventually find its way into the hands of the tax authority, and that’s when the trouble starts. The tax inspectors can attack the company with its own argumentation.

3. **UNJUSTIFIED BUREAUCRATIC BURDENS.** Formalism and the established regulatory approach collectively entail bureaucracy for both the companies involved and the tax authorities that is nowhere near justified given the expected results. There is no denying that excessive bureaucracy pervades the world of transfer pricing, which is demonstrated by the efforts made at Community level to deal with the issue in the European Union. This gave rise to the demand for simplified documentation requirements, and the OECD recognised the applicability of safe harbours as a method that does not align with the traditional arm’s length principle.
4. CRIMINAL LAW ISSUES. This is not a transfer pricing problem, and should rather be handled with instruments of criminal law, but there is no denying that transfer pricing appears in the embezzlement and money laundering efforts of corrupt politicians, oligarchs, bureaucrats and company directors, mainly in developing countries. More precisely, owing to the bureaucracy and formalism it is legally quite simple to comply with transfer pricing rules. An intermediary in a large goods, services or financial chain transaction, where related parties are also involved, can prove at any time on a transfer pricing basis that it deserves the 2–4 percent profit for the intermediary, advisory, marketing, market acquisition, etc. role it plays.

Where hundreds of millions or billions of dollars are at stake, a few percent can amount to huge sums. Everything can be in order from a transfer pricing perspective, but if the substance of these “special” roles could be examined, then it would be easier to see that there is no actual performance or added value behind the work of the intermediary companies.

5. IMPACT OF DISTORTED TRANSFER PRICES ON COMPETITIVENESS. The current transfer pricing system forces companies into artificial pricing, which influences the incomes and profits they disclose. These play an important role in the development of an economy’s competitiveness. If transfer prices become distorted, then the information determining competitiveness also becomes distorted.

6. TRANSFER PRICING – PLACE OF PROFIT REALISATION – TAX REVENUES. Finally, the most important problem is that through transfer pricing you can influence where profits are realised around the world, and consequently the tax revenues collectable as a result. The level of corporate tax in EU countries has
hovered around 2.5 percent of GDP in recent years, and over the last 20 years it only approached 3.5 percent prior to the 2008 crisis. The revenues generated by VAT, personal income tax and social security are more significant by some measure, yet despite this we are still talking about very considerable sums of money, and we cannot ignore the fact that there can also be other tax implications to profit manipulation.

The tax lost by countries on the losing side is missing from their budgets, which can impact on the standard of public services, while the forced tax competition only enhances this risk. It is not really possible for large countries to enter into the tax competition ring – as presented in this paper – but they are probably the biggest losers. This is why it is no surprise that the United States, Germany, France and the United Kingdom find themselves at the vanguard of the battle against international tax avoidance. If the United States and the United Kingdom were to close their own tax-avoidance loopholes, then they could take up this fight in a more credible and successful manner.

Realising profit without genuine economic substance is risky for the winning countries. It is no wonder that Ireland had no interest in easing its haven-like tax conditions even at the peak of the economic crisis. Its budget is now probably so dependent on these revenues that an exodus triggered by a tax increase would seriously have jeopardised its already shaky budgetary position. Yet it is the easiest of things to shift an activity without economic substance from one country to another. These revenues are very easy to move. One good example of this is when the new Hungarian-US double tax treaty was close to being signed, and in just a few months the vast majority of the enterprises with tax structures that exploited the favourable arrangements of the previous treaty simply left Hungary.

---

35 Eurostat [2014] p. 31
It is important to clarify that transfer pricing per se might be a necessary condition for international tax fraud (avoidance, optimisation, planning) but it is not always enough. This is why the problems associated with transfer pricing have to be comprehended within a broader set of correlations. Accordingly, some of my proposals fall outside the traditional field of transfer pricing in the narrow sense.
5. Publications on my thesis topic

A tanácsadó a jég hátán is megél. Magyar Pénzügyi Almanach, 2013.
6. Literature referred to in thesis


COOLS, MARTINE [2003]: Increased Transfer Pricing Regulations. IBFD


HELLERSTEIN, WALTER [2005]: The Case for Formulary Apportionment. IBFD


