TRANSFER PRICING, FAIR TAXATION AND ETHICAL ISSUES

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1. SETTING THE SCENE: WHAT IS FAIR?

In the last decade or so, tax avoidance has attracted significant attention from the media, politicians, non-governmental organizations and other stakeholders. Scandals such as the Luxembourg Leaks (2014), Panama Papers (2016), Paradise Papers (2017) and Pandora Papers (2021) disclosed how globalization and incoherent domestic tax rules opened up the opportunity to engage in tax avoidance and minimizing the tax burden through base erosion and profit shifting ("BEPS"). All this has led to negative publicity and reputational damage for business and tax advisors and international efforts to curb such avoidance have ramped up. Tax havens, including Caribbean tax jurisdictions, were also named and shamed, because they were suspected of contributing to BEPS in light of the use of artificial structures / shell companies (existing only on paper, with no substance) located in their jurisdictions. Several organizations publish a list of tax havens. For example, the European Union regularly publishes and updates a list of non-cooperative jurisdictions for tax purposes, which contains the Caribbean countries Trinidad and Tobago and the Bahamas in the October 2022 version.[2] Previously, the US Virgin Islands were included, as were Anguilla and Dominica, but those are currently removed.

The OECD/G20 BEPS project, which led to 15 BEPS actions in October 2015, served to reduce the possibility by multinational enterprises ("MNEs") to avoid taxation. The OECD estimated that BEPS contributed to losses in global corporate income tax

revenue of about USD 100 to 240 billion annually through amongst others aggressive tax planning, lack of relevant information at level of tax administrations, harmful tax practices and domestic tax rules that are not coordinated across borders. A consequence of this is that less money is available for public finances and that other taxpayers who play by the rules and pay their fair share in taxes, essentially need to pay more tax. As a result, ordinary citizens have become sensitive to the issue of fair taxation.

BEPS is referred to by the OECD as "tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity or to erode tax bases through deductible payments such as interest or royalties"[3] or "tax planning strategies that exploit gaps and mismatches in tax rules to make profits 'disappear' for tax purposes or to shift profits to locations where there is little or no real activity but the taxes are low, resulting in little or no overall corporate tax being paid."[4]Indeed, the transfer pricing related BEPS Actions 8-10 address transfer pricing guidance to ensure that transfer pricing outcomes are better aligned with value creation of the MNE group.

Nowadays 137 countries and jurisdictions of the OECD/G20 Inclusive Framework on BEPS, including Caribbean jurisdictions Anguilla, Antigua and Barbuda, Aruba, the Bahamas, Bermuda, Curaçao, Dominican Republic, Grenada, Haiti, Jamaica, St. Kitts and Nevis, St. Lucia, St. Vincent and Grenadines, Trinidad and Tobago, are collaborating to implement BEPS measures.[5] BEPS represents a change of mindset aimed at ensuring fairness and changes to tax rules and guidance. The OECD provides in relevant part that while some of the schemes used are illegal, most are not. This undermines the fairness and integrity of tax systems because businesses that operate across borders can use BEPS to gain a competitive advantage over enterprises that operate at a domestic level. Moreover, when taxpayers see multinational corporations legally avoiding income tax, it undermines voluntary compliance by all taxpayers." Importantly, many tax avoidance schemes used prior to the BEPS action plans were regarded as perfectly legal, yet nevertheless unfair, because they distort competition with domestic companies and provide the wrong example for other taxpayers.

The COVID-19 pandemic, the Ukraine crisis and high inflation (e.g., high energy prices) have required governments to provide financial support to business and society, which support is essentially funded by domestic revenue mobilization, a.k.a. taxation. As such, tax avoidance is not appreciated.

As a result, today there is increased pressure on MNEs to consider fairness in developing their tax and transfer pricing policies. When is tax avoidance fair? What is a fair intercompany price? Mere legal compliance apparently is not enough. Ethics is the study of morality and is regarded as a part of philosophy. Ethics is thinking critically about what is (morally) right to do. Ethical taxation or transfer pricing as such is not based on law.

For taxpayers, the ethical thing to do is in any case to at least comply with the law. Often tax avoidance is considered ethically acceptable, while tax evasion is not. The former does not necessarily undermine the integrity of the tax system. But if the ethical thing to do is to contribute a "fair share" of taxation, so that public services (e.g., healthcare, education and investment in infrastructure) can be funded, tax avoidance may be less acceptable and unfair. What is a 'fair' tax contribution is subjective and is difficult to define such that all stakeholders agree, however.

2. FAIR TRANSFER PRICING

Tax fairness means different things to different stakeholders.

In the context of transfer pricing ("**TP**"), which is the pricing of intercompany ("**IC**") transactions between associated enterprises of a MNE group, note that transfer pricing is mandatory part of international business. IC transactions need to be priced. The 2022 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("**OECD TPG**") provide that there is international consensus that the arm's length principle ("**ALP**") should govern the evaluation of transfer prices for tax purposes.[6] The ALP also presents the nearest comparative of how the open market operates.[7] The starting point of the arm's-length principle is that associated enterprises for tax purposes are presumed to act among themselves under the same conditions as independent parties would under similar circumstances. In this respect, we consider that the ALP in particular intends to accomplish fair taxation through reference to conditions in commercial or financial relations which would be applied between independent enterprises. This means that a result must be achieved in which the taxable profit that associated companies make on their mutual transactions is comparable to the profit that independent companies would achieve under similar circumstances with similar transactions.

In the general discussion on fair taxation, what is "fair" is not defined, vague and as a result, subjective. The ALP tries to objectively determine transfer prices for intercompany transactions through conducting a comparability analysis.

A comparability analysis is at the heart of applying the ALP and can consist of the following steps:

- **Step 1:** Determination of covered years;
- **Step 2:** Broad-based analysis of the taxpayers' circumstances (industry analysis);
- **Step 3:** Understanding of controlled transactions (five comparability factors);
- **Step 4:** Review of any internal comparables;
- **Step 5:** Determination of available sources for external comparables (if required);
- **Step 6**: Selection of most appropriate transfer pricing method;
- **Step 7:** Identification of potential comparables;
- **Step 8**: Determination of and making of comparability adjustments where appropriate; and
- **Step 9:** Interpretation and use of collected data and determination of arm's length remuneration

Granted, in following the 9-step approach, there can be different views and interpretations between the various stakeholders on amongst others:

a. the facts and circumstances of the intercompany transaction (e.g., characterization of the associated enterprises: can the manufacturing entity be regarded as a routine manufacturer based on the functions performed, risks assumed and assets used?);

b. the selection of the TP method to evaluate the intercompany transaction at issue (the taxpayer can choose between five OECD TP methods);

c. the application of the selected TP method (are the identified comparables really comparable, what is the arm's length range? and should comparability adjustments be performed to increase the reliability of range resulting from the analysis?).

As regards the ethics of it all, from a TP technical perspective there are various stakeholders to be considered, including:

- each of the group entities involved in the intercompany transaction (e.g., a manufacturer sells manufactured products to a related party distributor);
- the parent company who can be involved with determining the TP policy;
- the tax authority of the related party manufacturer's jurisdiction; and
- the tax authority of the related party distributor's jurisdiction.

While the ALP intends to accomplish fair taxation objectively, its application may be subject to different interpretations and choices made during the performance of the comparability analysis. This may lead to disagreement among the stakeholders. In our view, taxpayers should ask themselves when these situations arise whether the selected approach / solution is right, fair, logical, a defensible position or appropriate, the reason for selecting that TP approach in dealing with the specific issue (why has this approach been selected) and then document this. In addition, taxpayers should understand the weaknesses of their selected approach (counter arguments) and think about other / better options. The next section describes some ethical theories that can help in this respect.

3. ETHICAL THEORIES

The following ethical theories can help to justify and reflect on decisions that need to be made:

a. Utilitarianism: a moral theory that focuses on the results or consequences of actions. It suggests that all actions should be directed towards achieving the greatest happiness / welfare for the greatest number of stakeholders. In that case, focusing on the results or consequences of actions is the ultimate way to reach fair taxation. The outcomes justify the means. Does the selected TP approach lead to the most positive consequences for the greatest number of stakeholders?

b. Deontology: Rather than focusing on whether the consequences of an action is good, in deontological ethics an action is viewed as morally good due to some characteristic of the action itself. Deontological ethics provides that some actions are moral obligations in spite of their consequences for human happiness / welfare. Duties and rules are important to differentiate right from wrong ("Don't lie, Don't steal, Don't cheat"). The outcomes may not justify the means. Is the selected TP approach in line with (formal) rules and duties?

c. Virtue ethics: a moral theory that focuses on what type of person (or organizations) we should be. The value of virtuous qualities is important rather than formal rules or useful results. Virtue is a skill that can be learned through experience and is dependent on the situation. Does the selected TP approach match with what type of person or company you would like to be?

The next section presents some TP examples in which ethical theories can provide lines of argumentation in justifying and reflecting upon when making decisions.

4. TRANSFER PRICING EXAMPLES IN THE CONTEXT OF FAIRNESS AND ETHICS

4.1 Functional analysis (including risks assumed and assets)

The ALP attempts to objectively bring about fairness through determining an arm's length compensation based on functions performed (in particular decision-making), risks assumed and assets used. Contractual arrangements provide the starting point for delineating the transaction. In case of material differences between contractual terms and conduct of parties, however, the functions actually performed, the assets actually used and risks actually assumed, ultimately determine the factual substance and accurately delineate the actual transaction.[8] Considering that the decision-making functions of many MNEs historically resides with developed countries rather than with developing countries, this analysis may lead to a disproportionate allocation of welfare between countries. One can therefore nevertheless question whether the outcome of the -objectively conducted- analysis, is ethical / fair. Due to demographical and other developments (e.g., the ageing population of developed countries, the rise of African, Asian and East European countries), the balance may be restored in the near future, however. If and when that happens, can that be considered ethical / fair?

4.2 Fairness under the OECD TPG

The OECD TPG refers to fairness in the following context:

- In order to be fair to taxpayers and tax administrations, all aspects of a system relevant for a TP case should be considered to balance the interests of the parties (see Preface of OECD TPG, #18). For example, although the burden of proof may lie with the tax administration in a TP case, it is reasonable that the taxpayer is required to provide relevant information.

- It is unfair to apply a TP method based on information undisclosed to taxpayers (paragraph 3.36 OECD TPG).

- There should be clear procedural rules in a fair application of the arm's length principle so that taxpayers are adequately protected and to ensure that profits are not shifted to jurisdictions with excessive hard procedural rules (paragraph 4.4 OECD TPG).

- The fairness of the penalty system should be examined with respect to whether the penalties are proportionate to the offence. (paragraph 4.27 OECD TPG).

4.3 Change of transfer prices to minimize taxes

A MNE group headquartered in the Netherlands has a Dutch manufacturing entity selling manufactured goods to its related party distributors in the USA and Canada. The latter resell the goods to third party customers. The TP has been agreed at the start of the year between the managers of the manufacturing entity and the two

distribution entities. At the end of the 2nd quarter, the managers were informed by headquarters that the TP of the goods will increase as of the 3rd quarter.

The managers of the distribution entities complained that their bonuses depend on the distribution entity's operating profit and that a higher TP will decrease this profit and therefore their bonuses. Is this fair? They also were concerned that this higher TP will decrease the taxable profits of the distribution entities and will consequently attract the attention of the local tax authorities. The parent company's management explained that the reason to increase the TP is that the Dutch manufacturer is making losses and has carry forward losses. A TP increase will not lead to corporate income tax for the manufacturer. The distributors will earn lower taxable profits, but their margins will still lie within the arm's length range of benchmarked margins earned by comparable independent distributors, which will be documented in a TP report. Is this morally good / fair?

4.4 Using safe harbors

The above MNE group also has related party distributors in Africa, which buy goods from the related party Dutch manufacturer for resale to local customers. The transactional net margin method is selected as the most appropriate TP method to evaluate the margins earned by the related party African distributors. No comparable companies can be identified in African countries, because data is unavailable. The OECD decides to introduce a concept called "Amount B" which serves to simplify and streamline the pricing of in-country baseline marketing and distribution activities. The intention is to determine the arm's length results for baseline marketing and distribution activities. In implementing Amount B, the OECD contemplate i) to design Amount B as a safe harbor or ii) to prescribe Amount B as the interpretation of applying the ALP to baseline marketing and distribution activities.

Is option i) / option ii) morally good?

4.5 Cash box

An IP company located in Curacao licenses a valuable patent to related party manufacturers for which it receives royalty payments. The IP has been developed pursuant to an R&D services agreement under which a related party Dutch R&D company renders R&D services for which it receives a cost-based remuneration from the IP company. Under the R&D services agreement, all developed IP will be owned by the IP company. The Dutch tax authorities commence a TP audit for the year 2013. They argue that the IP company is a cash box, because it does not employ personnel conducting so-called DEMPE (i.e. Development, Enhancement, Maintenance, Protection and Exploitation) functions. Rather, it is the Dutch R&D company that performs the key DEMPE functions. The IP company only financed the R&D activities. The Dutch tax authorities therefore argue that the IP company is only entitled to a risk-free return.

Is it ethical / fair to apply the DEMPE concept, which was introduced in the 2017 OECD TPG following the results of the BEPS action plan 8, to the TP audit for the year 2013?

4.6 Intra-group loan
A company located in country X (corporate income tax rate of 25%) obtains an intra-group loan from its parent company located in country Y (corporate income tax rate of 5%) at an interest rate of 0%. To comply with the ALP in country X, a benchmarking analysis is conducted, which provides that the interquartile range of interest rate falls between 2% and 8%, with a median of 5%. Which of the following approaches is morally good / fair?:

a. An interest rate of 8% is selected, which lies within the interquartile range;
b. The related party borrower states in its CIT return an interest rate of 8%, which leads to a downward adjustment of its taxable profits. The related party lender does not report the interest revenue.

4.7 Profit split method
In applying the profit split method, a certain part of the relevant profits will be split based on the relative contributions of the parties to the intercompany transaction.It could be that this split cannot be based on comparable uncontrolled transactions, but based on internal data of profit splitting factors, such as assets (relative value of intangibles owned by the parties to the transaction), capital or costs (e.g., relative salary costs of employees of the parties to the transaction).

Because the ALP intends to accomplish fair taxation by reference to conditions in commercial or financial relations which would be made between independent enterprises, the question arises whether the aforementioned use of internal data on profit splitting factors will result in fair taxation.

5. CONCLUDING REMARKS

Levying taxes results by law and the legislator must deal with this properly. Taxpayers need to comply with the tax laws. Yet in recent years, the ethics of taxation and TP, and the topic of fair taxation have attracted the attention of many stakeholders.

As regards TP, our view is that the ALP is a principle that intends to objectively determine proper intercompany pricing and fair taxation. It enjoys international consensus and its reference to conditions in commercial or financial relations which would be made between independent enterprises serve to result in fair taxation.

However, its application may be subject to different interpretations and choices made during the performance of the comparability analysis, which consists of several steps. This may lead to disagreement among the stakeholders. What can you do?

1. Consider the arguments in choosing an approach based on ethical theories:

a. Utilitarianism: what are the consequences of my actions?
b. Deontology: what is my duty?
c. Virtue ethics: what type of person (or organizations) do you want to be?

2. Understand the weaknesses of the selected approach based on ethical theories;

3. Consider other options;

4. Document your choices.

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[2]https://www.consilium.europa.eu/en/policies/eu-list-of-non-cooperative-jurisdictions. To be cooperative for tax purposes, jurisdictions are evaluated based on tax transparency, fair taxation and anti-BEPS measures.
[3]https://www.oecd.org/tax/beps/about/#mission-impact.
[4]https://www.oecd.org/tax/beps/faq/.
[5]https://www.oecd.org/tax/beps/oecd-g20-inclusive-framework-members-joining-statement-on-two-pillar-solution-to-address-tax-challenges-arising-from-digitalisation-october-2021.pdf as of 16 December 2022.
[6]OECD TPG, paragraph 1,14.
[7]OECD TPG, paragraph 1.14.
[8]This also fits with the goal of BEPS action points 8, 9 and 10 which is to better align TP outcomes with value creation of the MNE group.