

Transfer Pricing As A Vehicle In Corporate Tax Avoidance

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ABSTRACT

Using transfer pricing, U.S. Corporations are able to transfer revenues to foreign affiliates with lower corporate tax rates. The Internal Revenue Code requires intercompany transactions to comply with the “Arm’s Length Principle” in order to prevent tax avoidance. We describe and use elaborate examples to explain how U.S. companies exploit flexibility in the tax code to employ transfer pricing and related tax reduction and avoidance methods. We discuss recent responses by regulatory bodies.

Keywords: Transfer Pricing; Tax avoidance; Inversion; Tax Evasion; Arm’s Length Principle; R & D for Intangible Assets; Cost Sharing Agreements; Double Irish; Profit Shifting

INTRODUCTION

 Over the last decade U.S. corporations have been increasing their use of Corporate Inversions. In an inversion, corporations move their domestic corporations to foreign jurisdictions in order to be eligible for much lower corporate tax rates. Furthermore, inversions allow U.S. corporations that have accumulated billions of dollars overseas through transfer pricing to access those funds tax free. With an inversion a U.S. corporation becomes a foreign corporation and would not have to pay tax to the U.S. government to access the funds accumulated abroad as the funds no longer have to be repatriated to be spent. Corporations continue to avoid taxation through Transfer Pricing. This article explains transfer pricing and discusses some of the tax issues that transfer pricing pose including recommendations and proposed legislation to mitigate the practice.

What is Transfer Pricing?

Transfer prices are the prices at which different entities of the same corporation trade. Corporations often acquire other companies to establish market advantage in their industry or achieve it through organic growth. Market advantage can be achieved through lowering the cost of raw material, acquiring, developing intellectual property and other intangible assets to strengthen the longevity of their business. For example, to minimize its input costs, Starbucks can have a subsidiary in Costa Rica (sa, Starbucks Farms Costa Rica Inc.) that sells coffee to Starbucks USA. Through Transfer Pricing, corporations located in high-tax jurisdictions can “transfer the prices” of income and expenses and shift their income to a low-tax jurisdiction in order to avoid or reduce taxation. This transfer is done by selling goods and/or services to affiliates in the low-tax jurisdictions at cheaper rates resulting in low revenues for the high-tax jurisdiction company and high revenues and profits in the low tax jurisdiction. Correspondingly, the high-tax jurisdiction company purchases goods and/or services from low-tax jurisdiction affiliates at a high price resulting in high expenses for the high-tax jurisdiction company. These transactions all result in income tax avoidance.

One might ask: “Can’t the taxing authorities track these transfers and sniff out any improprieties?” The answer is yes, and they do. The taxing authorities are able to identify and “clamp down” on these practices when the fair values of these goods and services are easily determinable, but these practices are not as detectable when the goods and/or services do not have a market in which to compare. Therefore, the IRS requires that the business transactions between related parties mimic that of an unrelated genuine business transaction. That is to say, the same price an unrelated customer would pay should be the price the affiliates offered. This rule, called the “Arm’s-Length” principle, is designed to prevent tax avoidance.

The Arm’s Length Principle

Transfer pricing is governed by section 482 of the Internal Revenue Code. Section 482 highlights the “Arm’s Length” principle as follows:

In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm’s length with an uncontrolled taxpayer. A controlled transaction meets the arm’s length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm’s length result).

The Internal Revenue Service has the ability to reallocate income and expenses so that transactions between two entities under common control are measured identically to how transactions would be measured between two entities that are not related. Revenue and expenses must be priced at a market price. The fact that two parties are under common control must not change the substance of the transaction to be one that is different from a transaction involving normal market conditions. Further, since pairs of transactions are hardly ever perfectly identical, taxpayers must use the “best method rule”, which dictates using comparable transactions and circumstances in determining prices for transactions between related parties.

The application of the “Arm’s-Length” principle can be quite straightforward for the tax authorities and other regulatory agencies when the transactions in question are for basic goods and services. This means that the fair market prices of those transactions are readily available to other market players, and thus, it is easy to determine if related party transactions are in compliance.

But the application of the “Arm’s Length” principle is not as straightforward in other instances. For example, suppose a U.S. corporation develops a patent domestically and licenses this patent to their subsidiary located in Ireland. The royalty charge by the U.S. Company is very low and therefore most of the income resides in Ireland. Ireland has a corporate income tax rate of only 12.5% rate. This form of income shifting is common among large U.S. multinational companies with significant intellectual properties. For example, if Apple is selling the set of intellectual properties on which the iPhone 5 is based to its Ireland subsidiary, it would be difficult to find a comparable transaction. Making the situation more challenging, Section 482 leaves much room for interpretation.

As another example, suppose a pharmaceutical company creates a drug that cures HIV. The company licenses its usage to a low-tax jurisdiction foreign affiliate at a cheap royalty rate, thereby shifting income. Because these kinds of intangible assets are new and unique in nature, they often do not have comparability. It is difficult to determine what constitutes an “Arm’s-Length” price for the patent or license. Thus, corporations have the ability to avoid U.S. income taxation and create unique problems for the tax authorities.

Research and Development for Intangible Assets

Research and Development (R&D) for intangible assets provides for another tax avoidance strategy. During the researching period, also known as the “exploration phase”, the IRS allows companies to expense R&D costs immediately, since it is not yet clear that the expenses will have any future benefit to meet the criteria for capitalization. This provision in the tax code is one of the ways companies shift expenses to high tax jurisdictions, thus maximizing tax avoidance.

Suppose that the R&D cost to develop the drug was \$100 million and the domestic corporate tax rate is 35%. Since R&D costs are expensed in the year incurred for tax purposes, the Company will have a tax savings of \$35 million. Then, at the conclusion of the exploration phase, when it is assumed that the company will begin to earn income and pay taxes on that income, instead, they license the drug to an affiliate located in Ireland, a country with a corporate tax rate of 12.5%. If we suppose the transfer price (royalty) earned by the U.S. company is set at 3%, and that the Ireland affiliate earns \$500 million from sales of the drug, only \$15 million in income will be reported and taxed in the U.S.—a loss of tens of millions of dollars in tax revenues. Additionally, if we suppose that the U.S. Corporation decides to buy the manufactured drugs from the Ireland affiliate at a very high price, and that they resell the drugs in

the U.S., the domestic corporation has artificially increased their expenses (Cost of Goods Sold), which further erodes taxable income domestically. Additionally, the U.S. allows for a tax credit to some eligible domestic companies during the R & D phase. These allowances reduce taxable income, and in many cases create a very low or even negative effective tax rate for the corporation. Exhibit 1 elaborates this example.

Exhibit 1. Licensed Patent

Domestic Entity (DE)		Licenses patent to		Ireland Affiliate (IA)	
R&D Cost*	\$100,000,000			Royalty to Domestic Entity	3%
Domestic Tax Rate	35%			Ireland tax rate	12.50%
* Expensed in previous years				Income Earned on Licensed Patent	\$500,000,000
DE Income Statement			IA Income Statement		
Income Before Tax (3% of \$500M)	\$15,000,000			Revenue	\$500,000,000
Tax (35%)	\$5,250,000			License Expense (3% X \$500M)	\$15,000,000
Net Income	\$9,750,000			Income Before Tax	\$485,000,000
				Tax (12.5%)	\$60,625,000
				Net Income	\$424,375,000
Total Income Accruing to DE = Domestic Entity income + Ireland Affiliate Income					
	=	\$9,750,000	+	\$424,375,000	
	=	\$434,125,000			
DE Income Statement Without Licensed Patent					
Revenue	\$500,000,000				
Expense	0				
Income Before Tax	\$500,000,000				
Tax (35%)	\$175,000,000				
Net Income	\$325,000,000				
Summary					
	A	B	C = A - B	D	E = C + D
	With License to Ireland Affiliate	Without License to Ireland Affiliate	Tax Avoided	Tax Savings on R&D Expense	Total Tax Avoided or Saved
Total Income	\$434,125,000	\$325,000,000	\$109,125,000	\$35,000,000	\$144,125,000
Tax Avoided as % of Total Income*			25%		33%
* As a % of income Total Income Earned with the tax avoidance strategy (i.e., as a % of Col A)					

Since the I.R.S. allows companies to expense R&D and advertising costs incurred to establish brand names, many corporations use the United States as the base for their research and development of intangibles assets i.e. intellectual property and technology. The tax effect during the development stage is more favorable in the U.S. compared to many other countries.

Cost Sharing Agreements (“CSA”)

The rules governing Transfer Pricing get even more complex when different affiliates decide to share in the cost of developing intangible assets i.e. intellectual property. This contractual arrangement is created through what is known as a Cost Sharing Agreement (CSA). Two or more subsidiaries in the same multinational group share the cost, and the risks of researching and developing an intangible asset. Since the costs and risks are shared between parties, the future economic benefit (asset) derived is also shared as outlined in their contractual agreement. Shared-interest allows each party the right to also share in the income derived from the intangible asset. CSAs describe ownership interests of each contributing affiliate and may incorporate a predetermined transfer pricing agreement between related parties. CSA arrangements are great tax planning tools used by many U.S. based multinational corporations to erode taxable income. In many instances, since the parties involved have different tax domiciles, income shifting practices allow these corporations to avoid U.S. taxation due to transfer price arrangements.

Another structure of the CSA is when the intangible asset is partially developed by the parent company and the subsidiary decides to buy-into the venture at mid-point. This practice is known as a “buy-in-payment.”

With CSAs, the “arm’s-length principle” becomes much more difficult to apply and for tax authorities to govern because the risk is now shared between affiliates. The market probably does not have a readily available tool to measure the fair value of conducting such shared-risk transfer pricing transactions. That is to say, ascertaining whether the transfer pricing represents an arm’s-length transaction is very difficult. Accordingly, companies with cost sharing arrangements are likely to engage in profit shifting.

The “Double Irish”

Corporations are constantly exploring ways to avoid or lower their tax liabilities from a global perspective. While U.S. corporations have been engaging in corporate inversions to jurisdictions like Ireland for many years, recently, they have developed a new technique that shifts income to a lower or a no tax jurisdiction. This technique is called the “Double Irish.” Jane Gravelle (2014), best describes this scheme:

“In this arrangement, the U.S. firm transfers its intangible asset to an Irish holding company. This Company has a subsidiary sales company that sells advertising (the source of Google’s revenues) to Europe. However, sandwiched between the Irish holding company and the Irish sales subsidiary is a Dutch subsidiary, which collects royalties from the sales subsidiary and transfers them to the Irish holding company. The Irish holding company claims company management (and tax home) in Bermuda, with a 0% tax rate, for purposes of the corporate income tax. This scheme allows the Irish operation to avoid the even lower Irish tax of 12.5%, and also, by using the Dutch sandwich, to avoid Irish withholding taxes (which are not due on payments to European Union companies).”

Exhibit 2 below gives a graphical example demonstrating the financial effects of the Double Irish scheme.

Exhibit 2. “Double-Irish” Arrangement

Domestic Entity (DE)		Transfers intangible asset rights to		Irish Holding Co affiliate (IHA)	
R&D Cost	\$100,000,000			(Based in Bermuda)	
Domestic Tax Rate	35%			Applicable Tax Rate (Bermuda)	0%
		Royalties		Irish Tax Rate	12.50%
				Earned Income on Intangible Assets	\$500,000,000
		Dutch Subsidiary			
		Royalties		Subsidiary of Irish Holding Co.	
				sells to Europe	
DE Income Statement Without IHA			IHA Income Statement		
Revenue	\$500,000,000		Revenue	\$500,000,000	
Expense	0		Expense	\$0	
Income Before Tax	\$500,000,000		Income Before Tax	\$500,000,000	
Tax (35%)	\$175,000,000		Tax (0% Bermuda rate)	\$0	
Income After Tax	\$325,000,000		Income After Tax	\$500,000,000	
Summary					
	A	B	C = A - B	D	E = C + D
	With	Without	Tax Avoided	Tax Savings	Total Tax Avoided
	Double Irish	Double Irish	on R&D Expense	or Saved	
Total Income	\$500,000,000	\$325,000,000	\$175,000,000	\$35,000,000	\$210,000,000
Tax Avoided as % of Total Income*			35%		42%
* As a % of income Total Income Earned with the tax avoidance strategy (i.e., as a % of Col A)					

The Global Effect

Many critics have accused multinational companies such as Google, Facebook, Yahoo, Starbucks, Apple, and Amazon of massive tax avoidance through the “double Irish” scheme.

This scheme is not only a concern for U.S. taxing authorities, but also the international community, since they too may be deprived of tax revenues. Income shifting practices through transfer pricing is creating a global buzz because the scheme’s ultimate plan is to make it possible for corporations to pay very little or even no taxes at all. On a global scale, other countries have begun to amend their policies to counteract transfer pricing.

Recently, Ireland has decided to close the “Double Irish” loophole by requiring all new companies domiciled in Ireland to also be tax-residents. This move by Ireland was due to international pressure from the European Commission, Organization for Economic Co-operation and Development (OECD) and, of course, the United States.¹ Despite international criticism about Ireland’s tax practices, their finance minister Michal Noon told the Irish Parliament that it should “...ensure that Ireland continues to be the home of the best and most successful companies in the world.”² While discussing the suspension of the “Double Irish” tax avoidance scheme, Noon announced Ireland’s intentions to further attract Multinational Corporation by creating a Research and Development tax friendly environment for corporations. Critics are calling the new tax attraction the “development box”, which will allow corporations to pay lower taxes on profits from intellectual property. This additional tax incentive is surely one of the reasons Ireland’s economy is said to be one of the fastest growing economies in developed countries and in Europe.

Proposed Legislation

The growing issues surrounding transfer pricing and its tax avoidance scheme has caught the interest of the international community. Robert Stack, Deputy Assistant Secretary of the U.S. Department of the Treasury addressed the Senate Finance Committee on July 22, 2014 to talk about the Base Erosion and Profit Shifting (BEPS) project. In his address, he highlighted that the BEPS project is expected to recommend policies for “...transfer pricing with respect to intangibles, treaty abuse...harmful tax practices...” The main issues included in Stack’s report to the committee included ways of safeguarding “tax base from stripping by multinational companies,” and recommendations to circumvent tax avoidance through transfer pricing. Some of the recommendations proposed in Stack’s report were:

- helping countries minimize abuse of their bilateral income tax treaties, including through so-called “treaty shopping”;
- requiring country-by-country reporting of profits and taxes by multinationals so that they can be made available to tax administrators for purposes of risk assessment;
- designing interest deduction limitation rules that can be applied across borders;
- updating the transfer pricing rules on the application of the “arm’s length” standard to intangibles and endorsing “special measures” when those rules produce stateless income; and
- Updating the rules on permanent establishment to minimize the artificial avoidance of those rules.³

Stack’s report stated that “In the area of transfer pricing, we must ensure that the currently-used arm’s length standard is clearly articulated and that profits are attributable to the place of economic activity – that is, where the assets, functions, and risks of the multinational are located. We must further ensure that any “special measures” agreed at the OECD are firmly anchored in these principles, and that legal and contractual relationships are ignored in determining intercompany prices only in unusual circumstances. The arm’s length standard has been a bedrock of international taxation for over 50 years, and while it is not perfect, it is the best tool available to deal with the difficult issue of pricing among affiliates of a multinational group. We must steadfastly avoid turning longstanding transfer pricing

¹ Ireland Declares 'Double Irish' Tax Scheme Dead.

² Taken from: Henry Michael in Dublin’ “Ireland to abolish controversial ‘double Irish’ tax arrangement,” Tuesday October 14, 2014. URL: <http://www.theguardian.com/world/2014/oct/14/ireland-abolish-double-irish-tax-scheme-apple>

³ Taken from: Testimony of Robert B. Stack, Deputy Assistant Secretary (International Tax Affairs) U.S. Department of the Treasury, Before the Senate Finance Committee. July 22, 2014. URL: <http://www.treasury.gov/resource-center/tax-policy/Documents/OTPTest-2014-7-22-Stack-SenFin.pdf>

principles into a series of vague concepts easily manipulated by countries to serve their revenue needs at the expense of the U.S. tax base and our multinationals.”

CONCLUSION

In his January 2015 State of the Union Address, President Obama proposed closing the loopholes used by multinational corporations to avoid U.S. taxation and shift income to low or no tax jurisdictions. These loopholes, he contended, would be closed by tightening up current tax laws and by implementing a new minimum tax on foreign earnings. His vision was to attract U.S. Corporations to bring home their foreign earnings, while also creating an incentive for corporations to remain in the U.S. While these provisions are being addressed, its effectiveness in preventing tax avoidance remains to be seen. In the meantime, the U.S. tax base continues to erode.

There is a very thin grey line between tax avoidance and tax evasion. Whether corporations practice either or both, the result is the same. The United States is unable to collect tax revenues when these tactics are employed. While one may argue that these actions by U.S. corporations are completely legal, and they are merely prudent business decisions, critics differ with such opinions and consider these actions to be intentional tax evasions or tax avoidance through loopholes in the tax codes. Clearly the erosion of corporate tax revenues in the U.S. is a response to the high tax rates imposed on U.S. corporations. Transfer pricing has been, and continues to be, the vehicle through which corporations are shifting their income to low-tax jurisdictions and in some cases to no-tax regions. As business evolves, more and more complex business transactions are created, and the lack of current legislation to prevent these transactions, creates an opportunity for excessively aggressive tax avoidance. The U.S. economy is losing tax revenues to European countries like Ireland. The U.S. regulatory agencies and taxing authorities will need to implement laws that encourage domestic investment and close tax avoidance loopholes.

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