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The dark side of Transfer Pricing
Shedding light on the most critical issues for tax authorities

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To my lovely mom, Stefania

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I would like to thank my teacher, Daria Arkhipova, to give me the opportunity to work together and to follow me until the accomplishment of this important milestone.

I would like to thank you to my family, Stefania, Simone e Riccardo, to supporting me each day: I love you!!

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ABSTRACT

The rise of Multinational Enterprises (MNEs) during the last decades has been accompanied by the explosion of the number of subsidiaries all over the world. Thanks to the closeness to raw materials and skilled labor MNEs have adopted an accounting system based on transfer price to account imports and exports of the resources.

During years, these corporations have used their subsidiaries to shift profits from high-tax countries to low-tax countries in order to avoid tax system. The manipulation of transfer pricing has started to be one of the principle issues for tax authorities and governmental institutions, that they registered a negative disproportion between the rise of corporate income tax and the tax revenue.

Through the analysis of examples of MNEs, both in developed and emerging countries, who used transfer pricing to avoid tax, with a focus on Intellectual Property assets, the final goal of this research is to highlight the critics of actual regulation system in order to give an idea about this issue and try to design some solutions.

PREFACE

Why was it difficult?

In this section, I would like to inform the reader about problems and obstacles that I have encountered while writing the present work.

This thesis explores and analyzes how companies can use the Transfer Pricing to avoid or evade taxes: certainly, it is a very delicate issue for both taxpayers and tax authorities.

For this reason, one of the most challenging parts of this research was the public availability of materials on this issues such as articles of practitioners or professional bodies or official documents published by tax courts.

Access to information is also restricted becuase of companies' privacy, anti-money laundering laws and professional secret. As a consequence, the selection of three cases for analysis in my thesis – namely Starbucks, Medtronic Inc and Ikea - was primarily motivated by the availability of data and documentation for these companies.

Another challenge related to the language of these official documents provided by tax courts and over state international bodies. For example, I found the case of Stanley Black and Decker, the holding company of the manufacturer and provider of the work tools for both professionals and private customers. The company has been involved in an investigative case with the object of tax avoidance through an illicit use of Transfer Pricing methods. The country involved was Norway: therefore, official documents about the background and an explanation of the circumstances have been published by tax authorities in Norwegian and the translation to English or Italian did not allow a fully and effective analysis of the case.

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Moreover, most of the existing literature has focused on applying econometric and statistical methods to evaluate the correlation within variables of Transfer Pricing methods. Like the rest of bibliography, it was interesting to read about the construction of these methods and some notions have been added during the thesis. However, the purpose of this work is to inform the reader about Transfer Pricing strategies used for tax evasion by means of an exploratory study and using the methods such as financial statement analysis which are available and frequently used by practitioners.

In addition, despite the simplicity of the notion of Transfer Pricing, the application of methods are not so simple: think about that intangible assets for which market prices as benchmark do not exist; it is the same for comparable uncontrolled transaction between unrelated parties due to the fact that intellectual property is unique and quasi impossible to perfectly replicate. As a result, auditing process is characterized by difficulties of evaluation.

The argument is very delicated both in terms of normative and company reputation. In such a very globalized economic environment, though the slightest information or negative comment on a particular company could have catastrophic effects for economic sustainability of the company.

INTRODUCTION

Recent advances in technology, transportation and communication are among the most important factors that led to the emergence of the Globalization phenomenon and proliferation of multinational enterprise (MNEs).

The MNEs are firms that have established affiliates or subsidiaries in other countries: thanks to their flexibility and freed from limitations of national jurisdictions, for MNEs is easier to place their relevant activities in different countries that gives them an increased competitiveness, growing markets of consumers and a primary role on the development of the local / global economy. According to survey of Cargill and Archer Daniel Midland, assets of the 100 largest corporation are located outside of their home countries meaning that specific production phases (especially for the manufacturing one) are located in strategically part over the world.

MNEs seems to dominate national economies because of their size and influence on global economy: in fact, the top 500 MNEs have control over more or less the 70 % of the worldwide trade (Sikka, Willmott, 2010). For this reason, the rise of these companies has increased the attention of tax authorities about cross border flows from different countries where the production chain is located. MNEs have different and independent subsidiaries located in both developed and developing countries. Each of them is closed to limited resources, specific knowledge and skilled labor: they develop specific activities and generate part of the value created with the provision of the finished product. In everyday life terms, people are used to purchase some items designed in the USA, manufactured in China and then sold to European final consumers (consider for example Apple or Nike final products).

Within an MNE group, transfers of intermediate goods are called "intra-group transactions" and they account for more than 30 percent of the total number of international transactions each year (Sikka, Willmott, 2010). As said before, these transactions involve different countries of more continents. Governments involved (especially those of developing nations) may start a tax competition in order to attract MNEs' investments and to stimulate domestic economies. They also focus to support local community on special economic zones providing basic necessities as food, protection, jobs, welfare and creation of networks.

Operating in different countries, MNEs deal with different taxation systems: different history and separate taxation rules may present difficulty for MNEs to determine income and expenses of the relative subsidiary's' jurisdiction in order to analyze the economic performance of branches all over the world. It will describe the evaluation of the performance is at the base of the determination of the managers' incentives system to evaluate also the productivity and the responsibility of single managers.

Potentially, difficulties may be double or multiple taxation, higher tax rates in case of repatriation of incomes: as a consequence, MNEs may face higher compliance costs. For this reason, developing countries may start a competition in order to attract foreign investments and make taxation leaner for MNEs.

This tax competition can result in the application of a more facilitated taxation regime: it means that taxation system will provide discounts and tax benefits, light regulation, very low tax rate, tax inducements and tax holidays as a "welcome prize" and other instruments for example carrying forward losses.

The flight of capital from high tax countries to lower ones is one of the most important and critical issues for regulatory authorities: nation-states, in particular off-shore countries count less than 2 % in terms of population, but they count for more or less 30 % for the net profits of the biggest American corporations. Nation states and micro-states as Cayman Island are described as "the cornerstone of the process of the globalization" (Palan et al.,1996).

MNEs have a very large incentive to move capital within countries for tax avoidance rationales and sometimes for tax evasion in order to increase after tax income. *The vast increase in global trade and corporate power provides plenty of opportunities for crafting transfer pricing strategies for avoiding taxes, especially as many corporations wield more resources than many nation-states* (Sikka, Willmott, 2010). MNEs adopt Transfer Pricing methods to manipulate the price of the related-party transactions to reduce their tax burden (Johansson, Skeie, Sorbe, 2016).

The relevant problem analyzed in this thesis is the difficulty for tax authorities to detect invisible situations of tax avoidance by MNEs and what is hidden for the public eye: in particular the adoption of the Transfer Pricing techniques to move capital between countries. Subsequently, the analysis will focus on manipulation of Transfer Pricing due to the increase in corporate power and management of key resources, two factors that give to MNEs the opportunities of transfer of wealth and, consequently, opportunities of tax avoidance through the use of Transfer Pricing.
Because of the intensification of the globalization, the transfer pricing has become

a well-established issue on accounting forums, economic debates and textbooks; nevertheless, the visibility of transfer price as instrument of tax evasion is not accentuated in public opinion due to fact that the information is confidential and difficult to find.

This research seeks to shed light on the phenomenon of flight of capital, drawing attention on the most critical factors and sensitizing the reader to this problem. Moreover, it wants to help the reader to develop a personal and more informed criticism about the possibility to adopt responsible and socially attentive strategies by governments. Also, it may be interesting to encourage the reader to think about possible strategies to adopt to limit the tax evasion through the manipulation of transfer pricing.

Moreover it will be interesting to highlight a contrast regarding the lack of adequate taxation and control systems developed by states especially developing countries that are not financially ready to sustain investments to design practices and decide common standards: is possible to talk about tax evasion if there is a lack on normative or have been created roughly?

The purpose of this study is to review and critically analyze the validity of market assumptions and to develop a more transparent and democratic normative framework for future challenges.
To accomplish this, the present work analyzed practitioners' articles published in economic and business magazines, academic research and surveys, as well as international guidelines and regulatory agencies framework.

The remainder of this research is organized as follows.

The Chapter 1 presents the Transfer Pricing and the intra-group transaction, describes the characteristics and applications of the most important methods to calculate prices for intermediate goods and services throughout the analysis of the OECD guidelines. At the base of the entire analysis there is the Arm's Length Principle and in this chapter it will be presented following OECD definition; it will pass through the two major topics of Transfer Pricing, as manager's incentive instruments and tax minimization strategy in cross-border transactions; subsequently there is a focus on the Transfer Pricing Manipulation (TPM) as the most critical issue for tax authorities. Chapter 2 presents some evidences and real cases of MNEs who have been involved in TPM with an analysis of advantages found by those companies and threats faced by tax authorities, in relation to the economic and political background of those countries involved. Next, a more in-depth analysis will be performed in order to understand the instruments adopted by nation-states and micro-states to attract MNEs investments. It is extremely important to know the logic behind of the work of MNEs in order to have a complete idea about the problem. Some data will be added during this chapter in order to give to reader a more detailed overview about the economic weight of the most common fiscal maneuvers. Chapter 3 focuses on the difficulty to find the right method and as a consequence the right price for the Intangible resources and Intellectual Property Assets, that are not traded in a specific market and so there is not benchmark. Also, in this case there will be presented a case of an international corporation that has adopted Transfer Pricing to cash out royalties through offshore subsidiaries. Here the chapter proposed is one of the core elements of this research especially for the difficulties noticed by regulators. Chapter 4 presents an opposite view in the sense that it tries to not defend the work of MNEs but rather to discover some flaws of the system referable to the lack of adequate normative; are MNEs only seeking to improve efficiency rather than to avoid tax?

Finally, Chapter 5 discusses potential challenges that tax authorities and MNEs may face in the future, summarizes and concludes the research.

CHAPTER 1

This chapter is based very much on OECD guidelines in order to provide a theoretical basis to the reader useful to better understand the underlying logic of profit shifting.

First, the meaning of Transfer Pricing will be analyzed, introducing the underlying principle and contextualizing the scenario characterized by the companies belonging to the same group and controlled by a reference holding company; Subsequently, the methods used to calculate the transfer price most suited to the corporate and fiscal needs of the multinationals will be treated, also trying to highlight the strengths and weaknesses of each and potential alternatives.

The end of the chapter will focus instead on the phenomenon of the manipulation of Transfer Pricing (TPM) for tax evasion: this focus will be the basis for subsequent chapters, in which real cases of multinationals that manipulated transfer pricing will be dealt with.

1.1 TRANSFER PRICING IN MNEs

Multinational companies have conquered the global economy in recent decades. The improvement of the technology has led to a significant development of the communication systems and the logistic channels: this fact has allowed a greater integration between the national economies.

These factors have facilitated the expansion of these global players in highly industrialized countries, especially in the United States and Europe.

MNEs are characterized by very large capital and considerable technical productive capacity. These enterprises operate in various countries of the world through the control of local branches and subsidiaries which take advantage of local resources to achieve a higher level of competitive advantage.

The multinationals are constantly looking for scarce raw materials, limited energy resources, specialized and low-cost labor, proximity to industrial areas connected by ports, inland ports, motorway hubs in order to obtain ever greater profits.

The main feature of these global players is the division of the value chain into different affiliates, managed and organized by different branch managers that control subsidiaries located in different countries often even in different continents. Through vertical integration, the product is then conceived and designed in a specific country, produced, packaged and shipped from one or more different branches and sold in third countries even different from the original one.

Think about for example of CAREL INDUSTRIES SPA: this company provide industrial fridge systems consisting on a composition of several elements such as the architecture and bearing structure and temperature control systems, humidity checks etc. These on-board computers in particular are composed of the battery, the screen, the sensor, another computer that performs the necessary calculations. Here are all these elements may not be manufactured in the same branch for different reasons: skilled labor, presence of a lithium supplier for batteries, stipulates a special commercial partnership with a foreign supplier for LED screens, the unit cost is more competitive.

The intermediate components of the finished product are internally exchanged between the various subsidiaries of the group. At a price which is referred to as transfer price?

Transfer prices are the prices at which goods, services or intellectual property are transferred between associated companies, companies belonging to the same group (companies controlled by the same entity that directly or indirectly participates in capital and strategies) and with which the holding company has

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formed an agreement of Permanent Establishment (PES).

Transfer Pricing is a kind of a phenomenon in tax areas which is considered as a threat for the tax revenue (Kukuh Leksono S. Aditya, 2015), used to reduce MNEs tax liability through some artificial arrangements in a trade that could lead some advantages especially for those companies who have lots of commercial relationships all over the world. In this situation, the connotation is seen as negative meaning that MNEs use this instrument deliberately to advantage by particular country's tax regime. However, not all practices and behaviors adopted by MNEs in terms of Transfer Pricing are fraudulent and with the scope to disturb tax revenues and to reduce tax burden.

The OECD institution published in July 2010 a document containing the *guidelines* on Transfer Prices, describing the principle underlying the calculation of the price, the main methods to be adopted by analyzing the nature of the transaction between the companies associated and not, the parties involved, potential risks and possible disputes between the state and multinationals, thus indicating to local institutions the correct modus operandi in compliance with international law.

1.2 THE ARM'S LENGHT PRINCIPLE AND ITS APPLICATION

Multinationals enterprises, operating in different jurisdictions, may be influenced either by taxation based on the group's country of tax residence or by taxation based on the country in which the branch affiliate operates or a combination of the two possibilities. In the first case, the tax base is the entire income generated from foreign resident corporations within the country's territory (Cavelti, Jaag, Rohner, 2016). In the second case, the tax base is formed only by income from companies operating in that country, leaving aside the fact that they have their tax residence elsewhere. Residence taxation and source taxation "*represent the two different ends of any cross-border income*" (Cavelti, Jaag and Rohner, 2016).

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The combination of the two systems of taxation leads to a double taxation. The Double taxation conundrum occurs when the income generated in a residence country is potentially subject to taxation by both residence country and the foreign country named source country where the production chain is conducted and the income is earned (Fleming, Peroni, Shay, 2012).

As a result, income data may be distorted. In both cases, separate entity approach is used. That is, local branches of the same MNE are treated as if they were separate and different companies.

In order to solve this dilemma and to accomplish the correct application of the guidelines, the OECD following the Carroll Report (the standard convention of the 1930s) stated the most sensible use of a separate entity approach as to minimize the risk of double taxation, reducing discrimination within the supply chain, promoting sustainable growth at global level and achieving fair data. In the Report by the Four Economists, Bruins, Einaudi, Seligman and Sir Josiah Stamp suggested *that income from business activities should be taxed by the source country (corresponding to active income); while passive income, for example dividends and royalties should have be taxed in residence country, where companies stakeholders reside* (Cavelti, Jaag and Rohner, 2016). The determination of separation of income taxation remains arbitrary especially in case of multinational enterprises which can move residence to countries with a preferential tax rate.

The separate entity approach requires, however, that the intra-group transaction is recorded as a real sale, therefore with market prices, with documents that attest to its regularity and above all that are accounted for and entered in the balance sheet. Official prices are generated by market forces and are determined every day by supply and demand and can be consulted in the various local or interregional databases.

One of the most critical issues about transfer pricing is that it involves two actors as both taxpayers and tax administrations. For taxpayers' side, transfer prices determine a large part of the revenues and expenses of subsidiaries because the provision of intermediate goods, services and intellectual property is used to be within a multinational group and in many case within the same tax jurisdictions. But a growing percentage is rising over transactions between subsidiaries located in different tax jurisdictions. Multinational enterprises and tax authorities start a challenge between them as to reach the highest competitive advantage and higher income. In particular, in order to give a continuity and a credibility to the entire system, tax authorities of different countries have to coordinate rules, behaviors and organize necessary changes to keep controlled intra-group transactions.

For this purpose, OECD has developed a standard suggesting a direction to MNEs and providing to tax administrations an instrument to maintain compliant their control systems over intra-group transactions. In fact, the entire normative on Transfer Pricing is based on the Arm's Length Principle: it explains that the profits generated by transactions between associated enterprises have to be taxed as well as those profits generated by transactions between independent enterprises. This because associated enterprises within the same multinational group may distort some conditions of the commercial trade and may favor income or expenses manipulation between branch managers as a result.

The Arm's Length Principle establishes that transactions between independent enterprises are called *uncontrolled transactions*. Such transactions are named uncontrolled because they are characterized by market forces and unpredictable by the nature. Instead, the transactions between associated enterprises are *controlled transactions* because the possibility is higher to set a particular transfer prices or certain conditions as transportation phase, payment phase and other contractual terms than in other circumstances.

In order to replicate conditions specific to a transaction between independent parties, the Arm's Length Principle tries to adjust these dynamics treating associated entities of the MNE group as separate companies (remind to the separate entity approach) rather than parts of a single unified group. In fact, the arm's length principle could be translated to competition principle just for the fact of the comparability of circumstances as prices, taxation of profits and so on. In the absence of a reference market, a certain and precise transfer price is not easily definable in particular for companies who trademarks, patents and other intangible assets (Sikka, Willmott, 2010). In this case, MNEs have to provide suitable financial documents in order to report the method adopted, the motivation behind that specific choice and the results came from the application of that method instead of another.

The application of the principle follows the comparison of these situations in which relevant dynamics could affect the result of the transaction. In order to apply the principle correctly, OECD Guidelines document introduces the comparability analysis: the comparison of the conditions is successful if there is not differences between situations that could affect the conditions examined as price or margins. In some cases it is inevitable to find significant economic differences such as risk profile able to influence the outcome: as a result corrections and adjustments are necessary to eliminate possible sources of distortion and to improve the reliability of the comparison.

To accomplish the comparability analysis, the taxpayer has to examine *five factors* affecting both *uncontrolled transaction* and *controlled transaction* in order to evaluate those dynamics and differences that could bring a distortion of the entire transaction.

The first factor is about the *tangible characteristics* of the product/service exchanged: very large differences may arise if the global value of the product is associated if all components have been calculated roughly or characteristics have been communicated in a way to influence open market valuations.

Tangible characteristics are for example physical features as colors, packages, functionality, quality, reliability, availability, the volume of supply. In case of intangible resources instead characteristics refer to the property like patent, trademark, the degree of the protection. Possible material deviations may incur during the analysis: for each characteristic there are necessary adjustments caused by the difference on the nature of goods and services transacted, the counterparts involved and the countries where the transaction takes place.

Secondly, the comparable analysis will focus on the identification of the *economically significant activities*, assets used, and risks taken by parties as risks of loss, market risks and risks of failure. This phase is called *functional analysis* and it regards on the composition, organization and context of the MNEs group. This phase is extremely important in order to have a clearer picture about the nature of the transaction in general and the relationship behind a particular trade within MNE group all over the world. Knowing the nature of the relationship is useful to learn if there were applied favorable conditions within a transaction and why. The subsidiaries' managers may have a particular agreement to set favorable prices in order to take the highest advantage for both parties. Not only the price is set, but also the risk sharing on activities that are able to create value: marketing and advertising, Research & Development, product design.

All of these conditions have to respond to the Arm's Length Principle in the means that none of the parties involved have to be advantaged by dynamics. In order to limit risk exposure, set responsibilities and locate possible benefits to generate, parties involved may define *contractual terms*, also to resolve functional analysis issues.

This is the third factor that characterize the comparability analysis. Contractual terms are the "glue" that keep together all elements derived by the functional analysis. Contractual terms are instrumental to give more responsibility to subsidiaries and to eliminate divergences on commercial interests of parties involved.

The fourth element is the *economic circumstances*: this means that transactions may vary a lot depending on the market, the country and the historical momentum. For this reason, the application of the Arm's Length Principle has to consider these circumstances and parties have to calibrate their comparability analysis following these situations: think about for example to the size of market, to the location (countries, languages, social attitudes), competitors and availability of scarce resource, similar to Porter's Five Forces analysis.

Similar controlled transactions may have carried out within different countries at homogeneous conditions and for this type of transactions could be interesting to analyze comparable circumstances on a multiple – country base, thus based on the context and not only on the object of the transaction.

The fifth factor regards on *Business strategies*. The comparability analysis has to highlight the most important purposes derived by transfer pricing, as innovation, product development, diversification and risk aversion. But also, the degree for market penetration with an commercial expansion perspective, and the threat of comparable products are other two critical variables to pay attention on.

Business strategies are important to complete the puzzle of the comparability analysis and to have frame of reference in order to define the direction and future perspectives imagined by the parties. For example, if a tax administration has to evaluate if a taxpayer follows a business strategy, it is necessary to examine the conduct of parties: in practice if the price charged by a company is below the market price, then the other company has to reflect this variation on price charged to its final customers to achieve a market penetration strategy.

Another example is the registration of continued losses of an associated company.

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Suppose that only one associated company realizes continued losses over the years but the MNE group as a whole is profitable. This fact may raise suspicion of the tax authorities and may trigger an alarm bell. Independent enterprises could register losses due to the high startup costs, an unfavorable economic condition during the year (as the recent sanitary emergency showed) or because of inefficiencies in production chain. Also, independent enterprise cannot sustain losses for a very long period and the business may cease. Conversely, an associated enterprise is part of a MNE group and the losses could be sustained for many years. The fact that only one company registers losses rise transfer pricing issues because the compensation received by that company is not adequate for the volume or the quality of products provided to MNE group: in fact in the face of the request to be competitive, the *loss company* may provide products or services at very low prices while the rest of MNE group remain competitive charging higher prices to final customers.

The case of loss company could be explained by the adoption of a market penetration strategy where present profits are sacrificed for higher profits in the future. In such case, a more complete analysis has to be conducted especially under the transfer pricing side. Tax administrations should not accept especially low prices, equal to marginal costs.

All of these factors give to MNEs group the possibility to conduct a comparability analysis as correct as possible in order to determine if a controlled transaction between associated companies could be comparable with an uncontrolled transaction in order to affirm the correctness of Arm's Length Principle application.

What emerges from OECD Guidelines is that the comparability analysis has to be efficient and useful to determine situations of potential anomaly and for this reason it has to be based on comparable economic characteristics (this sounds strange but the comparability is the pillar below the Arm's Length Principle). Time period reference, taxpayer's circumstances such as historical and economic situation, geographic locations, the size of the markets, both contractual powers of the buyer and the seller, competitive forces as availability of substitute of the provision of goods and services, the nature of the regulated market are the principal factors analyzed through the comparability analysis.

As said before, the intra-group transaction does not have to be characterized by special conditions such as to favor a particular business unit or company: if the transaction was based on artificial and fictitious prices, it would risk to manipulate incomes and move them elsewhere, in countries with lighter taxation regimes, even if it is difficult to observe and it takes a very important burden of proof by tax administrations. The Transfer Pricing normative finds origin to avoid these fraudulent behaviors by MNEs: thanks to stringent rules on the methods to apply in each situation that tax authorities can conduct correct and fair analysis on comparation of dynamics distinguished within international trade.

The Arm's Length Principle states the will to treat subsidiaries of MNEs as if they were different and independent companies.

The transaction has to follow particular market conditions: profits have to be correctly accounted and taxed in the reference country, where the company obtains those profits (residence or source country base taxation). In order to determine the correctness and the fairness of the conditions it is necessary to adopt the comparability analysis of the internal transactions occurred between the associated subsidiaries and transactions that would have occurred if these subsidiaries were independent enterprises.

To summarize, Transfer Price calculated through the application of the Arm's Length Principle represents the most accurate estimate of the market price. It provides parity of tax treatment for all the members involved in trade both MNE groups and independent companies. For this reason, it has been legitimated by authorities especially by the OECD countries as the pivotal principle within international trade to guarantee and promote foreign investments. It is used in the majority of cases, involving for example the purchase of commodities and the exchange of money through loans between associated enterprises. There are some limits of application of the principle in cases of transactions of specialized products or services. In this scenario OECD countries have adopted some methods to solve this issue presented during the chapter.

As well as it will be a focus on the most important alternatives to the Arm's Length Principle: it will be a more theoretical part because these alternatives are not used so much in practice between companies.

1.3 ARM'S LENGTH PRINCIPLE ALTERNATIVES

The most well and known alternatives of the Arm's Length Principle is the Global Formulary Apportionment. It is not largely used across national boundaries, but it is adopted by local taxing jurisdictions.

In practice with this approach, the global profits of a MNE group are allocated among associated enterprises located in different countries through a series of computations in which the components are the determination of these branches involved, the right determination of global profits and the variables of the formula to apply on, depending on costs, assets, sales and payrolls.

Global Formulary Apportionment (GFA) was born by the idea that could be created a mechanism quite close to the reality of businesses especially for those involved in a MNE group. The first precursors of this approach assert the inappropriateness of the separate entity approach because of the difficulty to determine the amount of profits to tax for each subsidiary and to evaluate the contribution of each branch to the generation of MNE group profits. As the pioneers supposed, GFA approach is useful to eliminate the need to compute profits for each subsidiary, facilitating the work of taxpayers and reducing compliance costs since the documentation of global profits generation is prepared only one time and then communicated to the branches.

One of the most important and critical aspect of the *Global Formulary Apportionment* is the great complexity and the need of data requirements is not sustainable by taxpayers: collecting documentation on national currencies' basis and tax accounting rules may be time consuming and counterproductive. Or think about the production of a whole series of data about intangible property. It is complicated not only because there is not a market price on these types of assets caused by subjective valuations, but also because of the differences in accounting and tax systems.

Moreover the inability to guarantee the single taxation rather than the double taxation incurred by taxpayers because it would need a great coordination between countries and tax administrations, efficient agreements and a single accounting system with which tax authorities can stabilize own profits choosing a common and coordinated system of measures. Just for the fact that all of countries have incentives to maximize tax revenues, they try to manipulate the computation process deliberately changing some *weights* and some financial components.

Reaching a common consensus is time consuming and for this reason such agreements are very difficult to stipulate. Hence, the coordination between countries especially on international taxation is extremely complicated to obtain. Dealing with different countries with different currencies, it is possible to face issues derived by exchange rate: Global Formulary Apportionment does not have the ability to deal with this fact because the formula may be based on a particular type of cost set in a determined currency, possibly stronger than the others. This discrepancy is not convenient for the branches with a weaker currency resulting on conflicts within the same MNE group.

1.4 THE TRANSFER PRICING METHODS

As said before, the Transfer Pricing method does not exist to each product or service exchanged within a MNEs group. This is because many products or services are very specialized and for them MNEs do not have a reference market price. Think about customized goods or personalized service, made and provided for a specific situation or by a certain request: there is no market for custom-made goods. Another example are the intangible assets, for which it is impossible to assign a specific value or to account an expense because these goods are of subjective interpretation.

As OECD Guidelines suggest, a unique method to determine the correct Transfer Price for each situation occurred in international trade does not exist. The products exchanged are different, the players have own history and organization, companies are located in separate countries where the legislation adopted by tax authorities is varied and complex. It does not exist a magic recipe for all MNEs because the complexity and the number of variables that come into play in this international scenario.

For this reason, thanks to OECD Guidelines is possible to choose the appropriate method depending on country involved, product and nature of the transaction. The choice of the proper method is reached by the help of the application of functional and comparability analysis, through which MNEs can find the right variables and possibilities to sustain. In this sense the availability of information is a fundamental element for this phase: in fact, more information available better could be the judgement on the appropriate method to apply in compliance with international standards and rules. Relevant information is on the nature of comparable uncontrolled transactions in order to design a scenario more similar to trade between independent companies. The collection of information may be difficult, time consuming and may result useless if insiders do not filter information in the right way.

The methods suggested and in compliance with the Arm's Length Principle are divided into two opposed sections: the *traditional transaction methods* and the *transactional profits methods*. The Traditional Transaction are methods based on the comparison between the price set in an *uncontrolled transaction* with the price determined in a *controlled transaction* at arm's length conditions. While, the Transactional Profit are methods based on the comparison of conditions rather than price such as net operating profits realized in comparable transactions. The relevant difference between the two methods is whether conditions are arm's length or not. In the first case the traditional transaction methods can be applied when prices are easily traced back to the commercial relation within enterprises because it is made or imposed between the two parties; relevant conditions are established in market bases. Hence the price could be easily substituted and applied from a comparable uncontrolled transaction to a controlled transaction.

In the second case, the application of transactional profit methods is based on unique conditions and in highly integrated activities in which parties involved contribute to provide higher valuable and unique contributions to the final products or services. Nevertheless, the availability of information on comparable uncontrolled transaction is limited: for this reason, it is very difficult to apply a method based on the comparison of relevant conditions because in this case comparable conditions do not exist.

Both macro area of methods do not have to be analyzed deeply because it could be time consuming and counterproductive for the final purpose; MNE groups have to follow functionality and comparability analysis before taking final decision of the most reliable method to apply on. In this sense, MNEs could obtain final results that do not bring to a suggested method by OECD Guidelines: for this reason, MNEs are free to choose *another method* not provided in the Guidelines. The use of not standard methods is possible only if MNE justifies the adoption of that particular method rather than those suggested and it provide an explanation of if the conditions over the transaction are in accordance with the Arm's Length Principle.

At the opposite, is it possible to use more than one method? For the Arm's Length Principle is not possible and required because this situation may provide an excessive burden for taxpayers. However, as said before if conditions are particularly difficult to examine MNEs could analyze both methods in conjunction always consistent to the Arm's Length Principle. The analysis in conjunction of more than one method is useful to determine the *Arm's Length range*, that is the overall set of Transfer Prices potentially adoptable in that particular transaction, depending on the availability and accuracy of information found. Each of the prices presented in this range are in compliance with the Principle and the determination of the final price to adopt depends on the minimization of risks of error of analysis.

The important things to keep in mind are a preferable more direct or closer relation to the comparable uncontrolled transaction, higher and deeper degrees of comparability analysis. In short, MNEs have to adopt all the instruments to research which method is the most suitable in compliance with the Arm's Length Principle even because it is impossible to make all the adjustments for all international transactions.

In the following pages provide a brief description of the *traditional transaction methods* and *transactional profit methods* suggested by OECD Guidelines in compliance with the Principle:

1.4.1 **Traditional Transaction methods**

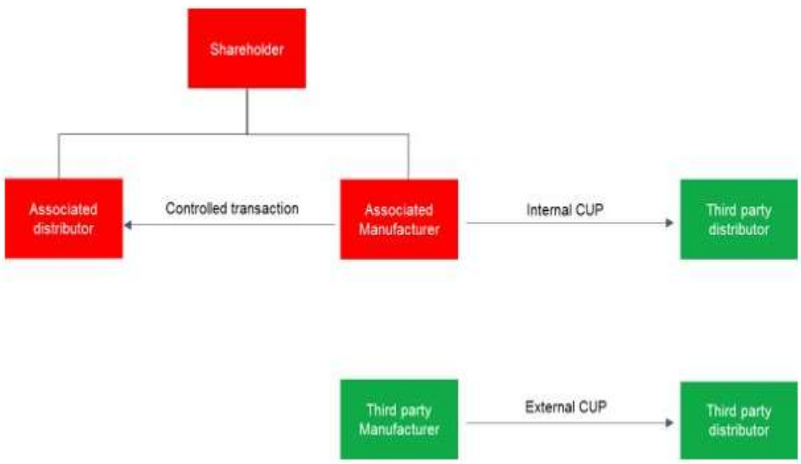
The *Traditional Transaction methods* include:

- The Comparable uncontrolled price or CUP
- The Resale Price method
- The Cost-Plus method.

The Comparable Uncontrolled Price (CUP)

In general, at comparable circumstances this method compares the price of property and service charged in a controlled transaction with the price charged in a comparable uncontrolled transaction. The CUP method could be based on (see the figure below):

- internal comparable transactions if the comparability analysis is done between the MNE group and a third party;
- external comparable transactions if the transaction is compared within unrelated and independent enterprises.



The CUP method could be illustrated considering a transaction in which there are the manufacturer, that is part of a MNE group, a controlled subsidiary of the same group and an uncontrolled/independent enterprise. The product sold is the same for both transactions. Consider for example a Ultra definition Television: if the product does not present material differences in the case of the two transactions, the CUP is most suitable method to apply on.

It happens that there are some differences within these prices, indicating that conditions are not at Arm's Length Principle: this situation may need some adjustments and corrections, for example substituting that uncontrolled transaction price for that applied on associated enterprises. For instance, in the suggested example different conditions may be related to transportation terms or any other contractual condition.

The CUP method is the most efficient method to apply the Principle when it is simple to identify a comparable uncontrolled transaction, in the means that for a particular type of product or service traded between associated enterprises it exists in parallel another transaction with the same conditions between independent companies who adopt market prices. The comparison between two transactions assumes that there are not differences in relevant conditions that could affect the price and in the case of presence of such differences, corrections are needed to eliminate material effects.

For example, the CUP method is particularly reliable for trade of a same product: independent enterprises provide the same good or service sold by associated companies. In this case the comparison is quite simple to complete due to the similarity of circumstances about quality, quantity, production and distribution chain. Differences may arise from insurance and delivery terms for example and for which tax authorities may ask for some adjustments and corrections.

In practice however, it is infrequent to assist a comparison between transactions similar enough to not register differences affecting prices and a result to apply CUP method. Even because, the comparison between transactions may not be based on only product or service comparability: it may respond to informative needs about broader business functions as to comprehend more about the international transaction.

The Resale Price Method

This method is applied to a particular marketing and promoting operation for a determined product or service, but it is always applied to tangible property transactions.

In order to obtain an arm's length principle, it is necessary to compare:

1) The price margin that it would be obtained by the resale of a determined product, purchased by the associated company within controlled transaction of MNE group at a price X, to an independent enterprise in a comparable uncontrolled transaction;

2) The price margin of the sale of the same product at the same conditions at a price of Y within parties totally and originally not associated, so between independent enterprises.

If these margins are very different with each other are mandatory corrections and adjustments on the determination of the price by the associated company; while the margins are quite similar, it is realized an arm's length transaction.

As said before, the comparison of these two margins dictates the fact that the two transactions are sufficiently comparable and none of the differences could materially affect the resale price margin. This may occur when for example two distributors sell the same product in the same market with the same brand, but one of the two offer some extra services as warranties or other forms of

accessories: this fact makes that the transaction is not comparable and adjustments are required because the two margins described before are different.
To comprise better the process of this method, consider this example: an Italian company distributes shoes purchased from a related subsidiary in Ireland and from an unrelated supplier located elsewhere. Both products are very similar and comparable with each other (for simplicity the contractual terms as spedition conditions are the same for both transactions).

To accomplish the Arm's Length Principle, the gross margin earned by Italian company has to be the same as it results from a transaction with its third-party and independent supplier or be on a range of acceptable gross margins yields. For example, if the Italian company makes a gross profit of 40 Euros for each 100 Euros of product purchased by the unrelated supplier, the gross profit margin of 40 % must be the same in the controlled transaction. If the cost applied from the Ireland related subsidiary is 200 Euros, the gross profit margin acceptable for tax authorities have to be 200 multiplied for 40 %, resulting 80 Euros; in other terms, Italian company earns 80 Euros on products purchased by the related party.

This method requires less stringent comparability requirements than CUP method because the products analyzed could report different minor features that they do not influence too much the gross profit margin. However, this method is not applied frequently because of the difficulty to find comparable controlled and uncontrolled transactions and the scarce availability of data on a transaction-by-transaction basis.

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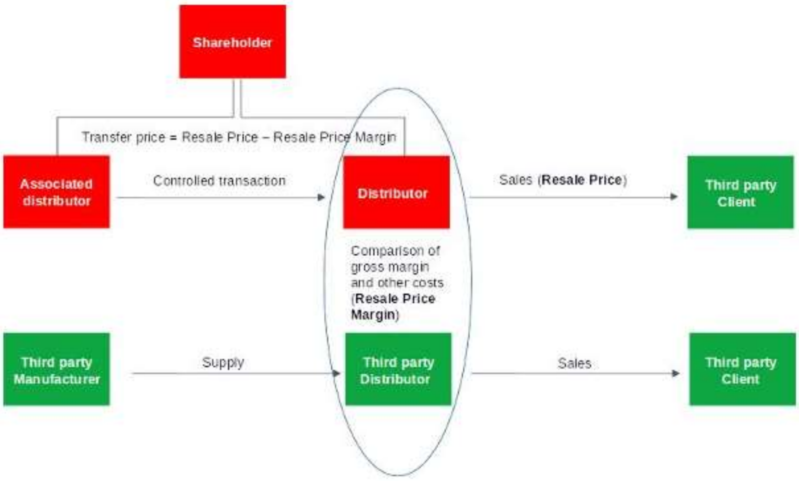


The Cost-Plus Method

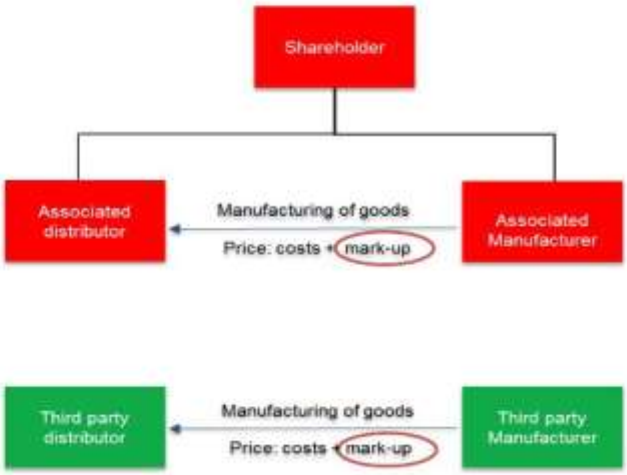
This method consists on the application of markup on the cost incurred by the supplier of a determined item or service and then sold to an associated purchaser in order to reach a sustainable profit level.

This method is the most used by parties who trade semi-finished goods with each other, especially by associated companies who agreed special treatments and commercial long-term partnerships.

The difficulties incurred in the application of the *cost-plus method* are the determination of proper costs (as to eliminate *accounting inconsistency* through which different costs are accounted in a different manner) and the application of the right margin, comparable to the cost basis. In this case if there are differences that are able to affect price margin on a market basis, adjustments are required.

An example of lack of *accounting consistency* is the situation where two companies account differently the supervisory, general and administrative costs, which could be not accounted in the cost of goods sold: this issue may rise some incongruencies within accountability of expenses and profits.

The cost-plus method is applied very often in "routine" manufacturing and on sale of tangible intermediate goods thanks to the reliability of internal and external data about markups applied. First of all, in general, a subsidiary has to determine its costs level incurred in a controlled transaction. Secondly, an appropriate mark-up has added to costs level to make an adequate profit. If comparable controlled transactions data are not fully available, it sounds reasonable to determine an average of gross mark-ups applied by companies similar to that considered in the analysis.



1.4.2 **Transactional Profit methods**

The ***Transactional profit methods*** include:

- The Transactional Net Margin Method (TNMM)
- The Transactional Profit Split Method (TPSM)

The Transactional Net Margin Method (TNMM)

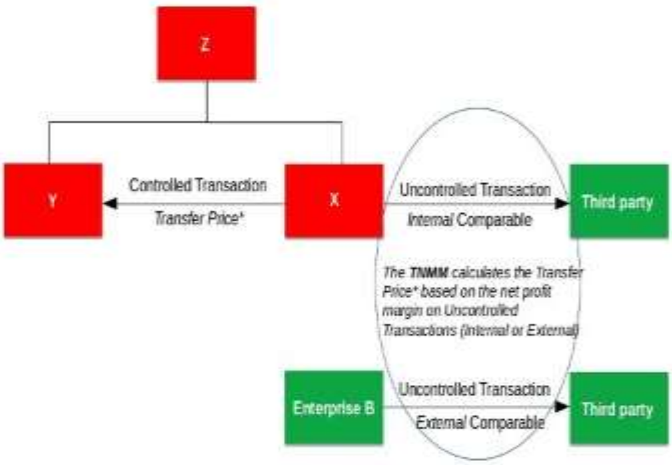
Both of the methods described below calculate the profit level arising from a particular controlled transaction. The first method consists on the analysis and comparison of the *net profit margin* realized in a controlled transaction with the profit level derived by a comparable transaction with third parties. Net margins are compared *internally*, so on comparable transactions with third parties, or compared *externally*, on transactions between independent enterprises. In general, not operating items are excluded by the computation of the net margin.

The difference with the other methods is that the transactions have to be similar and not perfectly equal within each other to compare the conditions and to evaluate the right transfer price to adopt. In order to accomplish this computation, this method is related to the concept of net profit indicators as *ROE* or *return on assets*: these indicators in fact are based on costs, sales or assets, depending on the choice decided by the company reflecting risks between parties involved (for example for capital intensive activities, the company should relate the indicator on assets as to compute the incidence of these activities on the entire risk sustained). Companies have to adjust these indicators through the application of a series of weights relating to what party bears that specific risk.

For this reason, one of the most important favorable characteristics is that profit indicators are less affected by transactional differences than in case of traditional method such as CUP method, because differences especially those functional, are reflected in variations of costs and finally also the profit margin is varied. The variation of margins is broadly similar to that of operating profit indicators. In this sense, the functional analysis has a primary role: it determines the application of some operating items which may vary considerably by companies.

Finally, the determination of net profit is the most delicate phase because of the need to eliminate those expenses and revenues that affect the generation of profit and as a result, affect the comparability between transactions such as interest income and expenses.

In order to apply this method, a very large amount of information about comparable transactions and benchmarks used to conduct the comparability analysis is necessary, that could be not available at the time of the conclusion of a controlled transaction and this may have a result a distort application of the method causing the production of not valid consequences. In recent years however, this method has almost become the default method for taxpayers because the TNMM method is less sensitive to minor differences in products exchanged.



The Transactional Profit Split Method (TPSM)

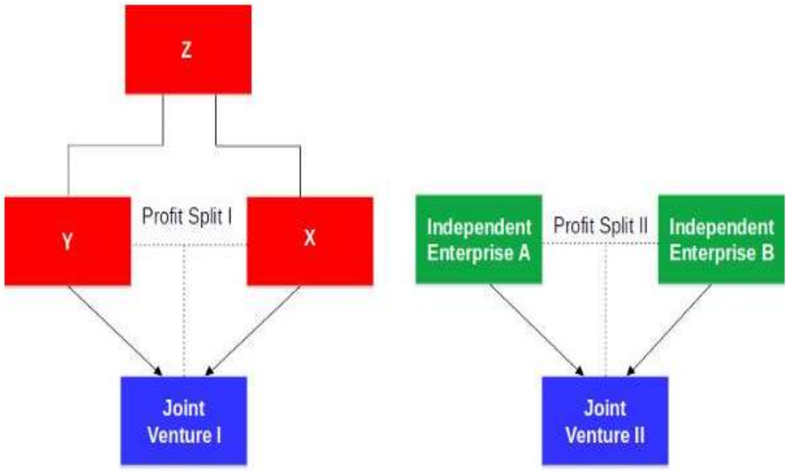
The aim of this method is to ensure the right proportion of profits achieved by associated companies in a controlled transaction relating to the contributions and compensation of the value creation of each division. The contribution has to be agreed to that occurred in a comparable transaction between independent enterprises. The final goal is still to accomplish the *arm's length principle*, but under profits perspective analyzed for single divisional subsidiaries.

This method is particularly advised when both parties make unique contributions to the transactions: this means that all of the cases of highly integrated operations are subjected to the application of this method. Cases of interconnection of activities, joint ventures, launch of a new brand require more complex studies and analysis, that a traditional method cannot answer cause the difficulty to analyze information on a single base, on single subsidiaries point of view.

It is a two-side method because it takes in consideration both parties involved, so going to determine the quote of each party. Let's consider for example a pharmaceutical company, that is developing a new patent for a new drug. The Research and Development department is managed by an associated company, so the risks connected to the success or the failure of this innovative solution to provide on the market is sustained by the affiliated company. Between the two parties, it has been established a permanent agreement: for this reason, both companies have the incentive to compute the right quote of profits earned depending on the contributions of each division. It is reasonable to think that the base for the division of profits is the total amount of resources invested by each company: if the R&D affiliate has contributed for 50 % of investments, it will collect 50 % of total profits.

Not all the cases are simple to examine by both taxpayers and tax authorities: at first sight the analysis could be accessible and interpretable because it tends to focus on controlled transaction rather than the trade between independent companies. A significant analysis of information is required, and results may be so subjective leading to different perspectives.

This method is particularly useful when two companies share synergies and make significant contributions to the development of the final product/service; in this case they want to share risk rather than having all the risk falling solely on a party. However, this method is expensive because it requires a very important amount of information and a significant attention to the analysis. At the contrary, challenges may raise resulting on different results for both parties.



1.5 TRANSFER PRICING DISPUTES

In order to apply the Arm's Length Principle, it is possible that may arise situations of conflict of interests between multinationals and tax administrations because of different results obtaining by the following of the OECD Guidelines and their methods explained above. Such disputes may emerge quite often in international relationships cause the various politics of taxpayers and tax authorities about Transfer Pricing: both parties want to obtain the best method to apply in terms of rightness and fairness of the transaction and to protect future commercial opportunities. As a result, parties involved may take different positions challenging themselves on the legitimization about procedures applied and then double taxation may arise: this means that a single income of a MNE group is included in

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more than one country tax base and in some cases MNE income could be charged twice but not always this is the case. This scenario has negative effects for global prosperity and is undesirable for the development of international trade and commercial flows within countries especially for investment opportunities in developing countries because of the difficulty to detect MNEs group incomes to determine the right tax base (Plasschaert, 1985; Christian-Aid, 2008).

OECD Guidelines give a sort of list of possible solutions to these conflicts evaluating different administrative approaches consisting in adjustments and corrections of the method or more than one method applied in the Transfer Pricing computation. These adjustments are very important in cases of cross-border Transfer Pricing because issues about compliance relating to Arm's Length Principle application may be missed and hidden by complexity of the taxation and the great series of normative to follow. In fact, the most relevant measures (and the most applied in real terms) to solve these practices turn around compliance from the point of view of information reporting provision, cooperation within parties involved and the protection of the taxpayer in general in order to avoid double taxation.

In practice, both tax administration and taxpayer may have to respond to challenges about evaluations on comparability analysis, markets insights and financial information that are come from differences in procedures, structure of taxation systems and past history of the countries involved. As a result, these situations may emerge some needs to evaluate these differences under a major critical point of view to respond better to particular challenges because Transfer Pricing is not a perfect science and for this reason a more accurate *examination practice* is required. Flexibility in the approach of examination on method adopted to compute Transfer Price and a sort of ability to put tax administration point of view in the shoes of taxpayers are the two skills to solve these disputes and to provide fair results for both parties.

Not in all situations it is required the authority must have to respond to these challenges only thinking as taxpayer does during the computation of Transfer Price; in the majority of circumstances tax administrations could ask a burden of proof relating to reasons why the taxpayer has adopted a particular criterion rather than one another and in other cases it could be possible to incur a sanction, administrative, monetary or criminal penalties.

These sanctions are applied also in cases where MNEs deliberately shift part of taxable income from one country to another just to hid part of their richness and to avoid the application of taxation. Hence, generally the disputes are not only regarded to administrative matters such as compliance with the Principle or provision of adequate information documents, but also and in the majority of the cases about some more material fact, more difficult to detect and to prove into justice.

1.6 THE TRANSFER PRICING MANIPULATION

This circumstance is called *Transfer Price Manipulation* (TPM) and it is the most negative fact about Transfer Pricing. The title of the present thesis is related to the TPM: in the following pages is provided a panoramic view about this issue, laying the foundations to continue the discussion on real cases of MNEs that have shifted incomes avoiding taxation.

The rising of the globalization through Internet developments has led to a greater confidence of MNEs to take more aggressive tax positions in order to challenge the exacerbation and sophistication of tax planners' techniques on legal arbitrage and fiscal check on international transactions. Moreover, "the international principles may not kept pace with the changing business environment" (OECD Addressing Base Erosion and Profit Shifting). In fact, domestic laws are based on lower degree of economic integration across nations and it does not take in consideration the increased importance of intellectual properties.

In recent years, the use of *intermediaries and conduit companies has expanded exponentially*; moreover the separation of business processes in different affiliates within the same MNE group or unrelated affiliates has led to taking decision on maximization of operative and financial efficiency: as a result, *taxes have been treated like any other costs which should be* minimized (Ault, Schon, Shay, 2014)). From this aggressive behavior taken by MNEs has as a consequence the rise of opportunities to reduce their tax burden and so to hide some incomes to fiscal authorities.

The manipulation of incomes has lead to a phenomenon called *Base Erosion and Profit Shifting* (BEPS). This phenomenon is explained by locate profits from high-tax to low-tax countries, manipulating transfer pricing method and relating these profits to locational corporate tax bases (Huizinga, Laeven, 2008).
This fact undermines fairness on tax issues and is a critical matter for all parties involved: countries especially the developing ones, may face difficult to erase enough financial resources to sustain investments and to support local activities and growth; *BEPS undermines integrity of the tax system* and *overall resources allocation*, if affected by tax motivated decision, *is not optimal* (OECD BEPS Action Plan); individuals bear a greater share of the burden because taxes have to be paid in any case; multinational corporations may face "*reputational risk is their effective tax rate is viewed as being too low*" (*BEPS Action Plan Oecd*): this is due because

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incomes are shifted away through Transfer Prices over years and the amount of taxes payed in relation to annual revenues could be ridiculous. At the contrary, local businesses have difficult to compete with MNEs cause the harming of the fair competition by BEPS.

The mobilization of income through the manipulation of Transfer Pricing for tax avoidance purposes is most of the time invisible and almost impossible to detect by fiscal authorities; moreover it incurs very high costs that have to be covered by "normal" flows of tax revenue but if taxable income is reduced by MNEs to increase their final income, what will be the amount of remaining resources and more important how do countries be able to collect enough tax revenue?

As explained by *Katie Webster & Nicholas Augustinos* in their article "*TACKLING BASE EROSION AND PROFIT SHIFTING THROUGH ENHANCED INFORMATION EXCHANGE*", profit shifting is only one cause that originate the base erosion.
In fact, MNEs could decide to reduce taxable base for example through:

- shifting losses in countries where it is possible to get back the payment in the future (carry forward losses and take advantage on fiscal incentives),
- reducing profits through a series of "artificial debt arrangements" as interest deductions
- taking advantage by disparities or complex legislation between states in order to avoid taxes in both places.

The phenomenon described above is recurrent over different years so a continuous monitoring of practices as are licit or illicit is mandatory. For this purpose, one method to know if a MNE shifts profits away is the computation of the effective tax paid on the total of revenues registered. If this amount declines over the period considered for the analysis, some doubts may emerge, and a deeper analysis has to be conducted.

Multinational corporations adopt different schemes about corporate – loss utilization involving affiliates located all over the world and across several jurisdiction. Such schemes as said before are not suspicious of illegal trade, but some doubts may emerge if these schemes have been made artificially and only to accomplish this purpose. The difficulty to discover and find the illicitness of these schemes is due by the complexity of information traded between companies: often the overall picture is not easily visible because of the presence also of different authorities that have a lot of interpretations and perspectives. For this reason, as highlighted by the two authors mentioned above, the exchange of the right information is fundamental to be alert and to see the complete picture. Moreover, the authors want to highlight that these schemes in practice are studied and designed in particular for trade of royalties and interest charges, for which there are not reference markets and the transfer prices adopted may not be compliant with standards of OECD Guidelines.

As a result, many reforms have been developed by authorities regarding the strengthen of transfer pricing provisions and the reduction of possibilities to deduct the debt charges between companies of the same MNE group, improving the quality of information exchanged to facilitate analysis and interventions by tax authorities. In this sense the co-operation between jurisdictions is desirable and preferable. Unilateral measures as fiscal maneuvers adopted by a single country may be effective for a specific a country but problems can emerge relative to double taxation of income of a company or inequities of fiscal treatment between more affiliates. For example, a country may enact some arrangements that deny some deductions on taxable income of taxpayer; the same action could be taken by another country in which that company have commercial and fiscal affairs: in this case payments are not exempted and a double taxation of income may occur even if these actions were thought to eliminate tax avoidance.

A real case example of measure of co-operation on exchange of information between countries is ***FATCA***, the *Foreign Account Tax Compliance Act*. This measure is not the perfect example of co-operation in the means that this action has been imposed by USA to partners countries in order to "*protect integrity of US tax base and limit powers of foreign tax havens*". In substance FATCA is a document that who wants to open an account in any Italian banks has to sign and demonstrate that not having American citizenship or residence that could go into conflict with local interests and vice versa (Italian citizens who wants to open an account in US banks). By doing this, financial institutions exchange automatically information with US fiscal authorities in order to prevent tax avoidance and facilitate analysis and procedures.

The co-operation on information exchange between countries has to be encouraged not only "through the signing of multilateral treaties": it is needed a full and pro-active participation of all countries, members of that agreement in order to give a more effective push and stimulation to reach better outcomes. Incentives and participation go beyond the mere design of fiscal incentives and measure to avoid illicit practices: countries have to focus more on administrative measures such as light bureaucracy, less time to fulfill requests, adoption of systems of continuous control in order to assist companies in international transactions following them in all phases and steps.
In 2013 the OECD developed a plan of action on Base Erosion and Profit Shifting comprising 15 particular steps in order to encourage collaboration between

governments and tax authorities involved in designing taxation system and accomplish fiscal goals within international trade. OECD countries have been encouraged to develop an action plan also because of the "failure of cross-border taxation rules to keep up with the realities of the modern commerce and finance" (Ault, Schon, Shay, 2014)): this political level urgency is dependent on the fact that the extent of the corporate tax avoidance was important and big enough to inspire public outcries and discussions on press reports. So it was needed a political intervention in order to protect governments interests to eliminate tax avoidance over the world. These political drivers highlight "*deeper problems in international taxation*": in fact since the time of the entry into force of OECD Action Plan, the international taxation system was based on bilateral treaties and for this reason it was possible to come across disputes and conflicts if a transaction was made within two or more countries: this because different agreements were made to accomplish different objectives stated by countries.

These 15 steps cover different aspects of international commerce, divided into groupings:

- there are actions about ***digital economy***, that is a supporting column on which international trade is based;
- actions about the prevention of ***double non – taxation***, limiting base erosion via interest deductions for example and increasing transparency on transactions;
- actions about the ***alignment of real practices with standard of Arm's Length Principle*** adopted such as assuring if the transfer pricing method is in line with value creation: this means that the Transfer Prices do not have to be manipulated to generate outcomes too higher w.r.t. the value creation

derived by that transaction; the alignment of Transfer Prices through these actions takes in consideration *intangibles* items (that contribute significantly to base erosion and profit shifting), *risks and capital activities* for example through funding to other affiliates and *high-risk transactions* (which refer on particular types of payment between MNE group members to erode tax base).

Double taxation and not or low taxation are two similar situations: both scenarios are associated with practices that artificially blind taxable income from companies who create value. These actions have been made to prevent the weakness of the entire taxation system in order to limit base erosion phenomenon, weaknesses due to frictions and gaps between single countries' tax laws; international standards have to set adequately and in compliance to these actions to provide a common and more coherent taxation system in international level. This means "*that domestic policies cannot be designed in isolation*" cause the interconnectedness of economies.

In particular, a primary role is covered by the realignment of taxation and the relevant substance on which tax burden is computed: in fact international standards "*did not keep the pace with changing business models and technological developments*" consisting on the use of intangibles and instruments to shift profits typically through the use of Transfer Pricing. The realignment is reachable essentially through the adoption of transparent practices based on exchange of comprehensive, relevant, certain and predictable information.

Transfer Price Manipulation is a central issue in Transfer Pricing regulation so much that *María T. Álvarez-Martínez, Salvador Barrios, Diego d'Andria, Maria*

Gesualdo, Gaetan Nicodeme, Jonathan Pycroft in their work of 2018 have demonstrated that the losses incurred in corporate tax revenues by EU countries from profit shifting activities are around 40 billion euros corresponding on 7.7 % of total corporate tax revenues. The same lost has been computed in USA and in Japan respectively about 101 billion and 24 billion euros or 10.7% of total revenues. The loss of corporate tax revenues could be traced back to profit shifting to tax havens through transfer pricing methods. Countries are linked through international trade of intermediate goods; countries are also placing objective to multinationals' investments. As a consequence, multinationals choose target countries with a lower taxation rate system because of the need to maximize profits overall. Doing so, practices of profit shifting may arise especially through the use of transfer prices which can be artificially increased or decreased in order to "*adjust internal costs and shift benefits to tax havens*" (*María T. Álvarez-Martínez, Salvador Barrios, Diego d'Andria, Maria Gesualdo, Gaetan Nicodeme, Jonathan Pycroft, 2018).* Profit shifting could be modelled also as *debt shifting* but for the majority of cases is conducted through the adoption of transfer prices.

The practice of profit shifting is carried out *only by multinational* that, differing to local firms, have the financial and productive capacity to sustain and make new commercial relationships all over the world. The adoption of *Transfer Prices* requires that intermediate goods are supplied by parent firms to local affiliates, placed in different countries relating to material (raw materials, natural resources and specialized workforce) and fiscal advantages. In this sense, MNEs have incentive to increase or decrease prices to minimize overall tax burden.

But is possible to eliminate *profit shifting*? In their work, *María T. Álvarez-Martínez, Salvador Barrios, Diego d'Andria, Maria Gesualdo, Gaetan Nicodeme and Jonathan*

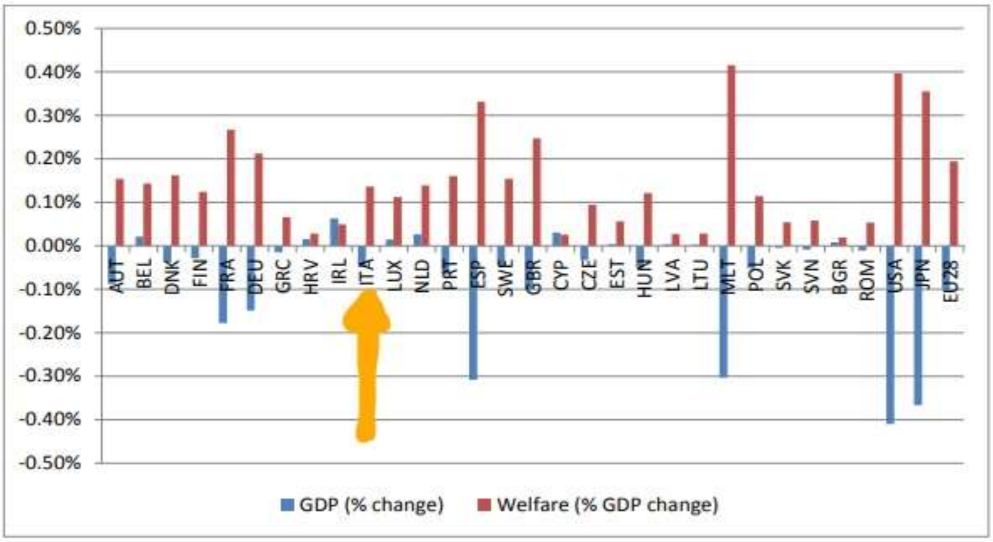
Pycroft presented very interesting simulations at a macroeconomic level on EU 28 countries about

1. the elimination of the access to tax havens
2. the restriction of the profit shifting projects between non-tax havens.

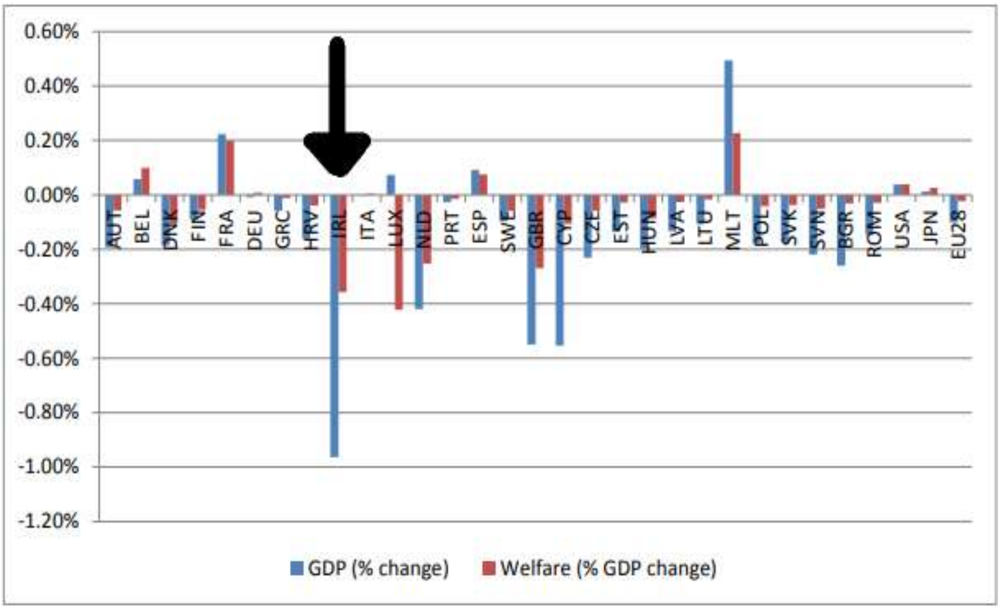
In the first scenario is observed a fall in GDP level caused by the rise of cost of capital for MNEs that discourages investments, that reduces GDP and so welfare increases.

The elimination of *tax havens* channels for MNEs means that the cost of capital rises in residence and source countries, which bring to a decrease of investments both on capital and labor resources. The rise of cost of capital however is different relating to the size of firms analyzed: in fact, for MNEs is higher than for domestic firms. This effect has a consequence on change in production level that sees an increase in domestic production and a decrease of MNEs holdings / headquarters and affiliates production. This leads to a rise of CIT revenues of most countries of EU despite the fall of production: "*this is because the rise of tax bases of domestic firms exceeds the reduction in tax base of MNEs*". In addition, the taxation system adopted by European countries especially by Italy allows firms to obtain deductibles on CIT tax base by the use of third capital: as just seen if investments are low, also the deductibles are not justified leading to increase of CIT bases.

Finally, an increase in CIT revenues allows for a reduction of consumption taxes which raise total consumption "*by young and old generations*": this is the main driver of the rise of ***welfare***. The remotion of tax havens on **Italy** in particular explains that the GDP falls about of 0.05% compared to an increase more than 0.12% of welfare; the production of domestic firms rises of 0.45% compared to a reduction of 0.20% of MNEs affiliates: this because of the particular environment of Italian businesses composed by PMI and familiar conducted firms (results showed in the figure below).



In the second scenario, "*the restriction of profit shifting practices between non-tax haven countries reduces production by MNEs affiliates in all countries of EU 28*" and as a result the production shifts to domestic firms: in this case is interesting to report Ireland results because of the presence of MNEs European headquarters like Apple, Google, Facebook and Pfizer due to the lowest CIT tax rate of EU, 12.5% compared to 24% Italian IRES and 28% or 31% French CIT depending on the size of income (data have been traced on https://taxsummaries.pwc.com/france/corporate/taxes-on-corporate-income).



In the simulation the changes on welfare and GDP move on the same direction as well as the impacts of changes on production and deductibles: this is due to the elimination of incentives to *receive inward profit shifting* characterized by paying intermediate inputs at a lower price than arm's length price and taxing incomes at a more profitable tax rate (especially in Ireland).

As a consequence, if in one hand intermediate goods are payed at full cost, in the other hand the cost of capital is raised leading to the fall of production of MNEs subsidiaries. Thus, GDP and welfare decrease. The authors estimated that the magnitude of effects of the elimination of profit shifting between non-tax havens countries (second scenario) are smaller than those produced by the elimination of tax havens (first scenario).

Tax reforms have brought a reduction in corporate tax rates all over the world but differences in international tax jurisdictions are an "*enduring feature of the global fiscal environment*" (Swenson, 2001). If firms use transfer pricing manipulation to shift income from high tax rate countries to low tax rate countries, reported customs values should rise and fall with changes in tax incentives. Income shifting and base erosion could be attained through customization of values of transfer prices, income reported in balance sheets and manipulation of debt planning in order to take advantage of different local taxation systems.

The "*direction of the manipulation depends on the tax system governing the multinational*" (Swenson, 2001), on the tax rates applied in residence and source country hosting affiliates and on the relevant product tariffs. Deciding the transfer pricing level to apply in a certain transaction, MNEs have to take in consideration economic effects and issues of taxes on tariffs. In fact, a simple rule to keep in mind is that *the tax cost of imported goods is not to exceed their customs value* (Internal Revenue Code Section 1059A). For example, an Italian affiliate can transfer taxable income from Italy to another country where the parent is located and in so doing, it manipulates transfer prices elevating them. Considering that if the Italian tax rate is higher than the tax rate applied in parent country, MNE group sees its tax burden reduced because of the more advantageous taxation system governing parent country where overall income is taxed. If transfer prices are overstated, the affiliate may incur in exceptional income shifting costs or penalties and may be afraid to be detected; as a result, the strategy of transfer pricing manipulation may not be so effective as desired by the firm. The incentives to develop a transfer pricing manipulation strategy could be sustain also in the opposite case, in which the headquarters of the MNE group are located in high tax rate country and through the decrease of transfer prices, income are shifted to abroad resulting on a decrease of worldwide tax payments.

As said before, profit shifting relates also to the misalignment between profits and the location of real activities take place. Cobham and Jansky in 2017 published an article to show this misalignment and highlight some discrepancies within allocation of total profits for US multinationals, and the benefit of a small number of tax havens jurisdictions. This issue is a first-order importance in terms of the world economy: just think that this misalignment in USA counts for USD 660 billion that represent more or less a quarter of overall US MNEs gross profits and about 1% of global GDP. It definitely is a very serious problem for tax authorities and the identification of the most important and used profit shifting channels could be helpful to determine some strategies to solve the current debate about the base erosion worldwide.

Base erosion and Profit Shifting could be also achieved by debt planning. In fact, debt plays a primary role in tax planning strategies of MNEs because of the possibility of deducting interests on financial transactions as intragroup loans. For this reason, the choice of the location of debt is one of the most important way that the holding firm has to decide to reduce overall tax burden. The so-called ***debt shifting*** among MNE groups implies that debt is located in higher tax countries as interest payments are deducted at higher rates. Besides the fact that debt manipulation has fiscal consequences, it has also economic implications because MNEs could decrease the marginal cost of debt "*leading to a potential increase on overall leverage*" (Sorbe, Johansson, Skeie, 2016).

The idea developed by the authors just mentioned is the identification of the debt manipulation opportunities through the comparation of the leverage levels of the entities involved relating to size, industry and country of reference, reducing also the effective cost of debt for MNEs groups thanks to the deductibility of interest payments. The results obtained in the article published by Sorbe, Johansson, Skeie support their hypothesis that MNEs groups tend to locate debt in higher-tax countries: the manipulation of debt location accounts for at least 20% of profit shifting, but this percentage could be higher if the analysis takes in consideration also internal debt and the effects of hybrid debt instruments (Møen et al., 2011; Buettner et al., 2012). Higher leverage is associated to a higher debt bias in respect to equity financing instruments, but taxation is not the predominant factor over the determination of firm leverage.

A sort of attractive solutions to limit or reduce transfer pricing avoidance and base erosion is given in the Chapter 4 going deeply in particular to the rules adopted by governments regarding the manipulation of debt location and the deductibility of interest payments.

CHAPTER 2

2.1 EVIDENCES OF TRANSFER PRICING MANIPULATION STRATEGIES

As seen in chapter 1, the Transfer Pricing could be used to avoid taxation system, reducing tax burden of MNEs group and shifting profits from high tax countries to low tax countries. Transfer pricing is used by virtually every multinational corporation to shift profits at will around the globe (Baker, 2005).

In recent history, numerous enterprises have been accused and prosecuted for the misuse of Transfer Pricing schemes all over the world and in all sectors. From production and manufacturing companies to service delivering, the list comprises very large enterprises sometimes knew and with which people deal with, indirectly, through the daily use of their products or services.

Transfer Pricing issues and tax base flight pose challenges to most nations, irrespective of their stages of development: both developing and developed economies have to face negative effects as a consequence of globalization. In fact, the free flow of the information is the reason of the proliferation of tax havens. Tax havens are the price of the globalization (Ganapati Bhat, 2009).
The issue of International Transfer Pricing is closely related to tax havens: in fact, MNEs have incentive to manipulate Transfer Prices if both residence country and host country are similar tax structures. Thus, a tax competition among countries started to attract MNEs investments in the form of Foreign Direct Investments. This competition is harmful to public finance and local communities (Killian, 2006).

In this chapter, the objective is to provide some real-world cases of companies that have evaded taxation system through Transfer Pricing policies. The Transfer Pricing policies may affect competitiveness, performance, branch manager's evaluation and allocation of firm resources. The companies suggested are from three different sectors in order to sustain the argument for which Transfer Price Manipulation (TPM) has many similar intrinsic characteristics regardless of the nature of transactions occurred. What are the major structures that facilitate anti – social tax behaviors of MNEs? Is tax avoidance the primary purpose for MNEs in the execution of Transfer Pricing policies? How is the role of Transfer Pricing influenced by internal and external factors?

The method adopted to report the suggested situations is the analysis of official sources as parliamentary investigate reports, newspapers and reports from professional bodies through which practitioners and experts of international fiscal affairs denounce the improper use of Transfer Pricing through particular agreements and illicit schemes within tax haven countries. It must be noted that the collection of interesting sources to use it was extremely difficult because of the secrecy of these practices. Negative events as tax avoidance is a very bad publicity for MNEs: this could lead an important reduction of revenues all over the world and as a consequence a reduction of market share.

Tax evasion and tax avoidance are considered the most serious threats for the integrity of the taxation system of a country (Otusanya, 2009) but they have not to be confused by each other. The focus of this chapter is the tax avoidance, so the use of non – criminal methods to minimize taxes. For this reason, tax avoidance is more lawful than tax evasion. Non – criminal methods could be taking advantage of the complexity of tax laws that give space to creative interpretations by MNEs;

Using tax havens fiscal incentives; determining highly artificial tax planning with the aim of avoiding taxes. The difference between the two practices are divided by a thin line: in this sense an adequate interpretation by all parties involved is required to set a cohesive front and mode of action.

In all cases reported, the common element is that this companies use Transfer Pricing to shift profits from residence country to tax havens in order to minimize tax costs. Secrecy, low regulation and confidentiality are key vehicles for the movement of hot money (Otusanya, 2009). Most of the profits shifted from EU countries remain within EU borders but they are accounted in books of countries as Ireland, Netherlands, Malta, Cyprus and Luxembourg exploiting ambiguities between local taxation systems. The choice to locate a subsidiary in a determined tax haven is one of the most important components of the decision about the Transfer Pricing method to apply on transactions: empirical evidences and computations have been provided by authors as Zeki Dogan in 2013 and Kimberly A. Clausing in 2001. In their works, Transfer Pricing strategies are influenced by tax motivations to minimize tax bill: for example if the country where a subsidiary is located provide lower tax rates, most of the time the firms exhibit lower export prices and higher import prices in order to generate more costs on residence country and vice versa more income on tax haven.

Tax havens and offshore financial centers have contributed to the mobility of capital. This fact is deeply analyzed in literature: authors as Sikka (2005), Picciotto 2007 and US Government Accountability Office claimed that tax havens are the *engine* of the tax avoidance. Christian Aid (2005) estimated that at least $ 100 – 150 billion had been lost annually as a result of such practices; Oxfam (2000) estimated that the contribution of tax revenue losses by tax havens for developing countries is about $ 50 billion annually.

In a 2005 Ernst & Young report, it has been reported that MNEs adopt "creative and practical solutions for Transfer Pricing needs". In addition, for the US Inland Revenue Service (IRS) the Transfer Pricing is "one of the most significant challenges" faced by tax authorities.

The dissemination of local subsidiaries in European and not European tax havens constitutes a key element to analyze the scenario in which MNEs operate. As already said in Chapter 1, the globalization has brought a more intensive competition between countries to attract foreign investments. The emergence of global production through the establishment of local subsidiaries give to MNEs more flexibility to determine Transfer Pricing strategies for tax avoidance and tax evasion purposes.

2.2 THE CRITERIA OF THE CHOICE OF THE COMPANIES PRESENTED

I selected the companies presented below on the base of the analysis of Transfer Pricing issues in recent history of the top 200 companies of the world, listed in ***Forbes*** website, regardless of the sector in which they operate.

It has been characterized by the following phases:

1) Initially, searching on Google News about the existence of articles or news about potential tax avoidance cases through Transfer Pricing Manipulation;
2) Secondly, it has been conducted an analysis of the Financial Statements of the last decade, looking to discover some possible correlations between budget items and tax payments in order to give a more practical view about the problem;

3) Finally, it will be evaluated the need to adopt more compliant Transfer Pricing methods regarding on the nature of transactions between companies involved going to suggest some improvements.

2.3 REAL WORLD DISPUTES ABOUT TPM

The companies analyzed in this work are:

- ***Starbucks Corporation***, an American multinational chain of coffeehouses;
- ***IKEA***, the Swedish provider of furniture and household utility products;
- ***MEDTRONIC Inc.***, a U.S. company engaged in R&D, design, manufacturing and sales of cardiac and neurologic medical devices.

2.4 STARBUCKS' CASE STUDY

Starbucks Corporation is the leading roaster, marketer and retailer of specialty coffee in the world operating in more than 75 countries.

In 2012 Reuters reported that Starbucks Coffee Company Limited, the UK subsidiary of the Multinational group based on Seattle (USA), assured to investors about the profitability of the company even if the business was going through a period of 16 years of losses.

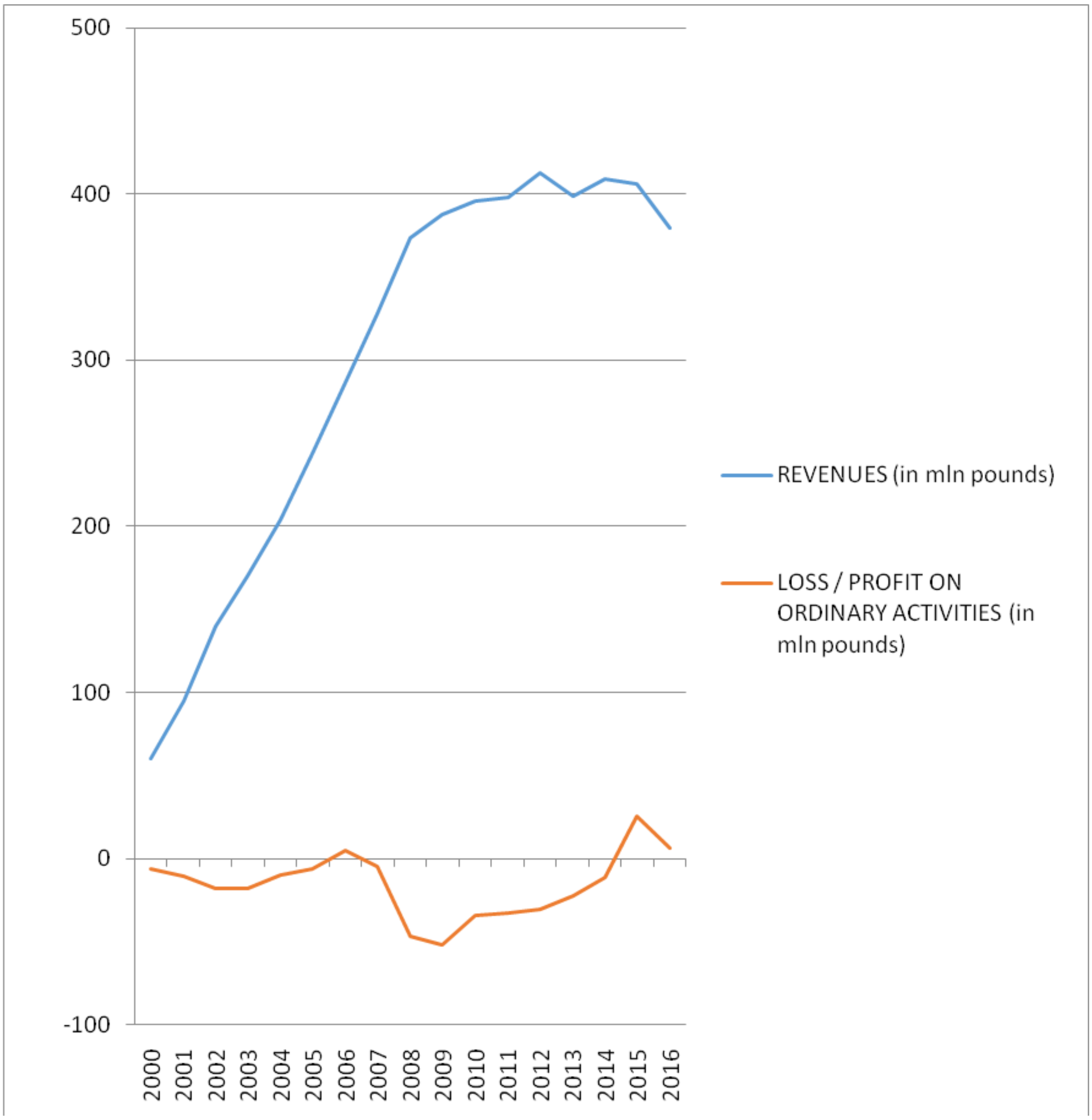
In fact, since UK opening in 1998, the subsidiary has racked up over 3 billion pounds in coffee sales; despite this enormous amount of revenues, the company paid about 8.1 million pounds: the proportion of revenues and taxes on corporate profits paid is contradictory, suggesting to tax authorities deeper controls and analysis. The Starbucks group organized a classic system of intra group earnings stripping transactions to reduce UK subsidiary taxable income and minimize overall tax bill.

In this thesis I have conducted an analysis of the financial statements of Starbucks UK of the period from 2000 to 2016. These documents are available online; further information is disclosed on UK government website (https://find-and-update.company-information.service.gov.uk/company/02959325/filing-history) according to transparency rules in order to provide more information to stakeholders.

Last 16 years financial statements have been downloaded: the focus of the analysis was about the correlation between revenues registered and tax payments over the period in order to find which expenses item has influenced more on the generation of profits.

In the figure below, they are reported the annual final loss or profit generated by Starbucks UK , the corporate tax rate applied, the effective amount of tax payments and the Royalties payments each year.

As the figure shows, only three years over 16 have been profitable for the company: 2006, 2015 and 2016.



The total tax bill has been computed as the summation of year corporate tax rate multiplied by the corresponding reference year profit. As a result, only 8.04 mln pounds have been paid over 16 years period showed in the following table.

YEAR	REVENUES (in mln pounds)	LOSS ON ORDINARY ACTIVITIES BEFORE TAXATION (in mln pounds)	TAX CHARGE / CREDIT ON LOSS ON ORDINARY ACTIVITIES (in mln pounds)	LOSS / PROFIT ON ORDINARY ACTIVITIES (in mln pounds)	CORPORATE TAX RATE applied in that period	EFFECTIVE TAX PAYMENTS (in mln pounds)
2000	60	-5,872		-5,872		
2001	95	-10,332		-10,332		
2002	140	-18,141		-18,141		
2003	170	-17,860		-17,860		
2004	204	-12,187	2,416	-9,771		
2005	244	-8,105	1,688	-6,417		
2006	287	-6,543	11,295	4,752	30,00%	1,426
2007	328	-1,399	-3,548	-4,947		
2008	374	-26,343	-20,627	-46,970		
2009	388	-52,221	0,114	-52,107		
2010	396	-34,236		-34,236		
2011	398	-32,853		-32,853		
2012	413	-30,403		-30,403		
2013	399	-20,465	-2,250	-22,715		
2014	409	1,056	-12,004	-10,948		
2015	406	34,216	-8,443	25,773	20,50%	5,283
2016	380	13,382	-6,718	6,664	20,00%	1,333
					TOTAL TAX BILL	8,042

Despite an increase of revenues showed above, Starbucks UK registered consistent annual losses: these losses have been originated by a surplus of costs derived by a string of payments to other group companies for purchase of coffee beans, for royalty payments and for interest charges in intra-group loans. In particular, the losses come after paying out relevant amounts of *administrative expenses* which include royalties on intellectual property such as brands and business processes to other Starbucks group entities located in Netherlands and in Switzerland, two tax havens where earnings from royalties are taxed at very low rate or not taxed at all. In the ***Reuters*** special report "*How Starbucks avoids UK taxes*" the destination of royalties payments was Amsterdam-based Starbucks Coffee EMEA BV described as the European headquarters although the firm president was based in London.

The application of the Arm's Length Principle on royalties is very difficult because of the lack of comparable products or services involved in a comparable uncontrolled transaction. Royalties evaluation is more subjective, and it is not dependent on market valuations. Stakeholders have to know if the payment of royalties are fair and compliant with the Arm's Length Principle or if the company pays too much for value generated.

A possible solution to prove the fairness of the payment is to determine if the royalty paid is a key component of the company profitability considering the profit generated, revenues, costs of sales another expense and other not financial indicators such as number of employees.

According to Kleinbard, "Starbucks had significant losses in some jurisdictions and higher profits in others". It is a stateless income tax planner meaning that this company generates income through internal tax planning, first of all through the generation of income from the host country and then transferring it to tax havens. *Stateless income is income derived for tax purposes by a multinational group from business activities in a country other than the domicile of the group's ultimate parent company; this income is subject to tax only in a jurisdiction that is neither the source of activities generating income, nor the residence of the holding* (Kleinbard, 2013). In substance, income is taxed in an intermediate country, deliberately chosen to minimize tax bill through intra company transactions.

Starbucks financial flows are characterized by three intra company transactions: the purchase of coffee beans, the intercompany loan and the payment of royalties. In order to analyze the consistency of these transactions to the Arm's Length Principle is necessary to focus separately on these sides, analyzing the comparability between comparable uncontrolled transactions. This phase is extremely important to support Transfer Pricing process and to provide to tax authorities reliability and appropriate information.

The most difficult test to run for Starbucks is the evaluation of the comparability between uncontrolled transactions and controlled transactions. In fact, the difference between this company and the other international coffeehouses is about the differentiation of business strategy: Starbucks organized two types of intra-company transactions, consisting on the purchase of coffee bean through the Switzerland subsidiary and then the shipping to the roasting facilities all over the world. As a result, this differentiation consists on a generation of a markup of 20% on original cost. Coffee beans do not remain on Switzerland places yet a markup is however applied. This markup has a significant impact on UK subsidiary's cost and on accounted net profits. In addition, the corporate tax rate in the two countries is very different leading to an increase of the incentive to buy coffee bean from Switzerland rather than directly from the supplier. Of course, the UK and the Switzerland subsidiaries have signed some special agreements in order to set specific conditions through the establishment of hybrid mismatch arrangements.
The role of Starbucks Switzerland as distributor of coffee beans to all subsidiaries in the world may suggest to investigate the Transfer Pricing method adopted. In fact, as already saw in the previous chapter, the *cost plus method* requires the creation of additional value and it requires the fulfillment of specific conditions as the trade of tangible goods and the existence of a joint facility agreement; in substance, the right role of the cost plus method is for manufacturing facilities. As a result, in this case cost plus method is not appropriate but a valid alternative may be the *resale price method* (Sari, Hunar, 2015).

Thanks to this instruments MNEs have the possibility to achieve unintended double non taxation or long-term tax deferral for example creating deductions or misusing tax credit. In addition, Starbucks has been benefitted from a particular tax ruling with Netherlands governments: tax rates on royalties were lowered

harming on competition, efficiency and transparency (Sari, Hunar, 2015).
Tax ruling may result from a race to the bottom on tax rates: countries compete to provide certain tax breaks in tax policies in order to attract foreign investments and sustain localities through tax revenues.
As a result, Starbucks have chosen to locate their EMEA subsidiary in Netherlands while most of activities and most of the sales derived by UK. As said in chapter 1, the transparency between countries is fundamental to contrast international Base Erosion and Profit Shifting.

Special tax ruling could result on generation of double non taxation especially for the taxation of intangibles property. UK domestic law requires payments on patent, copyright and on royalties arise from UK activities. Since the adoption of Advanced Pricing Agreement (APA) between countries, in this case between UK and Netherland, the payment on Royalty is zero. In addition, for the effect of special tax ruling between Starbucks and Dutch government, the tax revenues on intangibles property is highly reduced (Bergin, 2012).

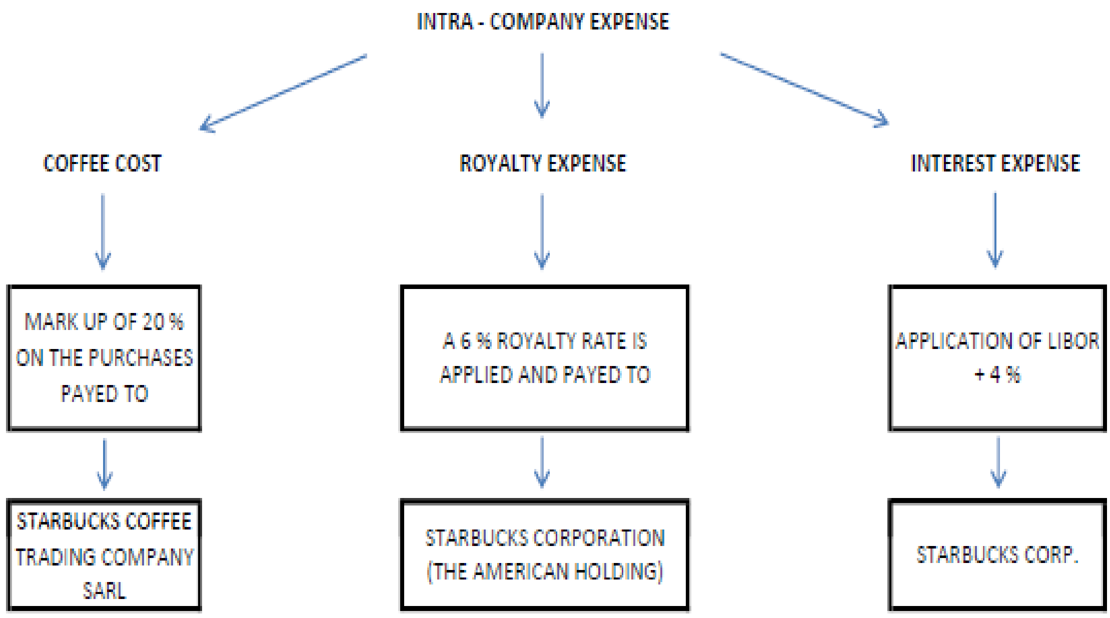
These APA arrangements are recommended in certain cases between tax payers and tax authorities, but the use of this instrument has to be weighted; both parties have to consider that the effects of this arrangements are not only attributable and applicable to them, but also to all tax authorities involved with that tax payer harming competition and economic efficiency.
Moreover, most of the problems come from the intra – company loans and from the payment of interests. Tax avoidance through interest expenses and deductions is very frequent including guarantees, internal derivatives and other insurance arrangements.

Starbucks UK registered 15 years of losses and it has been financed through intra company loans in order to remain profitable. The losses were carried forward during the years: losses have been covered when it was possible with shareholders equity fund raises financed by the holding company. The payment of too high interest expenses could be seen as a tax avoidance instruments and Starbucks was suspected for this. According to EU Commission, the charge of interest expenses was around at LIBOR + 4%, while KFC and McDonald's (the Starbucks' comparable two of the three biggest restaurant multinationals) applied respectively LIBOR + 2% and a percentage less the LIBOR rate (Sari, Hunar, 2015).

In summary, Starbucks UK used three intercompany transactions to minimize its tax burden. First of all, it moves profits from UK to Switzerland, where there is a more favorable corporate tax rate around 12%, through purchases of prime material; then a cost plus method is applied when coffee bean is sold to Netherlands. The mark up applied is around 20%: doing so profits generated by UK subsidiary are taxed at a lower tax rate passing through the intermediation of a controlled affiliate (Kleinbard, 2013).

Secondly, the charge for royalty payment is one of the highest applied in comparison with other competitors as Mc Donald's and KFC. Starbucks Corp. (US holding) applied a royalty of 6% on its sales for each subsidiary: this percentage is split between Netherlands headquarters and US holding. As a remind, in Netherlands there is a special agreement giving Starbucks a very low tax rate. Starbucks claimed that this percentage was an arm's length rate arguing that the same rate was applied in the majority of the cases around the world. Without exhaustive documentation is difficult to evaluate the goodness of the result provided (Kleinbard, 2013).

At last, the intra company loans played a very important role on the sustainability of Starbucks UK losses. The interest rate applied was LIBOR + 4%, the highest rate applied comparing the competitors suggested above. Interests payments are deductible: higher interests charged, higher deductions, lower tax bills (Sari, Hunar, 2015).



The financial flows of Starbucks group

The major problems in this case were:

- The establishment of *special purpose entities* as Switzerland affiliate and Netherland EMEA headquarters. Most of the transactions are made between these affiliates; as a result, they may consist a sort of vehicle to minimize tax bill both legally or illegally (Sari, Hunar, 2015). OECD in this case should enforce existing rules and develop new on Controlled Foreign Company normative (CFC) in order to limit the proliferation of this special purpose entities;

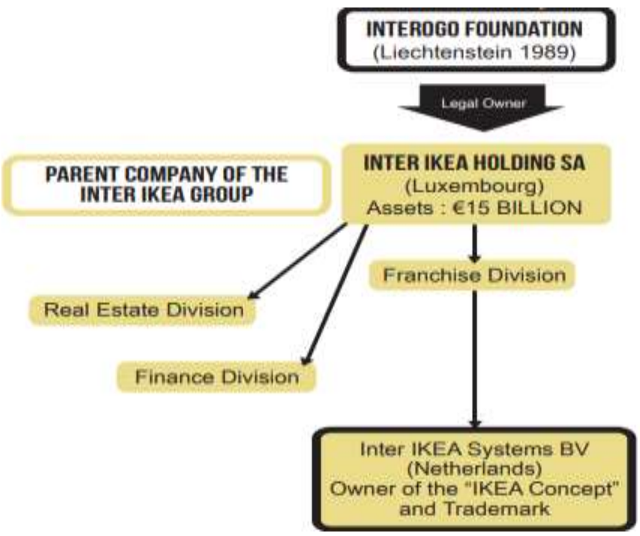
- The documentation provided by Starbucks about Transfer Pricing methods applied were inconsistent: in this case supporting evidence is required to document the steps of comparability analysis and data used especially in intangible assets transactions. In addition, analyzing the Financial Statements disclosed by Starbucks UK, it is important to notice that the company has taken advantage of the exemption granted by the Financial Reporting Standard 8 to not disclose related party transactions within Starbucks group.

2.5 IKEA'S CASE STUDY

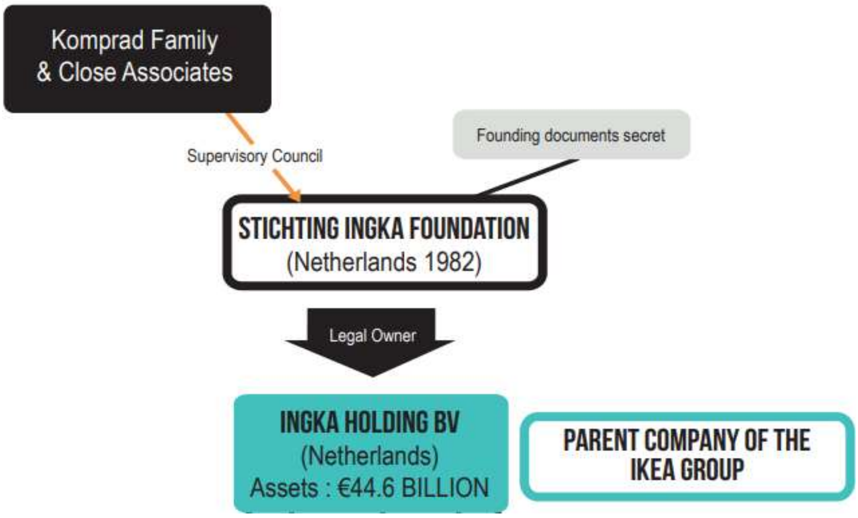
IKEA is the largest provider of low-cost home furnitures of the world. In 2016 IKEA owned more than 300 stores worldwide (about 20 only in Italy) and four subsidiaries in tax havens located in Netherlands, Liechtenstein, Belgium and Luxembourg. Moreover, IKEA has agreed a special arrangement (tax ruling) with Luxembourg in order to reduce taxes (Sava, Tureatca, 2017). Also, according to David A. Osborne, IKEA is not organized as a corporation, but rather as a Dutch charitable nonprofit organization (Osborne, 2011). In fact, this corporate form allows to IKEA group to keep much of what it earns in a tax-exempt entity or in subsidiaries located in tax havens cited above. IKEA uses a carefully planned corporate structure to reduce its tax burden (Osborne, 2011).

The process of relocation and restructuration of IKEA started in 1982 with the split into two legally different corporate groups:

1) The INTER IKEA Group located in Luxembourg, owned by INTEROGO Foundation formed in Liechtenstein; this group is the head of the retail system and the owner of the trademark;



2) The IKEA group under a Dutch parent company named INGKA and under the ownership of the STICHTING INGKA FOUNDATION; this group owns factories and logistic channels.



The two corporate groups play complementary roles but as reported in the Rapport Taask Avoyd "IKEA FLAT PACK TAX AVOIDANCE" report, there seems to be any rationale to divide the group. This fact may help facilitate large scale profit shifting (Auerbach, 2016).

In particular, the Dutch Foundation, represented above, is not primarily a charitable foundation: Euro 104 million of charitable contributions disclosed in 2014 were modest compared to revenues and assets managed, respectively about Euro 3.5 billion and 44 billion.

Thus, each of 300 stores around the world have to pays 3% of its sales to *Inter IKEA Group*, as a royalty, totally about 3.1 billion euros. As a result, part of these royalties, around 600 million euros, are moved through other companies administered by a trust located in tax haven (Sava, Tureatca, 2017). The Netherlands is popular for *royalty – conduit companies* because of the opportunity

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to benefit from the combined effects of Dutch tax system which allow to companies to minimize tax treatment. In fact, there is no levy a source country base taxation on royalties and for the effect of not taxation on tax havens, these amounts are not taxed at all, incurring in a double not - taxation.

As said before, a special tax ruling was signed between IKEA and Luxembourg and the corporate tax rate applied was only 0,06% of taxable income. In addition, in Liechtenstein dividends received from foreign subsidiaries are not taxed; rather these flows enter into the accounts of foundations mentioned on previous paragraph.

Greater transparency is needed from large multinationals operating in Europe. A "country – by - country reporting" suggested in "IKEA FLAT PACK TAX AVOIDANCE" in addition to a reform of corporate tax system are key proposals to reach tax cooperation and harmonization instead of an harmful tax competition (Auerbach, 2016).

As just seen, in IKEA case the internal transfer involves intangible property. In order to limit the tax avoidance, the Treasury Department has provided some methods to choose from and requires the use of tests to provide the most reliable measures complaint with the Arm's Length Principle. The main methods mentioned are:

1. The comparable uncontrolled price method (CUP) in order to compare the price charged between a controlled and an uncontrolled transaction;

2. The profit split method in order to determine the Arm's Length allocations of profit between units involved in value generation depending on the contribution of each unit;

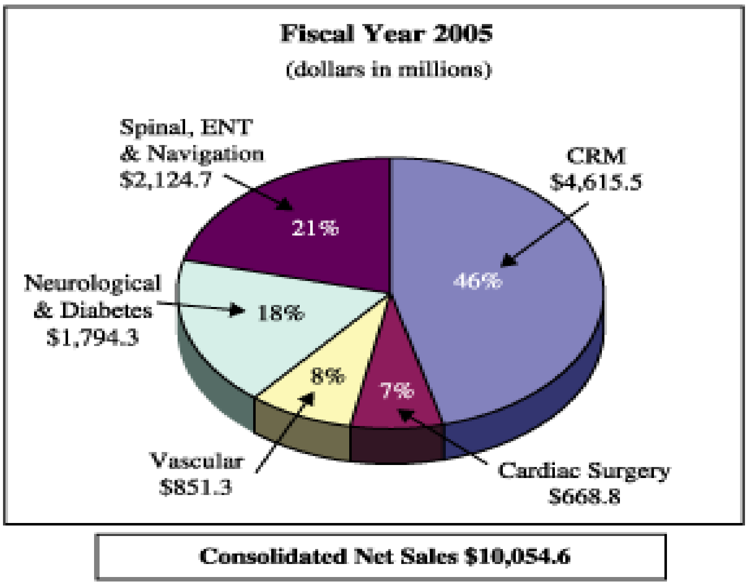
- The resale price method in order to evaluate the Arm's Length transactions based on profitability objectives.

Even though the suggestions of Treasury Department and the OECD, it is very difficult to say what is the correct valuation to use both in cases of tangible and intangible assets transactions.

2.6 MEDTRONIC's CASE STUDY

MEDTRONIC Plc is a U.S. medical technology company based in Ireland, engaged in the development, manufacturing, distribution and sale of devices and services used in medical therapies. It covers the 129th position on Forbes – Global 2000 report of the first 2000 firms more capitalized in the world.

It operates through the following divisions, each of them extremely focused on their core business and sub - categorized in different sectors:



- Cardiac Rhythm Management comprising cardiac rhythm, coronary and aortic structure division; this function counts for about 46 % of 2005 consolidated net sales (SEC report);
- Spinal, Ear, Nose and Throat (ENT) and Navigation which comprises spinal products division; this function counts for 21 %;
- Vascular Group which comprises minimally invasive products and therapies to treat coronary artery disease; this function counts for 8 %;
- Neurological and Diabetes Group which focused on the development of specialized products and services for all diabetes cases; this function counts for 18 %;
- Cardiac Surgery includes heart valve repair and blood management; this function counts for 7 %.

Medtronic Group was disputed by the *Internal Revenue Service* (IRS) about the compliance of royalty payments with the Arm's Length Principle within the group. The amount of adjustments required by the IRS to Medtronics Inc. was about $ 1.4 billion of tax deficiency resulted on intellectual property transactions.
The largest manufacturing facility is based in Puerto Rico. Medtronic Puerto Rico is responsible for the final step manufacturing and the sale of devices and leads. It licenses from Medtronic US (the parent company) the intangible properties required for the manufacture and sale of medical devices. The IRS estimated that received royalties accounted for 29% and 15% respectively on intercompany sales of devices and on leads.

The key dispute with the *IRS* was whether Medtronic Puerto Rico made payments to Medtronic holding compliant with the Arm's Length Principle for the intangible properties used in the manufacturing and marketing process; also, in this issue it has been evaluated the fairness of the amounts of royalties paid and the fact that these amounts were artificially low in order to avoid U.S. corporate income taxes. In particular the major problem was the choice of the most appropriate method used to account the royalty payments made by Medtronic Puerto Rico affiliate, that are related to "high – profit" intangibles for which there are not comparable transactions for such transfers.

The commissioner characterizes this dispute as involving "the classic case of U.S. multinational taxpayer shifting income from its highly profitable residence country operations to an offshore subsidiary operating in a tax haven, by charging an artificially low rate for the intangible properties" (U.S. Court of Appeals, 2018).
For transactions with the object the transfer of patents and trade secrets, the most relevant alternative methods are the Comparable Uncontrolled Price (CUP) and the Transactional Net Margin method (both analyzed in Chapter 1).
During the 2002, Medtronic US and the IRS signed an agreement determining that the best method to apply was the Comparable Uncontrolled Price (CUP method) "as long as there were no significant changes in any underlying facts" (Memorandum of Understanding, 2002). None of the two parties involved considered this agreement an Arm's Length price, but they were agree to resolve the audit with a compromise. The intangible properties are comparable if they have been created under similar circumstances, used as vehicles for value creation in connection of similar products or services within the same industry and have similar profit potential.
In fact, in 2005 and 2006 the IRS contested the method adopted since the agreement and after completing an audit IRS concluded that the royalty rate payed by Puerto Rico subsidiary was too low. In addition, IRS suggested the Transactional Net Margin method that is more reliable to support the Arm's Length nature of

intercompany licensing transactions. In fact, this method is based on objective measures of profitability named *profit level indicators* such as Return on Assets (ROA); moreover, this method monitors the profits associated to functions, risks and assets of the related parties involved in the transaction with comparable circumstances of transactions made between unrelated parties in order to determine the right allocation of value created by affiliates.

In order to determine the best method, tax court applied the Pacesetter agreement as the best Transfer Pricing method to evaluate the Arm's Length price for intangible property transactions. The Pacesetter agreement was negotiated in 1992 between Medtronic US and Siemens Pacesetter Inc. with the purpose of the resolution of a patent litigation related to the use of patents of cardiac devices. This agreement contained a lump sum payment of $ 75 million and a 7 % royalty rate for all future sales of cardiac devices covered under Medtronic's patents. However, the IRS contested the method adopted as benchmark because this type of agreement has been negotiated to resolve a litigation that is an extraordinary event outside that ordinary course of business (US court of appeals, 2018). Moreover, in 1990s Medtronic was the leader within medical devices market. Also, Jeff Goodman in his work titled "Economic analysis of Intercompany transactions between Medtronic Inc and Medtronic Puerto Rico" *concluded that the method adopted was not reliable to this situation and the comparability was not fully reached*.

As a result, the IRS conducted a functional and comparability analysis on Medtronic group transactions. In order to find the appropriate Transfer Pricing method to adopt, in the original analysis 14 comparable companies have been analyzed: these companies were diversified manufacturers in the medical devices

industry comprising diagnostic products, medical supplies, surgical devices.
A relevant factor is that all of these companies sustain a risk level similar to that supported by Medtronic in terms of operating risks encountered during a surgical intervention. Then, the application of the Transactional Net Margin method requires the computation of the Return on Operating Assets (Operating Profits / Operating Assets) of each 14 companies in order to estimate an Arm's Length range of results. The product and functions comparability are less important within the application of Transactional Net Margin method than cost method like Comparable Uncontrolled Price. For this reason, operating profit is less sensitive than gross profit because of the reflection of functions in operating expenses. (Medtronic vs. Commissioner, 2017). Hence, the median of this range is applied on Medtronic's Puerto Rico assets book value and compared with the result of the unrelated parties. The construction of a range of Arm's Length values rather than relying on a single comparable is consistent with the purpose of the analysis conducted: in fact, *using this range smooths out differences between companies for example company size* (Medtronic vs. Commissioner, 2017).

Due to the difficulty of find Heimert Analysis on Transactional Net Margin Method (Heimert is the IRS Transfer Pricing expert who conducted the analysis explained above), here there is a reconstruction of this analysis conducted on 10 potential Medtronic competitors rather than 14 companies.

Following the Heimert's analysis steps, the process included:

- Find 10 competitors focused on assets utilized, product liability and other commercial risks incurred: the companies analyzed are Abbott Laboratories, Stryker, Boston Scientific, Dexcom Inc., Baxter, Johnson &

Johnson, Becton Dickinson, Zimmer Biomet Holding, Diasorin Spa and Wright Medical.

- For each company, ROA was calculated by dividing Operating Profits by Operating Assets (as the sum of Cash, Inventories, Trade Receivables, Fixed Assets, Intangible Assets and Prepaid Expenses) for years 2005 and 2006 (*AnnualReports.com*); the ROA has been chosen as the profit indicator to use in the computation of Transactional Net Margin Method and adopted as bases for a particular transaction; in the original Heimert analysis, intangible assets have not been included in the computation of operating assets, neither for Medtronic Puerto Rico nor for comparable; in this case, intangible assets of all companies have been added because the litigation between IRS and Medtronic Inc. and Puerto Rico affiliate was about *royalty payments* for the use of intangibles as patents and trade secrets;
- Then, these values have been used to construct a statistic table that contains the minimum and the maximum values, the median number, the first and the third quartile and the average between of 2005 and 2006 values. This table focuses on the construction of the Arm's Length *range* used to compute the Transfer Pricing method.

COMPARABLE COMPANIES	Operating Profits 2005	Operating assets 2005	ROA 2005	Operating Profits 2006	Operating assets 2006	ROA 2006
Abbott Laboratories (ABT)	4362	16800	25,96%	2042	17100	11,94%
Stryker (SYK)	950	3830	24,80%	1074	4780	22,47%
Boston Scientific (BSX)	968	3560	27,19%	-2949	6350	-46,44%
Dexcom Inc.	-30	75	-40,00%	-46	80	-57,50%
Baxter (BAX)	956	9800	9,76%	1397	11800	11,84%
Johnson & Johnson	10060	40200	25,02%	11053	35000	31,58%
Becton Dickinson	1031	6120	16,85%	1050	6500	16,15%
Zimmer Biomet Holdings (ZBH)	1055	5313	19,86%	1165	5621	20,73%
Diasorin spa	27	185	14,59%	40	194	20,62%
Wright Medical	33	298	11,07%	19	317	5,99%

Amounts in million $

STATISTICS	2005	2006	Average
Minimum	-40,00%	-57,50%	-48,75%
I quartile	11,95%	7,46%	9,70%
Mediana	18,35%	14,05%	16,20%
III quartile	24,97%	20,70%	22,83%
Maximum	27,19%	31,58%	29,39%

The best range of values of ROA is highlighted by the table above: it should be within the range 9,70 % - 22,83 %. Values of ROA within this inter quartile range suggest that the transactions occurred between subsidiaries of Medtronic group are compliant with the Arm's Length Principle.

The determination of the ROA for Medtronic Puerto Rico was difficult because of the publication of consolidated balance sheets and not singular subsidiary financial report.

Based on information at the beginning of this case, it is possible to make an estimation of Medtronic Puerto Rico profitability. In fact, the plant is the biggest of the entire group; here there are final steps of value chain before selling products on the market. So, it is possible to determine a share like 55 - 60 % of consolidated profits to attribute to Puerto Rico affiliate. In this case, I calculated the values used in the ROA computation starting from Medtronic Inc. balance sheet for 2005 and 2006 applying the percentage suggested above. As a result, the Operating Profits were $ 3,444 billion and $ 3,341 billion respectively for 2005 and 2006. The Operating Assets amounted for $ 14,194 billion for 2005; for 2006 were about $ 18,000 billion. Finally, ROA is 24,27 % for 2005 and 18,56 % for 2006 (*SEC website Medtronic consolidated balance sheets report*). Heimert in his analysis concluded that Medtronic Puerto Rico sustained value – added costs for only 10 - 11 % for the two years period; despite this low percentage, the affiliate operating profits are about 65 % of consolidated operating profits. In the first, the profit level used is just above the maximum value of the range, in the second ROA is within the range. As a result, the construction of the Transactional Net Margin Method based on ROA is significant and compliant to the Arm's Length Principle.

On 2007 the two parties involved agreed to pay a royalty rate of 44 % for devices and 26 % for lead licenses on intercompany transactions: these results are computed keeping in consideration adjustments on know – how, future technology, profitability of devices licenses and market share. After completing the audit the IRS firstly noticed a deficiency on royalty payments of about $ 200 million for 2005 and $760 million for 2006; after a deep evaluation, these amounts have been adjusted in approximately $ 550 million for 2005 and $ 810 million for 2006 for a total of about $ 1,4 billion; as a result, IRS contested to Tax Court this anomaly, proposing an adjustment of Transfer Pricing method. Tax Court firstly rejected the propose of IRS stated that IRS's position was "arbitrary and capricious" (Rita Chung, 2019). As a result, Tax Court decreased the tax deficiency to $ 14 million, a hundred times lower. The IRS appealed to *United States Court of Appeals for the Eighth Circuit* questioning the rational of the decision of Tax Court. A solution for this case has yet to be taken; future considerations are necessary to finish litigation and scrutinize Transfer Pricing more closely.

The adoption of a particular Transfer Pricing method rather than another is a very important decision: certainly, it must be complaint with the Arm's Length principle. Moreover, it has to be reliable, significant, based on appropriate comparability and functionality analysis especially in case of intangible assets transactions between subsidiaries located in different tax systems.

Recent history sees many examples of multinational companies that reduce or avoid tax bill via Transfer Pricing schemes and rigorous tax plannings. Most of the time these companies are unknown to the public because of privacy motivations. The cases described above are the most representative cases of tax avoidance via Transfer Pricing occurred in the last two decades.

2.7 A FOCUS ON TRANSFER PRICES APPLIED ON INTANGIBLE PROPERTY

In the definition of Transfer Pricing guidelines for MNEs, tax authorities incur in a very important issue: how to define common standards on transactions based on Intangible Assets and Intellectual Property?

As said in Chapter 1, in order to reach a full standardization and application of the international guidelines, cooperation and collaboration of all countries involved is necessary. Cooperation that is not only the mere adoption of methods suggested by also this is about a proactive role in the definition of objectives and future challenges. For this reason, also in the case of Intangible Assets is required a deep analysis of what are the major issues and the common practices in order to define similar prospective.

The use of intangibles has been growing for decades in all industry sectors: from 1970s intangibles are fundamental to sustain business, to create more value and to reach competitive advantage (Lagarden, 2014). Moreover, as a result of globalization intangibles are moved within countries from MNEs to take advantage of local resources: this topic has an increasing role in international transactions within affiliates of the same multinational group. As a consequence, the OECD discussed intensively about the question: "Are intangible assets transactions complaint to the arm's length principle?" and recently OECD has developed further guidelines and provided the right direction for companies and state members through the publication of Base Erosion and Profit Shifting Actions Plan, already discussed in the previous chapter.

Before starting an analysis of the most important innovations in tax law developed by the OECD, is interesting to define the categories of transactions based on Intellectual Property within a multinational group. The three groups of transactions are:

- The *acquisition* or *sale* in which the ownership is transferred between two affiliates or between parent company and subsidiary; an Arm's Length price is established based on value estimations or negotiation between parties involved. In this situation is important to evaluate whether single intangible items are part of a bundle or are inseparable from the underlying tangible asset or service; in this category is easy to find intangibles such as patents, trademarks, copyrights, licenses and designs, so all of intangibles for which is possible to register a contractual codification in order to protect them to replication by competitors;
- The *licensing* that involves the use of that intellectual property through the payment of some royalties; also, in this case the evaluation of an Arm's Length price has to consider whether intangibles transferred are *single* or they form a combination of items, both intangible and tangible; in this

category, the intangibles considered are for example brands, designs and trademarks;

- The *R&D cost sharing* consists on a joint development and / or utilization of intangibles: this situation is the most critical one because joint development assumes that parties involved have relevant intellectual properties at the base and that they contribute to the development in more or less equal percentage; for this reason the valuation of the right price has to consider that particular *basic intangibles*. The *pool* of parties involved also contributes to create challenges regarding on the possibility to enter or to exit from this pool of participants: in this case, questions like "is there a fee to enter or exit from this pool? If so, at which price? And finally, who has the ownership of the future intangible?" are relevant within companies and may create conflicts between taxpayers and tax authorities.

Intangibles of this category are less oriented to commercial perspective because of the customization of intangible resource developed by parties; examples could be corporate culture, best practices, training and personnel development (Lagarden, 2014).

All of the intangibles are considered as relevant factors of the *comparability analysis* because of the role and the prime importance in the value creation cycles and business success. Relevant questions about comparability analysis phase could be related to the identification of relevant intangibles for the transaction and about the clarification of the ownership and remuneration of these intangibles. In order to answer to these questions, an *adequacy analysis* is fundamental to determine the most reliable Arm's length valuation: this is a complex process, involving in different phases and considerations not only mere calculations; starting from the definition of the qualitative and quantitative inputs, this analysis

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has the purpose of the selection of methods and the test of the key assumptions checking correctness of the results applied on a specified object of valuation.

Tax authorities tend to focus more on potential ways to resolve international Transfer Pricing disputes and to fill the gap between market parallel comparable for intangibles (Juranek, Schindler, Schjelderup, 2017). There is a need for a flexible and globally harmonized definition of intangibles to promote foreign investments; comparable transactions are rapidly ceasing to exist due to the fact that *digital economy* (and its integration in the value chain propositions) tend to generate quasi – monopolies that prevent all forms of comparability analysis made by both taxpayers and tax authorities. For this reason, the OECD worries about the fostering profit shifting power of intangible assets challenging traditional Transfer Pricing regulation. Practitioners expressed that in the future years Transfer Pricing applied on Intangible Assets "will be higher on the radar of tax authorities than even before" (Markham, 2005).

Intangible assets play an important role on value creation process and on corporate profit generation. The moving nature of these assets give to MNEs the possibility to manipulate prices regardless of the Transfer Pricing method adopted. This fact has consequences also on the choice of the location: as a result, MNEs are more incentive to locate these assets in jurisdictions with preferential tax treatment such as Ireland or other Caribbean tax havens.

When the OECD Guidelines were released in the end of 1990s, the economic environment did not base on intangibles as the actual momentum; a perspective focused more on tangible assets had been adopted. From the early years of the new millennium, new issues emerged. The distinction of the intangible assets into different categories, the attribution of the ownership and the correct and fair valuation of these items still place the attention on future normative updates and new reliable guidances that can be adopted by all states.

CHAPTER 3

3.1 ADVANTAGES AND DISADVANTAGES OF THE ARM'S LENGTH PRINCIPLE

The Transfer Pricing has started to be discussed frequently not long ago. Since some decades, it was a subject reserved for tax administrations and some taxation system experts. However, the payment of taxes on international businesses is a crucial argument for all organizations, from the political sphere to the entire society. Recently, within politicians, NGOs and economic forums has emerged the need to discuss about the importance to set adequate standards and to keep Transfer Pricing regulation n under control. As a result, tax authorities are modernizing their legislation to develop a taxation system coherent with the Transfer Pricing in order to protect the collection of a fair amount of taxes in their jurisdictions. In this context, Transfer Pricing is viewed as a necessary tool to stop MNEs from the voluntary avoidance of taxes through profit shifting practices to low tax jurisdictions.

Two reasons are at the base of the awakening of this sentiment: the first is the globalization and the second is the rise of the size of multinational corporations. As just said in Chapter 1 and to remind about the importance of the argument, about 60 % of international trades are placed within MNEs group between different affiliates located in different countries.

In this first part of the chapter, it will be analyzed advantages and disadvantages of the Arm's Length principle as the key concept of Transfer Pricing regulation.

In the middle part of the chapter, it will be discussing the effectiveness of the principle about the role to reduce international tax avoidance, going deeper on the evaluation of alternatives and the suggestions of experts and tax authorities.

In the final part, it will focus on the prospective about the Transfer Pricing and the future challenges of both taxpayers and tax authorities in response to economic changes.

The application of the Arm's Length principle is not an easy affair for both MNEs and countries. Especially for developing countries tax authorities, there is still an imperfect application of the principle even with the help of the OECD Guidelines discussed in the Chapter 1. Moreover, the administration of the rules and practices are not clearly defined and conducted; as a result, this ambiguity of treatments brings to different interpretations of standards regarding the problem.

As already said, this difficulty on the application of the principle is due to the fact of lack of comparable entities on which is preferable to conduct a *comparability* analysis of the transactions in order to find the most reliable Transfer Pricing method to adopt. Is the Arm's Length principle reflecting the economic reality? What about the comparability analysis for intangible assets? The concept of the comparability is one of the most critical aspect within the application of the principle. Reliable comparable are hard to find in the market: as a consequence, inadequate benchmarks are used to define the Transfer Pricing methods leading to the generation of unrealistic results distorting economic performances of the entities involved.

In this section it will suggest a discussion of the most important advantages and disadvantages of the application of the Arm's Length principle through the provision of comments of international tax experts perspectives.

3.1.1 **Advantages** of the Arm's Length Principle

In the new Transfer Pricing guidance about the Base Erosion and Profit Shifting (BEPS) discussed in the Chapter 1, the OECD organization believes that the Arm's Length Principle is the best method to counter tax avoidance especially for intangible assets transactions. In the following lines there are interpretations and comments about the adoption of the Principle in international transactions.

Nigel Dolman is a director on Baker Mckenzie, one of the largest law firm in the world. He reports that the application of the Arm's Length principle is *likely to remain*.

From the last decades, the proportion of internal transactions within multinational corporations' groups is increasing each year on global trade base. As a result, companies need to price these transactions in order to report them to financial statements. Pricing such transactions is not an easy process; companies need more consistent, effective and fairest measures to apply on controlled transactions. The rules should be clear and as simple as possible in order to avoid the heavy weight that both taxpayers and tax authorities have to sustain within an international tax litigation. In addition, compliance costs would have reduced for both parties involved: this because litigation and mismatches cannot resolved unilaterally but rather through a coordination between states and a mutual contribution to the allocation of the right amounts of taxes.

However, in recent years there is still observable the transition from tangible assets to intangibles due to the emergence of a digital economy (as said in the focus of chapter 2) that move the attention from real products and services transaction to exchange of invisible and hard – to – value intangibles. Businesses have become more digitized and supply chain processes more global, complex and difficult to manage. As a result, the source of value creation for companies is come from intangible assets such as patents and trademarks in a bigger way than from tangible assets.

This evolution of internal business processes creates problems to apply the Arm's Length principle because of the lack of comparable market prices for intangible assets.

3.1.2 ***Disadvantages*** of the Arm's Length Principle

First of all, it could be appropriate to contextualize the birth of the Arm's Length principle and its adoption in the international trades. This principle has been developed in the 1935: the economic world was totally different from now. Globalization and technological progress had not been kept in consideration and in fact the fundamental key points have been eroded. The source of the value creation moves from tangible assets to intangible assets. As a consequence, this fact leads to potential challenges between national tax authorities and the OECD and the EU about the request of reform. In this sense, it is necessary a re - examination of the fundamentals of the Principle in order to update rules and make them more reliable and secure for both taxpayers and tax authorities in a turbulent economic market. In addition, very high levels of integration within MNEs group make the

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Principle even more difficult to apply because of the impossibility to locate where the value is created, especially in the case of intangible assets.

The EU Commission stated that "**The current tax framework does not fit with modern realities**. *The first focus should be on pushing for a fundamental reform of international tax rules, which would ensure a better link between how value is created and where it is taxed*."

A very interesting perspective has been taken by Jeffrey Owens who is the director of the Tax Centre at the Vienna Institute For International Economic Studies, one of the important institutions for "first hand expertise on Central and East Europe".

He takes a different view saying that "it is important to remember that the Arm's Length Principle was first developed for commercial purposes and not for tax reasons" highlighting the fact that the contextualization of the rules is a serious matter to keep in consideration in the design of international tax system.

Moreover, "the Arm's Length standard is interesting, but it studies only all hypothetical situations and it fails to recognize transactions that occur within a MNEs group that independent parties would never do".

As a result, the Principle may be replaced with a different approach that it is able to recognize multinational profits occurs within the group and not at individual subsidiaries level. Treating affiliates of multinational enterprises as independent companies through the adoption of the *separate entity approach* has resulted in a greater number of avoidance activities due to integration of these companies. This approach might have lost in its relevance and it could have become redundant.

Furthermore, profits are more and more difficult to locate in international context.

The 2020 is the 85th anniversary of the adoption of the Arm's Length principle: it could be a good reason to think about the effectiveness of the principle in the current economic world. Not all international tax professionals celebrate this anniversary: many experts think that the Arm's Length principle "*appears to be in retreat*", "*dead*" or "*simply tracks of a tax system that it will be gone in 10 years*". These critics have been moved by experts for two major reasons:

- As just said during the Chapter 1, the comparability analysis could be difficult to complete due to the lack of reliable comparable especially for hard – to – value and in early – stage development intangibles for which MNEs should account for the potential future profits that may generate once developed and marketed; in this case, potential future profits could be overestimated or underestimated thus it could bring to wrong interpretations and results;
- MNEs have deliberately exploited abusive behaviors and engaged in tax avoidance practices in order to reduce tax bill and to drain the development of a particular host country;
- Transfer Pricing rules are difficult to implement due to the fact that MNEs may involve in such practices within multinational group benefitting from synergies that are not available to unrelated parties such as intercompany loans at subsidized rates or commercial partnerships around the world.

It seems that the arguments against the Arm's Length principle are more than arguments in favor of the application of the Principle. However, the Arm's Length principle still remains the supporting column of the entire international tax machine despite many critics and disapproves by professionals and scholars.

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But why is it still applied and approved by the major countries? Moreover, why is it the predominant principle of the last 85 years? Is it possible that in this period, organizations as OECD, United Nations and International Tax boards did not develop alternatives able to guarantee transparency and fairness within international transactions?

3.2 IS IT RATHER A TAX DESIGN PROBLEM?

In this paragraph it will conduct an analysis about the effectiveness of the Transfer Pricing principle and the appropriateness of national and international rules in order to try to discover some possible discrepancies. One of the main issues faced by tax authorities is that the Principle may give to taxpayers too much possibilities for *interpretation* about comparability and functional analysis and during the search of the most appropriate comparable.

Is this a Transfer Pricing duty or is it the result of a lack on regulations?

The Transfer Pricing is an instrument that was not meant for tax avoidance by MNEs; rather, it was created to sustain international commercial relationships. However, the majority of profits lost by tax authorities is derived by the fraudulent use of the Principle, by a not appropriate and correct interpretation of the rules and by the emergence of tax havens. Moreover, the quality of the statistics conducted by both national and international organizations: according to Sikka and Willmott, "governments are used to consider all of the data about country imports and exports, income, balance of payments and terms of trade"; they do not think about the "*corporate transfer pricing policies*" and the involvement of tax havens (Sikka, Willmott, 2010). Through tax havens, MNEs are able to move transactions without engaging in the production chain, just only shift products or service between countries.

To talk about the effectiveness of the *tax system design* was first Lorraine Eden, economist and management professor at A&M Texas University. She talked about potential issues of the Principle under tax design perspective analyzing criticisms of other important tax exponents. In her article published on the special section *Bloomberg Tax*, she did not blame the Arm's Length principle and rules associated but rather she tries to face and address an underlying problem: abusiveness of Transfer Pricing practices caused by a perverse use of national incentives in order to attract MNEs through the manipulation of transfer prices in order to take advantage of the different tax rates applied in the different tax jurisdictions. "This is not a Transfer Pricing problem, rather it is a international tax system design problem" (Eden, 2019).

A complete elimination of the Arm's Length principle is misplaced and misleading: on one hand it is true that the international tax system has important incongruencies and normative holes, providing a fertile soil to MNEs to incur in transfer pricing arbitrage practices; on the other international rules have become more complex and difficult to interpret for MNEs. For these reasons it is necessary to keep valid the Arm's Length principle: the principle statement has been well defined, and its purposes are clear. Without concrete alternatives it is quite impossible to leave MNEs and countries to manage international transactions: it risks incurring on more confusion and on more litigations.
As a consequence, it is more reliable to modify the principles of international efficiency "eliminating loopholes that create the incentives for Transfer Pricing manipulation and international income shifting by MNEs" (Eden, 2019).

This goal could be reached thank to the crucial role of the European Commission as the guardian of the internal European market. In fact, the Commission do not only act as the responsible and promoter of the enhancements of regulations, but it enforces on the investigations about potential state aid situations with which MNEs are sustained by countries through facilitated tax regimes. Moreover, the Commission and other international tax authorities have to reduce the incentives faced by MNEs to engage in fraudulent activities of income shifting between high tax rate to low tax rate countries. Incentives are made also from tax havens: contrasting politics of these countries is difficult and could result in a battle without winners. In order to contrast the income shifting activities is mandatory a more coral action by developed countries and also with developing ones. More collaboration, more cooperation, a more effective exchange of information could be the solutions to face this issue that it has been going on for several decades. Also, the adoption of not monetary incentives based on non - financial indicators could be a practicable solution to support legislative measures: for some years, the concept of social responsibility is one of the most critical arguments discussed by investors and all stakeholders. As a consequence, these incentives could be related to Corporate Social Responsibility action plans for example providing measures of legal protection of resources or through the attribution of certifications in terms of environment protections.

In addition, the OECD provide an online forum where national tax authorities could exchange information about tax planning scheme and strategies with which detect these fraudulent activities, adapt quickly their risk management strategies and identify the most reliable and effective legislative measures. The OECD promotes collaboration and cooperation between countries also to avoid the possibilities to face double or multiple taxation for businesses resulting in unilateral and uncoordinated actions. The scenario of double taxation discourages investments and initiatives of growth abroad national boundaries and "*comfort zone*" of businesses.

In the OECD's report "Addressing Base Erosion and Profit Shifting" of 2013, tax authorities also discussed about the possibility to include all stakeholders, as civil society, final customers and practitioners to participate in the discussion of long-term investments decisions. As said before, this fact could create more synergies, dialogues and develop a more mature awareness about international taxation systems and profit shifting activities.

The globalization did not bring only problems caused by the rise of MNEs and tax havens; thank to technology progress and established networks, it is possible to create synergies and combined actions, to define common goals and set guidelines in compliance with national characteristics.

3.3 THE ARM'S LENGTH PRINCIPLE ALTERNATIVES

Why are tax authorities still adopting the Arm's Length Principle? Are there alternatives to this approach?

The development of alternatives is very complicated in particular for digital base transactions. This fact is due by the confusion about digital economy definition: is this term regarding to the production of technological products or does it refer to the companies that adopt a digital business model? These questions have to address the discussion of new guidelines within the international community. Furthermore, searching for alternatives may create uncertainty between companies: the goals of these alternative approaches are to provide greater simplicity and clarity over multinationals but most of the time much Interpretations emerge creating overlap of international rules.

These elements suggest continuing to adopt the Arm's Length principle as the best option available. But as just seen in the previous paragraph, critics are emerging from professionals: this fact may encourage national tax authorities to develop new measures and to progressively abandon the current Principle.

In this paragraph, it will be provided and comment the two most important Arm's Length Principle alternatives: thus international tax experts name *global formulary apportionment* and *destination - based cashflow approach*.

3.3.1 The ***Global Formulary Apportionment*** method

For many tax practioners and campaigners, the most creditable alternative to the Arm's Length Principle is the Global Formulary Apportionment approach. It basically is a minimum corporate tax rate applied to the MNEs income using a formula which is tailored in a way to allocate profits to all different jurisdictions; the formula is based on a combination of assets, sales and payroll in each jurisdictions in which the MNEs operate through its subsidiaries. The common formula adopted is Massachusetts formula established in 1950 built around sales, payroll and properties (Lorenzo Mondin, Gianfranco Siciliano, 2014). In Japan for example the formula is based on the number of employees and the number of offices in each jurisdiction (De Mooij, Liu, Prihardini, 2019). Japan chooses the number of employees as the measure of profitability because people are the essential factor to reach and sustain the value creation. Moreover, the interest in the Formulary Apportionment lies in the digitalization of the economy: the number of employees and offices in each jurisdiction are two tangible measures and relatively immobile in order to tackle the fact that MNEs conduct businesses in other countries without physical presence. In this way, the debate of where allocate profits could be resolved in favor of the application of a country contribution base method.

A multinational corporation allocate its profits across countries depending on third party sales, payrolls, capital base or other production factors located in each jurisdiction. This approach is useful because of the impracticability of the separate entity approach in a highly integrated economic world. Formulary apportionment is used in the United States, Canada and Germany at a subnational level (Naegele, 2010).

The most important advantages of this approach are:

- The reduction of incentives for MNEs to shift profits from high tax to low tax country thank to the close relationship between real local economic activities indicators with tax liabilities; in fact, indicators of the real performance generated in a specific country are less vulnerable to the manipulation;
- The Formulary Apportionment would reduce compliance and administrative costs making tax system more flexible and less complex; the application of a determined formula based on a specific indicator shown above reduce the need to use traditional Arm's Length's Transfer Pricing

methods that as seen in the previous chapters, is source off tax avoidance and major disputes between tax authorities.

However, like any other Transfer Pricing approach designed, there are disadvantages; otherwise most of the issues occurred in international transactions would have already been resolved if a definitive approach had been invented. The most critical aspects of this approach are:

- The biggest problem is that the major economies have to be agree to create a common standard way to face all potential challenges; all countries must agree on the same formula (Naegele, 2010); if the agreement is not reached, unilateral decisions taken by a single country may result in possible double taxation or double not taxation situations;
- This approach is based on the concept of the "*unitary*" because all subsidiaries are treated in the same way eliminating possible distortions resulted in the application of the separate entity approach; the second problem deals with the definition of the unity and the inclusion of branches or subsidiaries for tax purposes during the determination of the appropriate tax base for fiscal apportionment calculation purposes. The idea is reporting combined profits of all affiliates and then allocate them on the basis a weighted average of sales, payroll and properties factors of the whole corporate group.

In the 2019 International Tax Review article about the Arm's Length Principle, Jeffrey Owens said that the Formulary Apportionment approach is a "*pragmatic method*, but it is not based on a principle like the current approach". Moreover, he suggested three questions to raise when a possible alternative is discovered. He suggested to answer to "is the alterative principle – based?", "is it feasible in administrative terms?", "can tax authorities reach a consensus about the underlying policy in order to sustain these approaches both in practical and theoretical terms?".

These questions are used to define whether a possible alternative is adequate to the standards set by the OECD in the Transfer Pricing guidelines. It is true also that these guidelines are not unmodifiable and usable forever independent to economic conditions. For this reason, tax authorities can modify guidelines and purposes at any time changes and adjustments are required.

Avi-Yonah and Benshalom in their article of 2011 published in the University of Michigan Law School Repository advised the use of Formulary Apportionment to tax authorities as not an utopian base rather a more practical and a real world solution. Also, the application of this approach does not require the modification of the entire international tax regime that could lead to challenges between tax jurisdictions (Avi-Yonah, Benshalom, 2011).

A practical example to show how does Formulary Apportionment work has been provided by Fleming Jr, Peroni and Shay in 2015 article for Harvard University. In their research, the apportionment formula was based on the computation of three factors to determine the right apportionment base for a specified country by worldwide profits. For example, for US portion of profits it is necessary to compute the following factors:

1) (US assets for all the subsidiaries considered / Total worldwide assets of the corporate group) * worldwide profits of the subsidiaries * 1/3 = worldwide profits allocated to US per asset factor;

2) (US payroll for all the subsidiaries considered / Total worldwide payrol of the corporate group) * worldwide profits of the subsidiaries * 1/3 worldwide profits allocated to US per payroll factor;

3) (US sales for all the subsidiaries considered / Total worldwide sales of the corporate group) * worldwide profits of the subsidiaries * 1/3 worldwide profits allocated to US per sales factor.

As a result, the taxable income in the US is the summation of the above three items. In the formula, the term 1 / 3 represents that the computation was based considering three factors; if the formula would comprise only 2 factors this item will be 1 / 2.

As said above, this approach is less manipulable than the Arm's Length Principle because of the tangibility of the numbers used for computations.

3.3.2 The ***Destination - Based Cashflow*** tax method

The US are already adopting a unitary method to tax companies inside national borders through the application of a *destination – based cashflow tax* approach for the multinationals enterprises. This approach is a more comfortable model for business, and it is a hybrid approach between the present principle and the formulary apportionment model. This approach also provides long term stability both to reduce the incentive of MNEs tax avoidance practices and to increase incentive to adopt it by countries through its resistance to tax competition among states.

This approach is based on two dimensions: the *destination* basis and the *cash flow*. In an international transaction a key question arise about which country has to apply tax. For the *destination* perspective, this means that the country where products and services are finally destinated (or sold) that gets to levy tax. Apparently, MNEs cannot use tax havens to avoid taxation because it is transparent and obvious where goods are sold at last.

The application of taxes in a destination country is based on *cash flow* perspectives to give immediate relief to all expenditure and tax revenues (Auerbach, Devereux, Keen, Vella, 2017). It consists on the difference between real inflows and real outflows of both real and real plus financial base (Meade Commitee, 1978): as a result, this approach analyzes the sale and the purchase of products, real assets or services including leanding repaying borrowing and the payment of interests. The rationale to adopt an alternative based on the computation of the cash flow is that investors always seek to maximize the net present value (NPV) of their profit on a particular investment. The NPV is the sum of the discounted cash flows associated with the investment; as a consequence, the maximization of NPV corresponding to an economic rent. A tax applied on cash flows can be thought to a tax on economic rent on an investment because of the effect of the *tax relief* that affects incentives making the investment not desirable.

Finally, the destination-based cash flow tax approach has universal adoption thank to its remarkable properties in terms of:

- *economic efficiency* because it does not distort the choice of the locations of the investments;
- *robustness* to tax avoidance and evasion because of the reduction of the incentive of MNEs to shift income from high tax to low tax countries

- through lending and intra debt transactions, locations of intangibles and royalty payments;
- *reliability* and relative *ease* on administration practices due to the reduction of compliance costs in terms of information disclosing of operations on assets during the fiscal year;
- *fairness*: this is a fundamental characteristic for international tax approaches in order to attribute the right effective incidence of the tax burden to both countries and tax payers;
- *stability* neutralizing competitive forces that affects other tax systems based on profits.

CONCLUSIONS

Current international tax standards have not kept pace with changes in global business practices, in particular in the area of intangibles assets and the development of digital economy. For example, today it is possible to be heavily involved in the economic life of another country by doing business with local customers only via the internet, without having a physical and so taxable presence in that country. As a result, Non – residents taxpayers can derive substantial profits from transacting with local final customers: for this reason, questions have been emerged on the whether the current rules are effective and applicable or not to the current economic situations and fit for the initial purpose. If substantial legislative and taxable measures are not adopted, legal structures will still remain valid to take advantage of the asymmetries of both national and international tax systems to avoid taxes.

Future research has to prove whether or not the proposed alternative methods are feasible from an economic point of view. As of this moment, I believe the research on the alternative approaches to be more of a conceptual nature. Additionally, it would be very useful to statistically substantiate the benchmark I created in this thesis in order to be able to give 'scores' on the aspects of the various transfer pricing approaches. Finally, I believe that the economic effects of the OECD regulation should be closely monitored in the near future in order to calculate the effectiveness of the new guidance on fixing the arm's length principle regarding intangibles. In any case, I believe the OECD should be more open towards new transfer pricing approaches. To end this thesis on a positive note, I believe that harmonization is something countries should strive for, regardless of the complications.

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Finally, Transfer Pricing is not just used as accounting technique; however, it is the most important vehicle to allocate financial resources between countries and to avoid taxes. For this reason, shedding light on these fraudulent practices is necessary to stimulate a common critical view in order to take more responsible actions. We need a top – down approach and directives coming from the governments who the only institutions are able to check the adequacy of the intra firm transactions. Thus, the politics of the Transfer Pricing cover a very critical aspect on international regulation and on relationships between countries.

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