IMPACT OF BASE EROSION AND PROFIT SHIFTING (BEPS) REGULATION IMPOSED BY OECD/G20 ON MULTINATIONAL ENTERPRISES: TRANSFER PRICING ANALYSIS

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***Abstract*:** Base Erosion and Profit Shifting (BEPS) refers to a practice or tax planning strategy used by Multi National Enterprises (MNEs) to exploit gaps and mismatches tax rules between different countries to artificially shift profits to low or no- tax locations in order to bypass corporate tax laws, resulting in little or no corporate tax being paid. BEPS causes loss of tax revenue to national governments. The international tax scenario had taken such shape that the governments all across the globe had to suffer revenue losses. Countries' governments, then, began to grow concerned of the way with which multinational enterprises started exploiting tax rate differences among countries to book profits in low-tax locations. This exposed the issue of 'unfair' transfer pricing among related entities and brought forth the importance of the principle of arm's length pricing. In recent years, the Organization for Economic Cooperation and Development (OECD) has coupled with the G20 representatives and raised the need for a tax rule which is uniform across the board (internationally) in order to prevent multinational companies from getting undue advantage of tax differentials between countries. This is being done with the objective of keeping the government revenues from deteriorating as the primary source of revenue of governments is taxation. The current paper focuses on BEPS regulation and case study of Amazon with reference to transfer pricing.

Index Terms: Organization for Economic Cooperation and Development (OECD), Base Erosion and Profit Shifting (BEPS), G20, Multi National Enterprises (MNEs), Transfer Pricing

I. INTRODUCTION

Transfer Price is the price of transaction between related parties, for example – a parent company and its subsidiaries. This kind of pricing directly affects the allocation of taxable income of a firm as the tax structures vary across countries. Many Multinational Enterprises (MNEs) have taken advantage of this fact, and have successfully booked their profits in another country so as to exploit the lower tax rates.

Base Erosion and Profit Shifting (BEPS) refers to a practice or tax planning strategy used by MNEs to exploit gaps and mismatches tax rules between different countries to artificially shift profits to low or no- tax locations in order to bypass corporate tax laws, resulting in little or no corporate tax being paid. BEPS causes loss of tax revenue to national governments.

Policy makers of the OECD and G20 countries have come together to enforce an international tax system wherein profits of a company are taxed where economic activities take place and value is created. In September 2013, the G20 Finance Ministers came up with a BEPS package consisting of 13 reports which seek to change international standards of taxation and formulate concrete measures to tackle the problem of BEPS. As the OECD member states tighten rules for taxation of transactions between related companies and treatment of tangibles, the MNEs are looking at a significant increase in their tax compliance burden. For the tax authorities of OECD member states, this regulation would tackle the issue they perceive as tax avoidance.

II. BACKGROUND

Even in today's advanced business environment, there is a poor coordination between various domestic tax rules and policies across borders. Further, international standards have not been made to adapt to the changing global business scenario. The initial OECD report of 2013 *Addressing Base Erosion and Profit Shifting* identified 15 actions (listed with details in Appendix) along the fundamental pillars – introducing coherence in the domestic rules that affect cross-border activities; reinforcing substance requirements in the existing international standards and improving transparency; and certainty for businesses that do not take aggressive positions.

Action 11 explains that an estimated current overall tax loss due to BEPS ranges between 4% and 10% of global corporate income tax revenues. This is at least USD 100 to 240 billion annually. Developing countries have a higher dependence on corporate income tax revenues for their growth than developed countries. Therefore, developing countries are impacted more by BEPS than developed nations. In addition, the interest-to-income ratio for subsidiaries of large MNEs in highest tax rate countries is almost three times higher than their MNE's worldwide third-party interest-to-income ratio. This has highlighted the principle of arm's length price – this price is charged in a transaction in which the buyers and sellers of a product or service act independently like they have no relationship to each other. It is desirable for national governments if the MNEs transact with their affiliates at arm's length price rather than a transfer price so as to circumvent the problem of BEPS and avoid loss of tax revenue. In Actions 8-10 of the BEPS package, the arm's length has been upgraded to ensure that results are obtained as per their economic motivation. It has resolved the issue of assigning values to Intellectual Property and intangibles.

In Action 13, transfer pricing documentation required by MNEs have been revised to bring about increase in transparency in operations. By means of country-by-country reporting, it will become clear where profits are booked, and where tax is paid and accrued. It is recommended that MNEs file their country- by-country reports starting January 1, 2016. Transparency among governments will also be a measure implemented toward tackling BEPS as there are rulings in the current system that could erode other countries' tax base. The digital economy is believed to worsen BEPS issues, especially those related to permanent establishments, transfer pricing and Controlled Foreign Corporation (CFC) rules. These issues will be addressed by the BEPS package. In addition, ensuring that the Value Added Tax (VAT) is collected in the country in which the consumer is located is important for the online business-to-consumer market. This, in turn, affects the level-playing field between domestic and cross-border suppliers.

The package also aims at eliminating double taxation by tweaking the international tax standards in order to curtail BEPS activities. The transfer pricing guidelines are being modified – intangibles, which are hard to value, will be given a pricing technique that bridges the gap of information between the tax authorities and the firms dealing in transactions such as these. Along with this, to avoid tax nexus, the definition of permanent establishments will be made clearer (Action 7).

Implementation of BEPS package measures requires coordination and cooperation between tax administrations particularly because of the difference in domestic laws. OECD, G20 and the participating developing countries will develop a modern tax framework that would clearly reveal the locations where profits are generated and value is created. Some of the revisions that the BEPS package would bring about include – change in transfer pricing guidelines, tax treaties; and domestic changes like – CFC rules, interest deductibility, country-by-country reporting, mandatory disclosure rules, and preferential IP regimes. These measures will need to be consistent with and convergent toward the international standards that are going to be set by the countries together.

It is also essential that this compliance rule be extended to international organizations and regional tax organizations beyond the ambit of only OECD and G20 countries. The interest shown by many developing countries in the BEPS project drives the need of a more inclusive framework to support the implementation of the BEPS package. Secretary-General, OECD stated that OECD would prepare a framework by early 2016 that would build on how non-OECD and non-G20 countries can contribute to the standards and measures of the project.

III. TRANSFER PRICING METHODS

Methodology of reaching transfer price for a multinational enterprise can be understood in two categories – traditional transactional methods and profitability methods.

The traditional methods include-

1. **Comparable Uncontrolled Price (CUP) Method**: In this method, the price charged in a controlled transaction is compared to the price charged for a similar (comparable) transaction between the taxpayer and an unrelated party. The CUP method is not widely applicable in the industry because the requirement of comparability is highly strict, and it is often difficult to find products or services that meet the requirement.
2. **Cost Plus Method**: This method compares the mark-up on costs from the uncontrolled transactions to that of controlled transactions. Cost Plus method is used for manufacturing firms typically – compares gross profit to cost of sales. It requires detailed comparisons of products produced, intangibles, cost mark-ups, risks, functions performed, between controlled and uncontrolled transactions. It would be a less reliable method if differences exist between transactions in the said factors.
3. **Resale Price Method (RPM)**: This method compares resale price margin or gross profit margin in controlled and uncontrolled transactions, typically in sales and distribution entities. Comparability

The profitability methods include-

1. **Profit Split Method**: When transactions are complicated in such a way that they cannot be evaluated separately, independent enterprises might form a partnership and agree on a profit split. This method eliminates the effects of conditions imposed in a controlled transaction by means of splitting profits like they would have been split in a transaction between independent parties (firms).
2. **Transactional Net Margin Method (TNMM)**: This method seeks to compare the net profitability, that is, Profit Level Indicators given by ratio of net profit relative to appropriate base (costs, sales etc), in a controlled transaction to net profitability of a similar transaction which is uncontrolled. Net profit indicators are less affected by transactional differences as compared to methods using price.

These transfer pricing methods are recognized by OECD, and a selection process has been laid out that defines the most appropriated method that should be used for a particular case. OECD requires companies to fulfill a set of criteria in order to reach a transfer pricing method that they would adopt. As stated by OECD, these criteria are:

i. The respective strengths and weaknesses of the OECD recognized methods
ii. The appropriateness of the method considered in view of the nature of the controlled transaction, determined in particular through a functional analysis
iii. The availability of reliable information (in particular, on uncontrolled comparable) needed to apply the selected method and / or other methods; and
iv. The degree of comparability between controlled and uncontrolled transactions, including the reliability of comparability adjustments that may be needed to eliminate material differences between them

The use of these methods becomes clearer with the help of the flow diagram given below in Figure-a. This diagram points out the comparability issue between two transactions (controlled and uncontrolled) that the authorities try to compare to reach a conclusion on the methodology to adopt for transfer pricing.

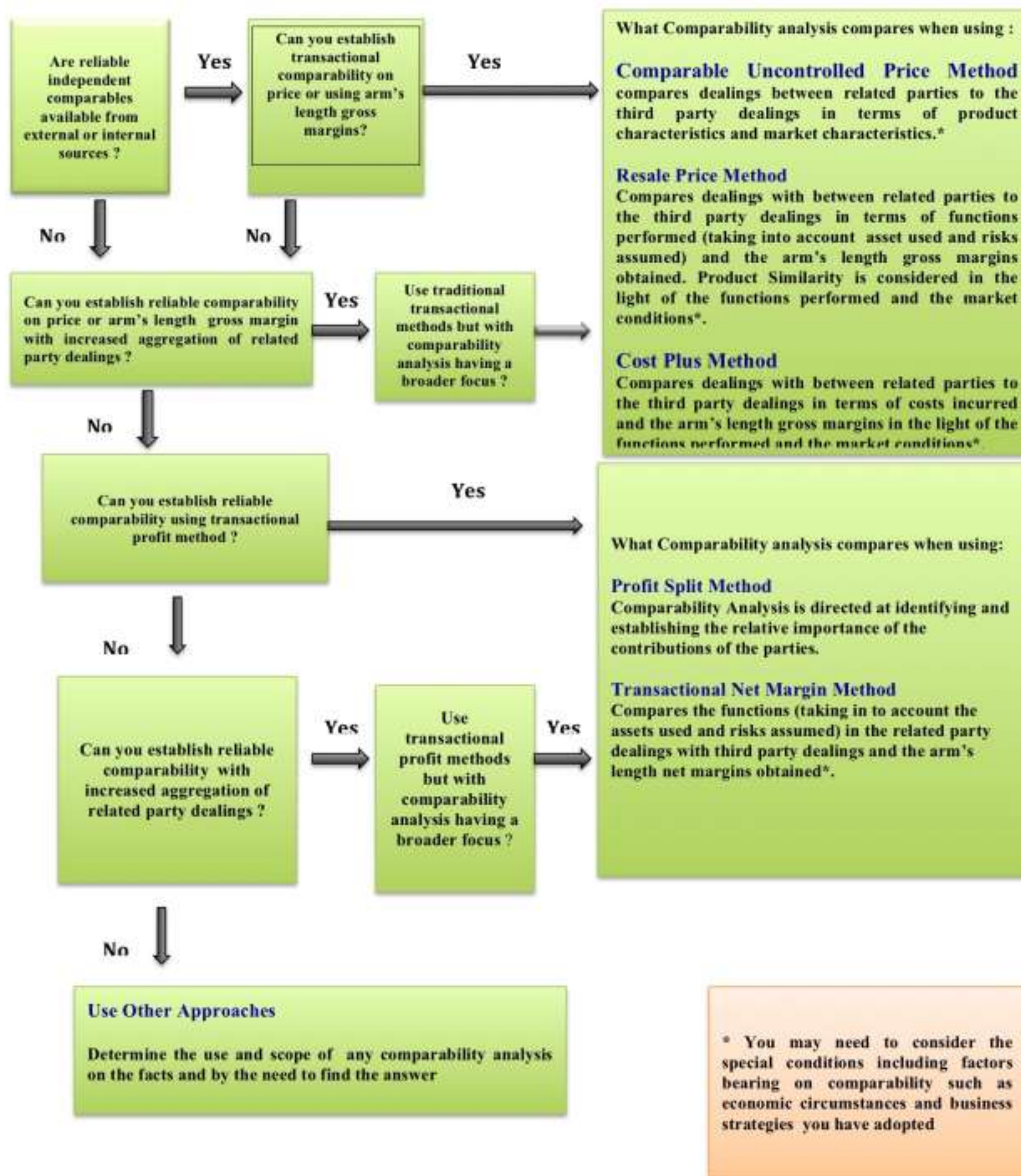


Figure-a : Comparability Issues in Methodology for Selection

Source: Compiled by author

Under the regulation, the arm's length range will be based on all of the comparable only if these comparable meet the high standard of comparability. If close/exact comparable are not used, then the range will be based on those comparable that are between the 25th and 75th percentile of results. If the taxpayer's transfer pricing results are outside the arm's length range, the IRS may adjust those results to any point within the range.

IV. CHALLENGES IN APPLYING TRANSFER PRICING

Transfer pricing poses challenges as the methodology is not as straightforward as it seems. The transactions are never easily comparable in related parties as between unrelated parties, unless there are some requisite adjustments placed in order. The relationship between tax administrations and large Multinational Enterprises across the world. Transfer pricing relates to tax policy and therefore, it engages three parties in the type of exercise that is required for transfer pricing – the domestic tax authority, the foreign tax authority and the taxpayer. The objectives of the tax authorities are to maximize revenue and that of the taxpayer is to minimize tax payment. Applying transfer pricing may have disputes arising between tax authorities and tax paying parties. Tax authorities may challenge the assumptions that the taxpayer has used to build its economic method for pricing; authorities may question the model that the firm has chosen for calculating tax and pricing; and tax authorities may question that tax payer's characterization of the value chain within the group.

V. INTERNATION TAX LAWS IN THE UNITED STATES OF AMERICA

The United States is a very significant market in world trade and even transactions between and within various multinational enterprises. Compliance with the US rules, therefore, becomes of key importance. The Internal Revenue Service (IRS) has created an elaborate set of regulations that are important for the multinationals to abide by in order to conduct business in the US. The detailed nature of the US policies on transfer pricing has invited criticism from tax authorities outside the US. How the IRS defines arm's length has not entirely been agreed upon by trading partners of the US firms. There has been observed an increase in the number of issues being considered through US Competent Authority because of the aggressive regulations and strong enforcement by the IRS. At this stage, the Advanced Pricing Agreement (APA) is also worth mentioning. APA is an ahead-of-time agreement between the taxpayer and the tax authority on an appropriate transfer pricing methodology for some transaction over a period of time. The Competent Authority process forms the basis for APA, which is becoming increasingly important in today's multinational scenario since it eliminates the chances of occurrence of violations of the arm's length standard as set by the tax authorities in the country. The US corporate tax system is based on self- assessment wherein the burden of proof borne by the taxpayer, which in turn, is believed to make the relationship between the taxpayer and the tax authority adversarial.

The IRS issued regulations about applying arm's length standard in transactions between related parties and laid down the pricing methods in order to reach the transfer pricing results in 1968. These methods, as discussed above, serve as the pricing standard depending on the industry and the type of firm they are being applied in. In 1994, the IRS issued final regulations as captured in section 482, which were effective for cases with tax years beginning 6 October, 1994. Section 482 of the Internal Revenue Code states that the Secretary of Treasury has the power to make allocations necessary to prevent evasion of taxes or clearly to reflect the income of organizations, trades or businesses. This section also deals with treatment of intangibles. The income with respect to such transfer shall be commensurate with the income attributable to the intangible.

In 1996, the final transfer pricing regulations under section 6662 were issued effective for cases with tax years beginning 31 December 1993. In the same year, the APA procedures were also revised. In 1998, however, the APA procedures were revised for small businesses.

The tax regime in the US is in keeping with the OECD guidelines on transfer pricing. Less than single or double taxation both need to be ruled out in order to reach a 'fair' level of tax charged for transactions between related parties or intra-firm transactions. The arm's length standard enacted by both OECD and the US tax authority, thus, becomes of significant importance to multinationals that aim to comply fully to the local laws of all jurisdictions and avoid double taxation.

VI. TRANSFER PRICING AND THE DEVELOPING COUNTRIES

Tax authorities are found to have extreme difficulty in applying arm's length standard in case of some developing countries as it is rather difficult to calculate MNE profits in developing and transitioning economies. It is argued that the arm's length principle and the transfer pricing methodology can be applied to developing countries in much the same way as the OECD countries, and that these countries can benefit from the enactment of this regulation on the

transactions occurring in that country. Therefore, it is evident that being part of an international consensus is the most efficient method of achieving the objective of protecting a country's tax base and avoiding double taxation. Application of arm's length standard is a resource-intensive and complex procedure, so one would be tempted to assume that developing and transitioning economies may face issues in adopting these measures straight away. Such economies, typically, have fairly limited administrative and bureaucratic resources to administer regulations related to transfer pricing. The way around this is to modify the pricing rules according to the strategic needs of the country based on its resources. In context of transfer pricing this means that the enforcement should be enacted according to the circumstances of that particular economy, the type of trade, the volume of cross-border trade and the size of the base of taxpayers. OECD stays actively in dialogs with non-OECD economies for facilitating the implementation of legislative measures pertaining to transfer pricing in the economies where resources and administrative capacities are limited.

Another issue faced by the tax authorities in developing countries is finding data on transactions that occur within a multinational in that country. The financial databases usually provide very limited data on companies that are exclusively operating in individual developing countries. This can be accounted to the lack of infrastructure such as the absence of requirement for the public registration of statutory accounts, or difficulty in obtaining access to these statutory accounts where they are available. Negotiations and/or compromise assume an important role in resolving conflicts on transfer pricing. In the situation with lack of comparable data, negotiations do not find appropriate grounds to begin with.

OECD suggests possible actions that can be taken in order to circumvent this problem. These actions can be broadly categorized into the following heads:

1. Expanding access to data sources for comparable
2. More effective data use of data sources for comparable
3. Approaches to reducing reliance on direct comparable
4. Advance pricing agreements and mutual agreement proceedings.

These actions will further need to be streamlined so that priority is assigned to the country, which has limited resources and thus, needs more attention.

VII. CASE STUDY – AMAZON.COM INCORPORATED TRANSFER PRICING (TAX) DISPUTE

Amazon is an American multinational, which is engaged in electronic commerce and cloud computing business founded in 1994. It is the largest internet-based retailer in the United States which started as an online book seller and later diversified its business segments to encompass sale of many other items of daily use like DVDs, MP3 downloads/streaming, consumer electronics, apparel, food, toys, furniture, and the like. Amazon has separate retail websites for United States, United Kingdom, Ireland, France, Canada, Germany, Italy, Spain, Netherlands, Australia, Brazil, Japan, China, India and Mexico.

VIII. BACKGROUND

Amazon.com Incorporated entered a Cost Sharing Arrangement (CSA) with its subsidiary in Luxembourg under the prior 1995 cost-sharing regulations. The subsidiary in Luxembourg was entitled to take advantage of the intangibles in Europe. Amazon had assigned pre-existing intangibles to its subsidiary in Luxembourg pursuant to a license for a buy-in payment of $217 million. The IRS, however, reached the conclusion that this amount should be increased to $3.6 billion. The difference in the calculation done by the tax payer and the IRS is that the tax payer valued intangibles as separate assets that it owns with a limited time use, whereas the IRS treats this as a business transferred to foreign subsidiary. Here, intangibles are treated in a way that they have a long life and value for the items separate from the intangibles is included.

This transfer of intellectual property to the Luxembourg subsidiary with the intention of use in Europe was done back in 2005. According to the concept of transfer pricing, the subsidiary paid the parent company Amazon.com Incorporated for this transaction. Following this transaction, the Internal Revenue Service claimed that the company undervalued these assets and thereby ended up charging an 'unfair' price for this transaction instead of the fair arm's

length price. This reduces the taxable income of the company in the United States, while making it larger in Luxembourg. This is a clear example of profit shifting, wherein the company Amazon.com is booking more of its profits in Luxembourg which has a lower tax rate than the United States. As a result, Amazon got an unfair advantage as compared to its competitors that have not been granted this favorable tax treatment.

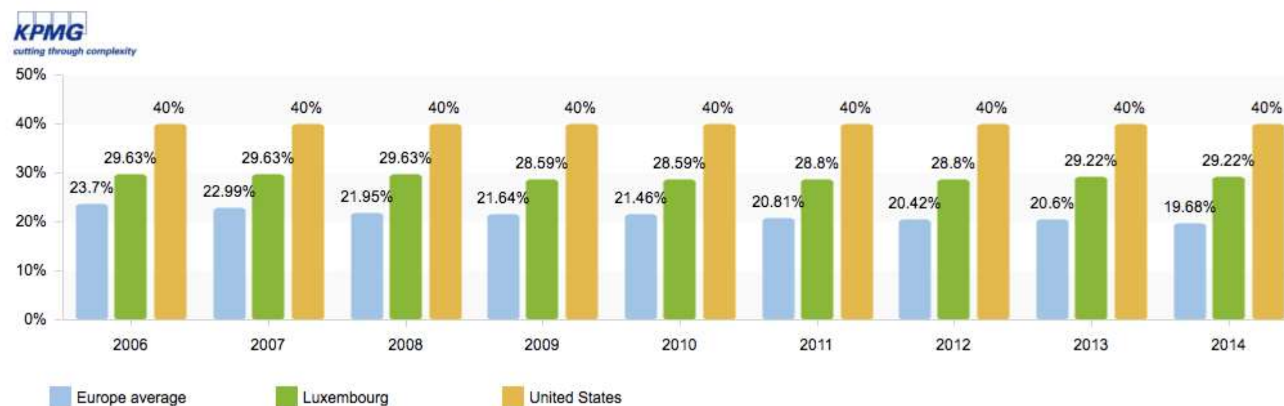


Figure-b :Corporate Tax Rates for 2006-2014

Source: https://home.kpmg.com/xx/en/home/services/tax/tax-tools-and-resources/tax-rates-online.html

Amazon argued that the IRS is overestimating the value of its transferred intangible property like software, marketing assets, trademarks et cetera. Later according to a Securities and Exchange Commission filing - in 2011, Amazon declared for the first time that it is liable to pay $1.5 billion in accumulated taxes over the seven years starting 2005 up to 2012. The comparison of the movement of Corporate Income Tax in Luxembourg vis-à-vis the United States from 2006 to 2014 is shown in Figure-b above. This will indicate how much profit shifting has benefited Amazon by selling intellectual property in Luxembourg.

Despite the violation pointed out by the IRS in this transaction between Amazon and its subsidiary in Luxembourg, the agreement stands to have certain benefits as well. Amazon.com Incorporated, its subsidiary Lux SCS, Amazon's customers, and the country Luxembourg are main beneficiaries of this agreement. This can be understood in the following way. Firstly, Amazon did not have to pay taxes, and the taxes will remain unpaid until profits are transferred from Luxembourg to the United States. This means that Amazon is clearly saving a significant amount of money on taxes. Second, Luxembourg is now earning additional tax revenue (albeit low), which implies there is a gain for Luxembourg. Third, since Amazon is selling its products in Luxembourg under this arrangement, Value Added Tax (VAT) is being paid in Luxembourg, which is a low-tax country. Therefore, consumers enjoy a low price range for products as the markups had fallen. Effective 1 January, 2015 the tax rates have gone up in Luxembourg eliminating this effect. The 6% rate has gone up to 8% - mainly applicable to supplies of gas, electricity, and heating. The 12% rate has become 14% for certain non-exempt financial services. The standard VAT rate of 15% has become 17%. The impact of VAT depending upon what role you have in the market has been described in a concise way by Ernst & Young in the flow diagram Figure-c.

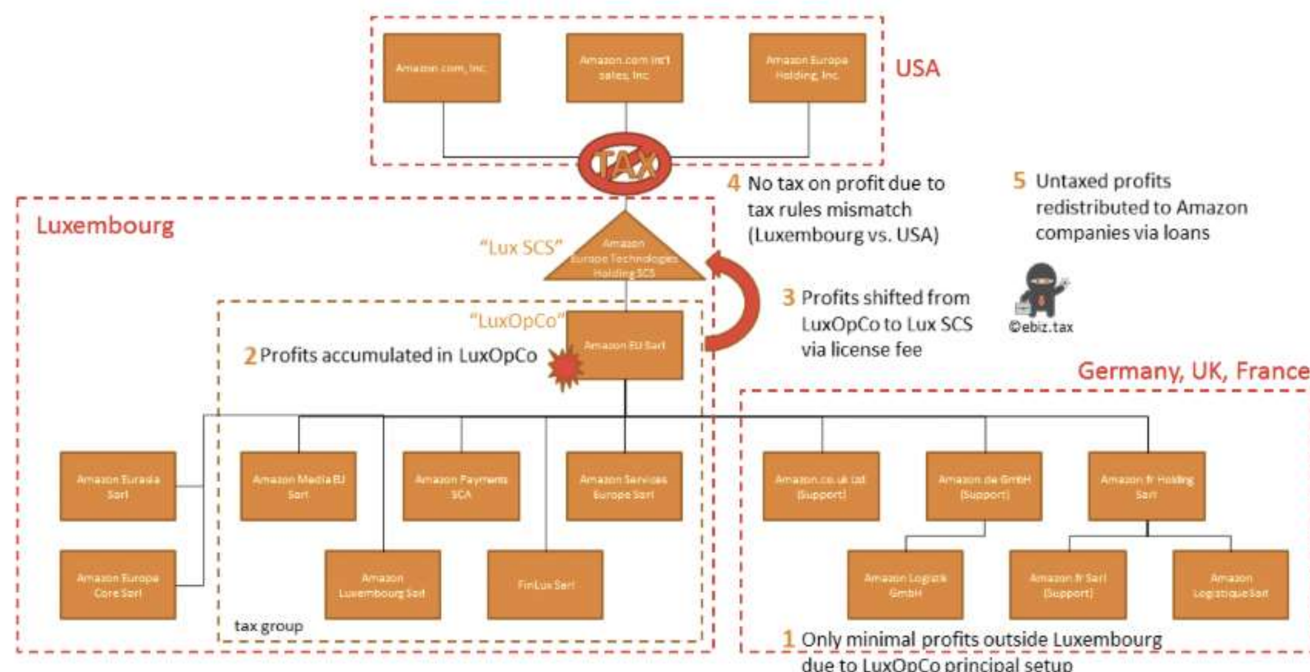
Figure-c: Impact on Amazon Due to Being Seller of Digital Services Source: http://www.ey.com/Publication/vwLUAssets/EY- Digital_products_and_services_in_2015/$FILE/Digital_V A T_Campaign_Brochure.pdf

This figure is clearly portraying the impact that Amazon would have to face due to being a seller of digital services. The liabilities of the company's subsidiary in Luxembourg will go up. However, they will not increase by the amount that offsets the gains that Amazon makes by saving on taxes. Therefore, Luxembourg continues to be the e-tax haven of the European Union (EU). European Commission's Investigation on Amazon's Corporate Tax

Through a press release of the EC in October 2014, it was communicated that the EC is conducting an investigation to examine whether the decision by Luxembourg's tax authorities with regard to the corporate income tax to be paid by Amazon in Luxembourg comply with the EU rules on state aid. On 16 January, 2015, the European Commission published its decision of the formal investigation. The Press Release clearly states that Amazon's subsidiary Amazon EU Sàrl, based in Luxembourg records most of Amazon's European profits. Lux SCS owns IP (intellectual property) and licenses it to LuxOpCo (that is, Amazon EU Sàrl). Based on the methodology set by the tax ruling on transfer pricing determination, Amazon EU Sàrl pays a tax deductible royalty to a limited liability partnership (LLP) established in Luxembourg but which is not subject to corporate taxation in Luxembourg. As a result, most European profits of Amazon are recorded in Luxembourg but are not taxed in Luxembourg.

Amazon EU Sàrl serves as the headquarters of Amazon in Europe, and its role in Amazon's operations is that it takes strategic business and commercial decisions for Amazon. It also manages commercial, inventory and operational risks of Amazon websites. All profits of this subsidiary are reinvested back into Amazon and thus, are used for business expansion. At the same time, the tax obligations of the company remain low so the consumers do not lose anything.

The European Commission (EC) asserts that "if the method of taxation for intra-group transfers does not comply with the arm's length principle, and leads to a taxable base inferior to the one which would result from the correct implementation of that principle, it provides a selective advantage to the company concerned."



Based on data in the European Commission's decision "C (2014) 7156 final" dated 7.10.2014 – English working language version

Figure-d : Interaction between Different Parties

Source: http://ebiz.tax/european-commission-amazon-tax-avoidance-luxembourg-state-aid/

A flow diagram in Figure-d depicts the interactions between different parties involved directly and indirectly in this arrangement. The EC questions whether the Transfer Pricing method applied and the royalty calculation method in the agreement is in line with the OECD Transfer Pricing standards.

The EC pointed out the following as reasons for triggering this investigation on Luxembourg aid to companies like Amazon by enabling them to set up shops in Luxembourg and take advantage of low tax rates:

- Luxembourg failed to turn in economic analysis of the consequences attached to this move.
- The EC questioned if the transfer pricing method and the royalty calculation method applied in this agreement is in line with the standards mandated by OECD about transfer pricing.
- The EC wanted to review the transfer pricing method applied in this agreement by considering the case of Amazon.com Incorporated and Amazon EU Sarl.

Findings from Amazon's 10-K Amazon's global tax position can be studied by looking at its annual filing, its 10-K report.

As can be clearly seen, the tax liability of Amazon.com Incorporated remained significantly lower than what the Federal government of the United States imposes on corporations. However, due to the IRS case on Amazon, there was a settlement in which Amazon had to pay its accumulated taxes for seven years beginning 2005 in the year 2012. This is the reason why there is a spike in the effective tax rate that Amazon was facing in the year 2012.

Since 2012, Amazon continues to pay higher tax as the transfer pricing issue was detected by the IRS, and Amazon was compelled to pay its taxes in keeping with the U.S tax law.

The OECD BEPS project aims to address this issue between countries without having the tax administrations interfere each time by correcting misreported or manipulated figures. The BEPS project will, therefore, lead to profits remaining where they are supposed to be. Tax base of countries' governments will be prevented from getting eroded since all MNEs operating in any nation would be governed by a uniform tax law that pre-empts the possibility of moving profits

to low-tax location

Table : Comparison Between Statutory and Effective Tax Rates

	2013	2012	2011	2010	2009	2008
Federal Statutory Tax Rate	35%	35%	35%	35%	35%	35%
Total Effective Tax Rate	31.8%	78.6%	31.2%	23.5%	21.9%	27 .4%

Source: http://ebiz.tax/european-commission-amazon-tax-avoidance-luxembourg-state-aid/

IX. CONCLUSION

As is understood from the information above, the two concepts of Foreign Direct Investment (FDI) by MNEs and transfer pricing are spoken about in the same breath. Countries all across the globe have, in past, grappled with falling tax revenues, thus affecting government expenditure, which is a growing concern for any economy. Inflation directly stems from a deficit that a country's government faces. Falling tax revenues due to manipulation by MNEs in their subsidiaries present in other countries has been recognized as a significant reason of less than optimal revenues being collected.

OECD has laid out an action plan that aims to curb this issue as over time, loop holes or weaknesses have been identified in the current tax rules that create opportunities for profit shifting by MNEs. This is the reason that the G20 countries have reached a consensus of adopting multilateralism. The deliverables on the BEPS Action Plan form groundwork and provide points of action that will align the international tax rulings with economic activity and prevent MNEs from taking unfair advantages of these.

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