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Survey

Inconsistent tax transfer prices: tax filings, audits, and double taxation

Executive Summary

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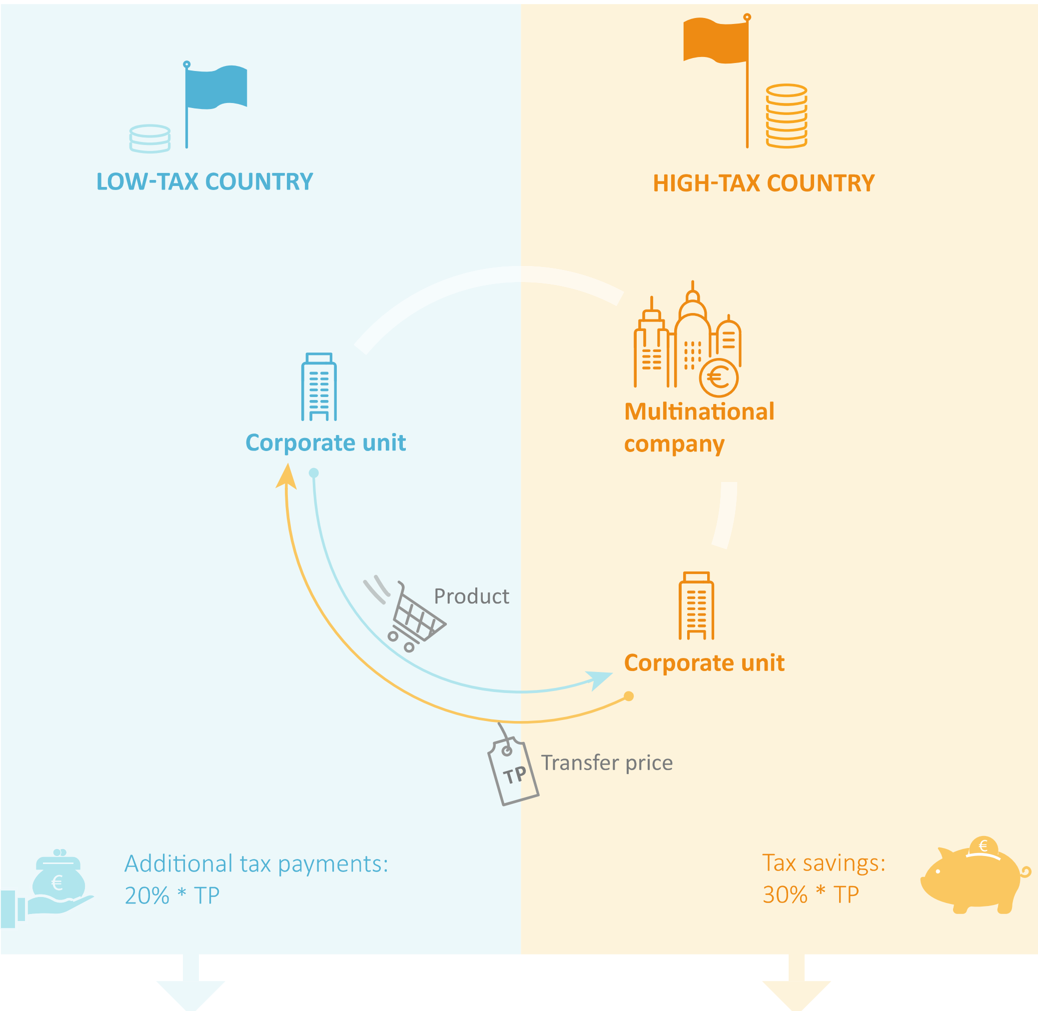
1. Background and aim

There is no market price for cross-border intercompany transactions. In order to be able to correctly allocate taxable income and expenses to the countries involved, a proxy is therefore required: the so-called tax transfer price.

Effects of the tax transfer price

If there is a tax rate differential between two countries, tax transfer pricing in multinational companies can in principle lead to tax substrate being shifted from one country to another.

Transfer prices and tax rate differential



Total tax savings:
a) TP = 5 10% * 5 = 0.50 €
b) TP = 10 10% * 10 = 1.00 €

Although a higher transfer price (in the example: €10.00 instead of €5.00) leads to a higher tax burden in the low-tax country, the tax savings in the high-tax country overcompensate this disadvantage. Overall, a savings of € 1.00 per (internally) sold product is thus achieved with a tax rate difference of 10%.

Arm's length principle determines transfer price

There are rules that prescribe how transfer prices are to be determined. Many countries are guided here by the so-called arm's length principle from Art. 7 (2) and Art. 9 (1) OECD-MA: Consistent with this principle, in the case of transactions between associated enterprises, the conditions on which taxation is based are those that would also have been agreed by independent enterprises. If, for example, an (intermediate) product is sold across borders between associated companies, a price is assumed that comes as close as possible to a (fictitious) market price. Ultimately, the arm's length principle per se does not allow for the calculation of one unique price, but merely specifies a corridor and provides some orientation for the involved parties (taxpayer and tax authorities). The determination of transfer prices is therefore difficult; in particular because countries are ultimately in competition for tax revenues and therefore have conflicting interests with regard to the level of transfer prices.

The concrete formulation of the arm's length principle is operationalized in the national tax laws – and can therefore differ between different countries. The interpretation of the national standards by the respective tax authorities can lead to additional deviations.

Differing transfer prices for one and the same transaction?

So while high-tax countries try to prevent losing tax substrate to low-tax countries, multinational companies have to fear double taxation due to inconsistent transfer prices. Although mechanisms exist to resolve such conflicts (e.g. mutual agreement procedures, joint audits), they are not always applicable, sometimes lengthy, expensive and not always successful. In the course between the submission of the tax return together with the corresponding transfer pricing documentation and the conclusion of the respective tax audits and mutual agreement procedures, it is therefore possible that transfer prices for one and the same transaction can differ in the countries involved.

Aim of the survey

The aim of the survey is to obtain an overview: When do these deviations occur (do companies anticipate the problem and already report deviating transfer prices in their tax returns? Or do deviations only occur as a result of a tax audit?)? What are the consequences of these deviations (reduced taxation or double taxation)? Can double taxation be prevented through mutual agreement procedures? Which countries are particularly vulnerable to induce transfer pricing inconsistencies?

The survey ran from Dec. 10, 2020, to Jan. 20, 2021.

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Based on this information, we develop a theoretical model that describes the interplay of the incentives of the actors involved (multinational company, tax authorities of the two countries) to find out what consequences divergent transfer prices have for the internal structure of the company, the production decision as well as the tax revenues of the countries involved. A preprint of this paper will be published here soon.

2. Sample

The survey was conducted via the Working Group “Transfer Pricing” of the German Consortium for Economic Management (Arbeitsgemeinschaft für wirtschaftliche Verwaltung e.V., AWV) and the Tax Committee of the German Chemical Industry Association (Verband der Chemischen Industrie e.V., VCI). The invitation was sent to a total of around 60 transfer pricing experts from German multinational companies. The survey is therefore not representative, but it does fulfill our aim of reaching highly qualified and specialized experts who hold the relevant decision-making positions in the companies.

More than two-thirds (70%) of the participants have a master's degree (or equivalent), and more than a quarter (26%) hold a doctorate. 83% have been working in the field of transfer pricing for more than ten years.

Experience
Years of experience in tax transfer pricing

>15	10–15	5–10	>5
52.2%	30.4%	13.0%	4.3%

Specialization
Proportion of daily working time in transfer pricing

68.9%

Education level

PhD	Master	Bachelor
26.1%	69.6%	4.3%

3. Occurrence of deviations and geographic distribution

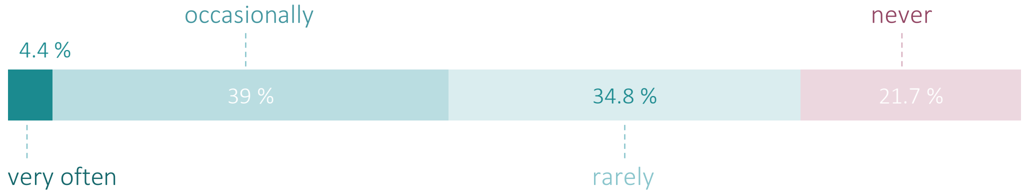
Deviation in the tax returns

If the transfer pricing regulations of two countries are structured in such a way that no price is considered permissible by both countries, companies would actually have to use deviating transfer prices when filing their respective tax returns. At the same time, however, firms are expected to have one uniform global transfer pricing system and there is at least anecdotal evidence that the declaration of deviating transfer prices arouses "suspicion" on the part of the tax authorities.

We asked the participants to indicate how often they have experienced that deviating transfer pricing regulations were used when filing the tax return. 43.4% of respondents state that they have experienced this occasionally or more frequently.

Divergent transfer pricing regulations are occasionally or more frequently used when filing tax returns

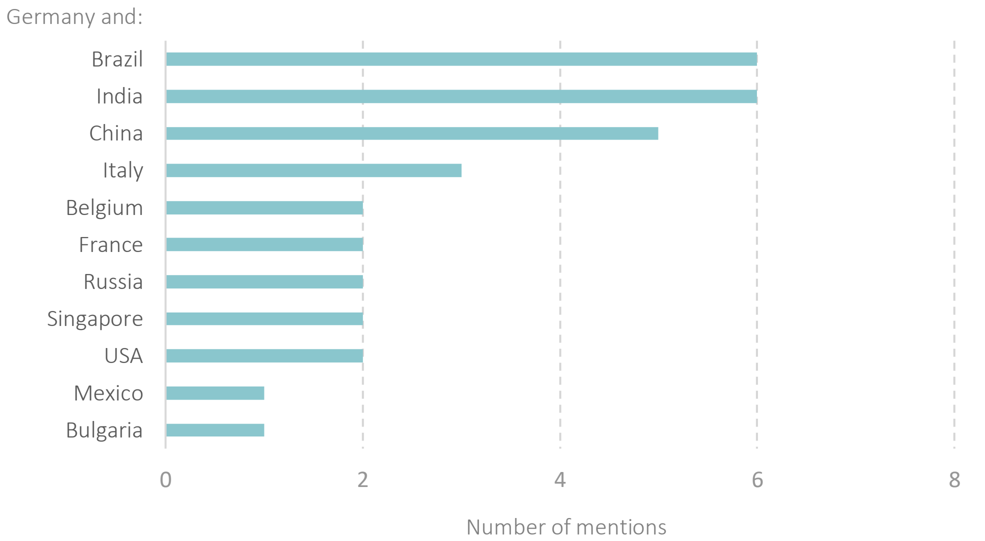
"Have you experienced that the respective deviating country regulations were already considered when filing tax returns?"



In order to get an impression of the geographic distribution of the problem, we asked the participants to name country combinations where deviating prices were already taken into account when filing the tax return.

Inconsistency in tax returns:
Brazil, India and China are frequently mentioned

"Please name country combinations where you have already experienced deviating transfer prices when filing your tax return"



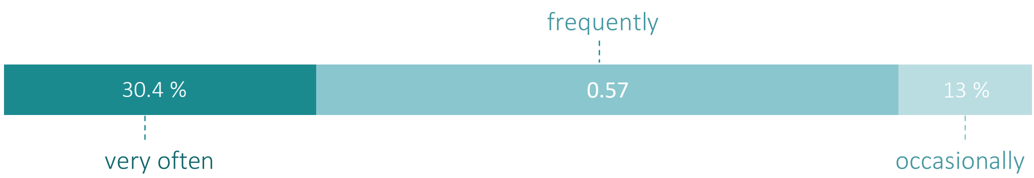
Brazil, among others, was mentioned particularly frequently. This is not surprising, as the Brazilian transfer pricing rules are not based on the arm's length principle and there is currently no double taxation agreement between Germany and Brazil. Interestingly, the problem also exists between EU countries; Italy was mentioned most frequently.

Deviation as the result of an audit

In addition, the deviations (provided for by law) can arise in the course of a tax audit. We asked the participants to indicate how often they had experienced audits leading to deviating tax transfer prices.

All participants have experienced inconsistencies as a result of an audit

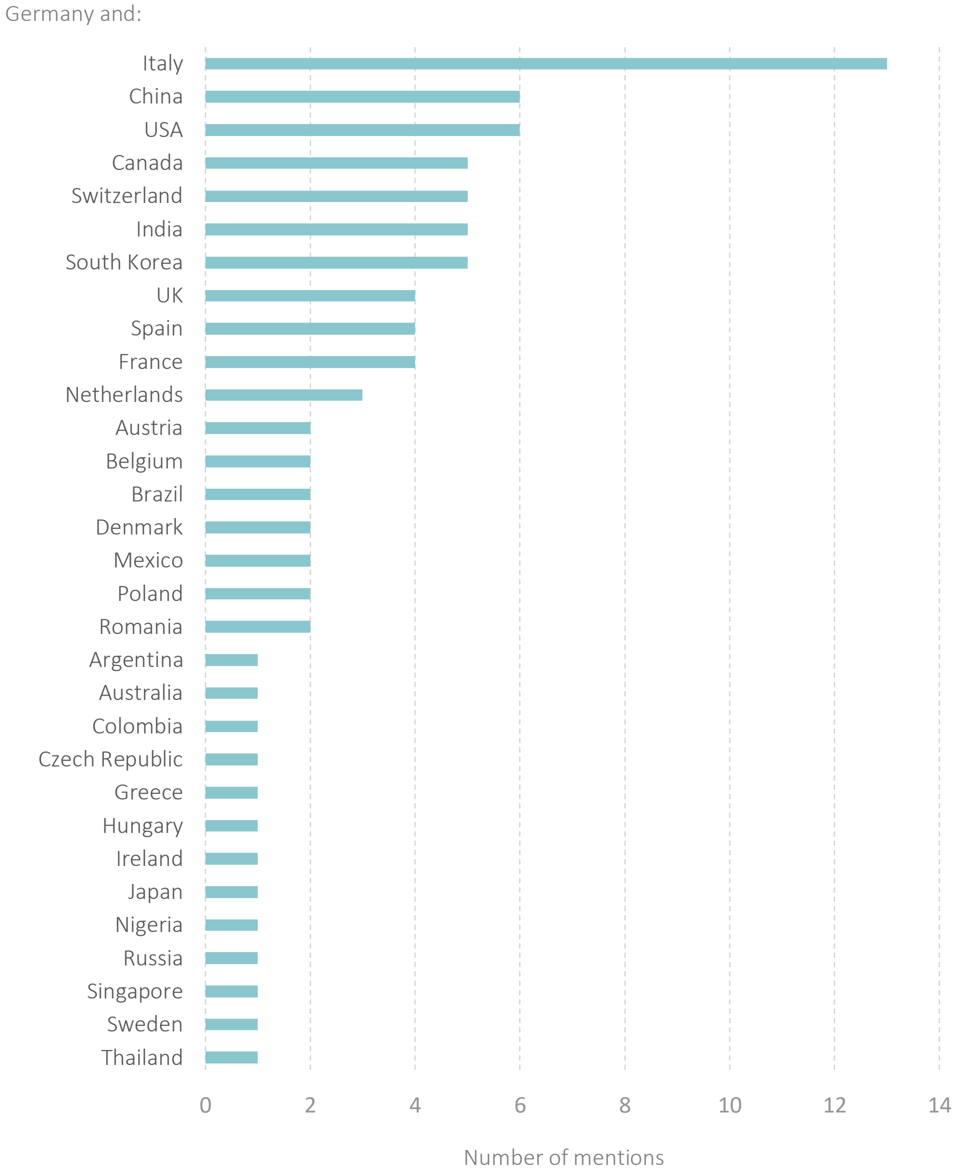
"Have you experienced inconsistencies as a negotiated result of an audit (not a joint audit)?"



All participants have experienced inconsistencies as a result of an audit; 87% say they have experienced this (very) often. Since discrepancies as a result of a tax audit seem to be very common, participants also mentioned more countries with which they had similar experiences. The survey shows that deviations occur in EU countries as well; Italy in particular was often mentioned. In the case of Brazil, on the other hand, there seem to be comparatively few additional deviations *after* the tax return has been filed. One participant mentioned that deviations after audits occur "in all" countries.

Inconsistencies after an audit:
EU countries also often affected

"Please list country combinations where you have experienced divergent transfer pricing as a result of an audit"

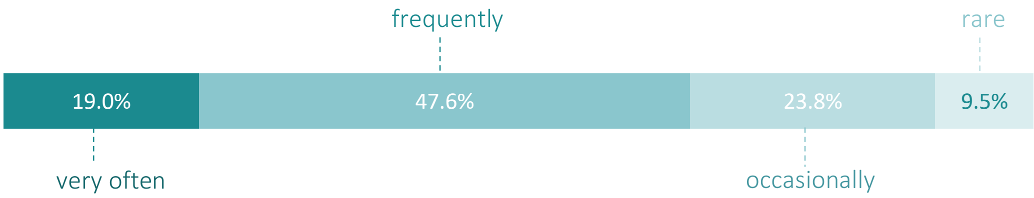


Effects of deviating tax transfer prices

Companies especially see the risk that divergent tax transfer prices could lead to double taxation. The responses of the participants confirm this view.

Inconsistent transfer prices can lead to double taxation

“Have you experienced that different transfer prices (before a possible. mutual agreement procedure) resulted in double taxation?”

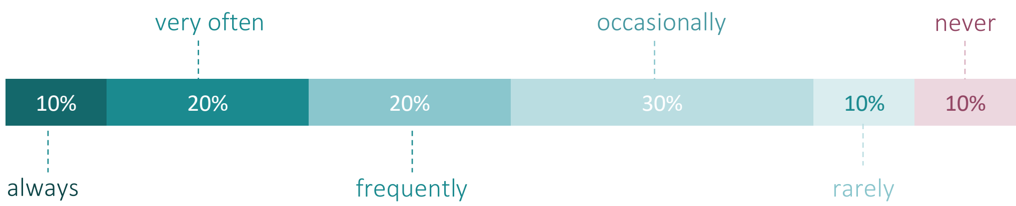


All participants indicated that they have experienced results of tax audits in the countries involved in a particular transaction resulting in (at least temporary) double taxation.

According to the experience of the participants, such double taxation can be avoided in many – but by no means all – cases by means of a mutual agreement procedure.

Mutual agreement procedure not always successful

“Could this double taxation be avoided by means of a mutual agreement procedure?”



However, divergent transfer prices can also result in income not being taxed in either country (undertaxation, so-called white income) – in addition to possible profit shifting, which is also possible in the case of consistent transfer prices.

Undertaxation rarely occurs

“Have you experienced that different tax transfer prices have resulted in an undertaxation?”

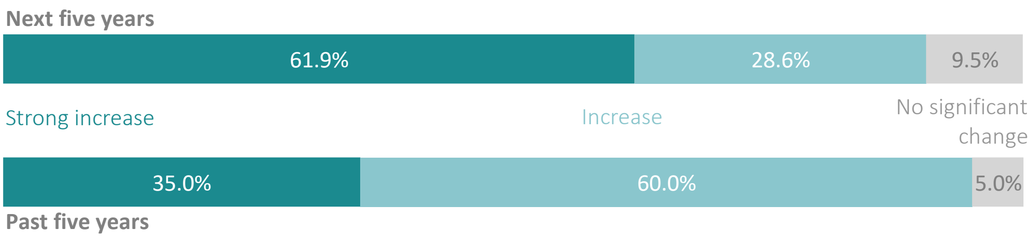
The participants' answers suggest that undertaxation only rarely occurs. Nevertheless, 40% have already experienced undertaxation.

Double taxation on the rise

Within the EU, efforts have been made to harmonize the individual tax systems. In the area of VAT, a uniform framework has already been created with the so-called VAT Directive. Attempts to achieve harmonization in the area of corporate income tax with the Common (Consolidated) Corporate Tax Base (CCCTB) initially failed after a first attempt in 2011; however, work has been underway since 2016 on a new version (within a CCCTB regime, tax transfer prices would be obsolete). As part of the Base Erosion and Profit Shifting (BEPS) action plan, a draft was created by the OECD to align the calculation and documentation of tax transfer prices. The corresponding BEPS Action 13 has already been implemented by many countries. These activities conflict with the efforts of countries to secure or expand their tax revenues, particularly with regard to digital business models which ultimately increase the risk of double taxation. Against this background, it is worth taking a look at the development of experienced and expected double taxation.

(Strong) increase in double taxation in the last 5 years

"Please share with us your assessment of the development over time of the problem of double taxation"



The participants observed a (strong) increase in double taxation as a result of divergent transfer pricing in the last five years. Moreover, they expect a further increase in the next five years. A "decrease" or "strong decrease" is neither observed nor expected. Instead, participants even expect this dynamic to intensify.

Collaborative Research Center

This survey was conducted as part of sub-project A05 of the DFG-funded Collaborative Research Center “TRR 266 Accounting for Transparency”.

TRR 266 Accounting for Transparency is a supraregional Collaborative Research Center funded by the German Research Foundation (DFG). Our team of more than 80 dedicated researchers investigates how accounting and taxation affect corporate transparency and how regulation and corporate transparency impact the economy and society. The goal is to develop effective regulation for corporate transparency and a transparent tax system. In our own research, we ensure transparency as well.

Contact information

We look forward to your suggestions and an exciting discourse on our research results. Please feel free to contact us.

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