

The Efficiency of Transfer Pricing Rules as a Corrective Mechanism of Income Tax Avoidance

Beebeejaun A*

Department of Law, University of Mauritius, Reduit, Mauritius

Abstract

Tax avoidance has always been in the limelight attracting media attention, parliamentary scrutiny and public spotlight. The main actors concerned are the taxpayers, advisers and revenue authorities operating in a complex domestic and global tax environment that give rise to uncertainties, differing interpretations on taxation provisions and an exploitation of the loopholes of the tax system both at the national and international fronts. Much of the literature on tax avoidance calls for radical structural changes including fundamental policy thinking and international cooperation as remedies to tackle the issue of tax avoidance. However, it is important to highlight that tax avoidance needs to be dealt with vigour and public confidence as well since the underlying principle of any taxation system is to treat people in an equitable manner.

Keywords: Pricing rules; Income tax; Parliamentary scrutiny; Public spotlight

Introduction

This paper aims at discussing tax avoidance in the international sphere including the fundamental concepts in tax avoidance techniques and in the process; the notion of tax evasion will also be examined. This paper will also demonstrate the losses incurred by developing countries as a result of loopholes in their domestic taxation systems and will also initiate the investigation of the efficiency of transfer pricing rules and mechanisms by analysing the possible reasons as to why MNEs are being involved in transfer pricing abuses.

Definition of Tax

Before delving into the concept of tax avoidance, this part will provide a brief explanation of the term taxation. The Oxford Dictionary has defined tax as being a compulsory contribution to state revenue, levied by the government on worker's income and business profits, or added to the cost of some goods, services and transactions [1,2]. The OECD back in 1996 has also highlighted the compulsory nature of taxes but has also defined taxes as being unrequited payments to the government [3]. The wording "unrequited" was used by OECD to demonstrate that benefits by government being made available to taxpayers are not normally in proportion to their payments of taxes. In other words, this could mean that some people pay a huge amount of taxes without really recuperating the money or benefits in kind, while others pay no or very little amount of tax but in return, they are entitled to large amount of both monetary and non-monetary benefits from the government whose main source of revenue is taxation. Similarly, Bhatia defined tax as a compulsory levy by government payable by an economic unit to the government without any corresponding entitlement to receive a definite and direct quid pro quo from the government [4]. Such definitions can argumentatively be questioned since on one hand, taxation is meant to correct social injustices by catering for the less well-off ones, while on the other hand, taxation can be a demotivating factor for the working population especially in a progressive tax system since higher income would mean higher tax liabilities to pay to the government without receiving the corresponding benefits.

Definition of tax avoidance

Over the years, tax avoidance has been in the limelight by the government, media and the public at large, and in recent years, the

fight against tax avoidance practices has been amongst the major prerogatives of governments, especially for those in developing countries who are suffering from the adverse effects of tax avoidance.

In its glossary of tax terms, OECD refers to the term "tax avoidance" as simply "avoidance", and the latter term has been described as being a difficult word to define but which is generally used to refer to the arrangement of a taxpayer's affairs that is intended to reduce his tax liability and that although the arrangement could be strictly legal, it is usually in contradiction with the intent of the law it purports to follow [5]. Viewed from this perspective, Gunn (1978) argues that tax avoidance may be used as shorthand for the suggestion that the law needs to be amended so that some who do not pay tax for the time is being, have to pay tax in the future [6]. For instance, the income tax laws need to be changed especially the part on exempt income since most people try to arrange their affairs to ensure that their source of revenues is categorised as an exempt income. This would also mean that those earning a living on interest derived from tax-free bonds will now have to pay taxes if the intent was to avoid taxes once the law has been amended accordingly.

The term "tax avoidance" has no fixed definition and there is no general consensus on a precise meaning, although courts have come up interpreting some practices that may be classified as tax avoidance in case laws. In this pursuit, courts have analysed the definitions of tax planning and tax mitigation to see whether these can be categorised as tax avoidance. For instance, in the New Zealand case of *CIR v. Challenge Corporation Ltd* [7], tax mitigation was described as a practice to reduce or avoid tax by an act which is very much within the ambit of law, and the court further held that there is no offence or illegality where a taxpayer seeks to reduce or avoid his tax liability

*Corresponding author: Beebeejaun A, Department of Law, University of Mauritius, Reduit, Mauritius, Tel: +230 403 7400; E-mail: a.beebeejaun@uom.ac.mu

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by adjusting his income and expenditure in explainable circumstances. On the other hand, tax planning may be regarded as tax avoidance as in the case of *Challenge Corporation Ltd v. CIR* [8], whereby court held that the arrangement has yielded results that Parliament did not intend, and therefore if the tax planning nullifies the legal impact to the extent that it provides a purpose or a base for tax avoidance, then the arrangement is void and the tax authorities are empowered to adjust the income of any person affected by it to counteract the tax advantage obtained by the planning (Iqbal, 2017) likewise the case of transfer pricing in international transactions [9].

Coming back to the OECD definition of tax avoidance, the term has been defined as being in contradiction with the “intent of the law”, and in this respect, it is important to highlight that it is the courts that have the ability to interpret legislations in a way that gives effect to parliamentary intention. The term “parliamentary intention” is in itself quite complex and is the subject of various debates in existing literatures, although there is common consensus that courts construe the intent of parliament as an objective concept limited only to the interpretation of the language used and not a subjective intention of the minister or persons who promoted the legislations. Viewed from this perspective, Lord Hoffman argues that there is only one way to know the intention of the parliament and that is by reading the wordings of the statute [10]. As per this interpretation, an avoidance of tax would imply that a person has not paid taxes that accordingly to a particular statute, ought to have been paid. This reasoning was adopted in the UK case of *MacNiven v. Westmoreland* [11], whereby a particular structure was found not in contradiction of any particular statute and was therefore held to be legal. It is therefore well understood that the activities which courts classify as tax avoidance are legal, as compared to tax evasion that involves deliberate non-disclosures or concealment of any relevant information or the setting up of fraudulent schemes to avoid or reduce the payment of tax liability.

Definition of international tax avoidance

While there is common consensus that tax avoidance is legal although not a moral practice, tax evasion on the other hand, refers to the practice of illegal activities or steps so as to escape from paying taxes. As indicated by Alm and Vazquez and Chiumya, tax evasion occurs when the taxable income, profits liable to tax or other taxable activities are concealed, the amount or source of income are misrepresented or tax reducing factors such as deductions, exemptions or credits are deliberately overstated [12,13]. From this analysis, we can see tax evasion can be characterised by firstly a wilful and conscious intent to violate laws, and secondly, there is a negligence from the taxpayer to honour his tax obligations while disclosing correctly his income revenues but by deliberately engaging into activities that will have the effect of reducing its taxable income. In contrast, as explained above, tax avoidance techniques do not entail breaches of the relevant laws.

At the international level, a study conducted by the Oxford University Centre for Business Taxation (2012) differentiates between ineffective and effective avoidance, in that ineffective avoidance refers to the practice where there is no criminal activity and no failure to disclose information but the legislation or treaties are effective in avoiding the respective tax avoidance techniques. On the other hand, effective avoidance means the successful avoidance of tax which occurs due to shortcomings in legislation or failures in the way the legislation is written that cannot be corrected by purposive interpretation. However, international tax avoidance has been defined as a practice that can neither be categorised as ineffective avoidance nor effective avoidance. Therefore, international tax avoidance occurs when

taxpayers take advantage of the domestic legislation and/or double taxation agreements to reduce their tax liability and that the latter is not paying their “fair share” of tax. For instance, business enterprises within a particular group have the tendency to shift their profits or expenses in countries which have low tax rates in case of profit-shifting, and high tax rates in case of expenditure transfers so as to maximise the value of the group as a whole. This practice is known as transfer pricing which will be elaborated in depth in the following sections.

The Legal Status of International Tax Avoidance

Distinguishing between international tax avoidance which is legal but undesirable, and illegal tax evasion is not straightforward. As detailed above, one way of differentiating between the two is to figure out the intent behind the tax payer’s action in that if the activity has occurred due to shortcoming or loopholes in the legal system, then although it is against the spirit of the law, it will be tax avoidance and hence legal. On the other hand, deliberate actions that result in a reduction or complete elimination of the tax liability have the element of concealment or misrepresentation which therefore results in an illegal manner of evading taxes [14]. Therefore, viewed from this perspective, each activity has to be analysed on a case by case basis in order to classify its legality and for this purpose, the following parts will review some existing literatures and case laws on the categorisation.

Methods of international tax avoidance

It is crystal clear that the non-declaration or underreporting of income, financial assets and income from such assets held abroad to the domestic tax authorities are considered to be tax evasion techniques [15]. Similarly, crass mispricing or unscrupulous transactions with the view to reduce tax liabilities are also tax evading activities. While on one hand, such activities are more likely to be structured by individuals or a limited group of persons, on the other hand, it has been seen that international tax avoidance arises mostly from wealthy groups of persons and from large multinationals although many scholars have advanced that the dividing line is not completely clear. For individuals, various studies and investigations have demonstrated the most common forms of tax avoidance that reflects evasion since the “intent” behind the individual’s activity and omission could be verified and proved, for example, evading taxes on financial investments by human beings have led to revenue losses of US\$36 Billion [16]. The impacts of corporate tax reductions have also been assessed and the revenue losses amounted to an estimate of US\$ 54 Billion to US\$ 133 Billion in 2013 [16]. The figure is on an unprecedented rise since there are several activities undertaken by corporations that are referred to as avoidance but that have been structured in a way that could well be termed as evasion. For instance, Tanzi and Shome argue that in some countries such as India, courts have considered tax avoidance with the intention of evading taxes as tax evasion [17]. In this line of reasoning, referring to a hypothetical example, if Company A operating in a high tax jurisdiction charges low sales price to its affiliate Company B operating in a low tax jurisdiction that what would otherwise be charged much more to an independent party, and pay high prices from that Company B for purchases that would otherwise be much lower if the transaction was dealt in between or amongst unrelated independent parties, then this activity may be categorised as evasion since it involves the deliberate artificial determination of prices resulting in low tax rates for the entire group.

Farok summarised the main seven types of tax avoidance techniques that are commonly used by corporates who exploit the provisions and loopholes granted by the countries involved [18]. One

amongst those is the deferral of foreign affiliate income which goes through several rounds of jurisdiction before landing into the hands of the parent company. This tax avoidance scheme exists because many countries across the globe are taxed on their worldwide income when such income is remitted to their respective jurisdictions. Consequently, if a parent company derives profit from its subsidiary in the form of dividend, interest or profit-sharing, it will need to declare the income which will therefore be subject to tax. As an alternative, MNEs defer those additional taxes by simply not remitting the money to its jurisdiction but rather channel the money to investment vehicles situated in tax havens in order to be reinvested in other foreign corporations [19]. To combat this issue, the US has in the year 2010 enacted the Foreign Account Tax Compliance Act (FATCA) to make it compulsory for foreign financial institutions to report information on US citizens holding assets, or otherwise, penalties up to the amount of 30% withholding rate will be applied to money remitted to the US citizen. Nevertheless, this requires the collaboration and willingness of all parties involved through all the jurisdictions concerned, and the effectiveness of this measure is yet to be determined, which may be a potential avenue for research. The second major form of tax avoidance is transfer pricing, which is the subject of this paper. The rise in the practice of manipulating prices in order to shift profits from high tax to low tax countries have resulted in countries adopting transfer pricing rules and framework to control price fixing. Nevertheless, there are many loopholes in the legislations and the international collaboration of countries is required to combat this form of tax avoidance.

Avoiding taxes also occur through royalty payments on intangible assets and research and development between firms within the same group. MNEs take advantage of such legislations in countries that allow deductions for royalty payment even if the licensee is part of the same MNE or even if no research and development was carried out by the company in the country concerned. Intercompany loans are also considered as tax avoidance since some MNEs make use of debt instruments for the purpose of reducing taxes in high-tax jurisdictions by making its lower-taxed affiliates to lend more to its affiliates who can then benefit from deductions on the interest payments. Some countries have tried to reduce the negative effects of such practice by bringing forward thin capitalisation rules which allow tax deductions on interest only to a certain extent.

Another method of tax avoidance that is also practiced is that the parent company retain the majority of the group's overhead expenditures such as research and development, costs of maintaining brand loyalty, headquarter's administrative costs, human resources expenditures amongst others. One reason advanced by MNE for this practice is that it is not convenient and fair to proportion central overheads to the foreign affiliates (Contractor, 2015), nevertheless, the affiliates are also somehow benefitting from expenditures from the headquarter and thus need to pay their fair share of costs as well. However, the method of proportioning and slicing of overheads is yet to be determined. The practice of roundtripping is also another way to avoid taxes, and this is further accelerated by the use of shell companies with no operation but which only exist for the purpose of channeling money or incurring costs with the view to avoid taxes. Another new form of tax avoidance is the shifting of a company's headquarters to a lower-tax jurisdiction, not many MNEs have engaged in such practice like Contractor has advanced with only 44 occurring in US since 2000 and only 6 in 2015, but with the opening up of the world and easy accession to residency, it is expected that such practices will increase [20].

Further to the above, it is seen that international tax avoidance is practiced by both individuals and corporations, and that losses of tax revenues arise mostly from tax evasion and are most likely to be associated with activities of individuals. On the other hand, corporate tax avoidance is characterised by measures that can either arise from legal avoidance or illegal evasion. The distinction between the two can also be made through those measures or remedies that may be taken to reduce the loss in revenues. The remedies for evasion require resources for enforcement and the legislative enactments of sanctions for being indulged in such activities or if such provisions already exist in the laws, then the imposition of such sanctions, while avoidance is more likely to be tackled with changes in existing tax legislations, by adopting precautionary measures, engaging in a system of sensitisation or issuing guidelines on specific tax avoidance techniques.

A legal analysis of the extent to which international tax avoidance is permissible

The whole debate focusses on the question as to whether there is anything wrong with tax avoidance. Xuereb argues that the logic answer to the query is "no" as it is not a criminal offence to make an effort to pay the least possible tax [21]. By analogy, the author further compares the situation of an investor who looks out for means and ways to invest his money in a manner that brings him the highest possible revenue and in which case, there is nothing illegal. However, in most parts of the world, countries have enacted anti-avoidance provisions either in the form of a separate set of legislation or such provisions are embedded in the respective income tax rules. Arnold is of the view that anti-avoidance provisions are necessary for any tax system in order to ensure that taxpayers cannot avoid obligations that the law seeks to impose by engaging in transactions that are structured to avoid tax payments [22]. From this, we can deduce that tax avoidance comprise of both permissible and impermissible practices. This part aims to highlight the distinction between permissible and impermissible tax avoidance techniques.

Permissible tax avoidance: One form of permissible tax avoidance is the practice of having an in-depth knowledge of tax laws and thereafter making use of such provisions to make adjustments in his or her affairs to avoid tax. This is in line with the well-known case of *IRC v. Duke of Westminster* [23] whereby the court stated that every man is entitled to order his affairs so that the tax attaching under the appropriate legislations is less than it would otherwise be. For instance, if a person transfers assets to another jurisdiction by using a company, and in that country, the company is exempt from tax, then the person is free from tax liability on those assets because the legislator intended immunity to be enjoyed by the respective company to whom the assets have been transferred to. An example of this form of permissible tax avoidance can be found in Lord Templeman's statement in *Craven (Inspector of Taxes) v. White* [24].

Further to the aforementioned case laws, it is seen that there is general consensus that taxpayers have a right to avoid tax in that a person has the individual liberty in taxation to arrange his financial affairs to avoid tax. However, Weisbach questions the validity of the right to avoid tax by arguing that the existence of mechanisms to curtail impermissible tax avoidance does not necessarily mean that the right exists in the first place [25]. The author further argues that there is no constitutional or statutory provision entitling an individual the right to avoid tax and that this right has come up from statements made by judges further to their own statutory interpretation theories. To rebut Weisbach's statement that the right is unconstitutional, one has to

consider the ambit of the right to property which is embedded in most constitutions of several countries. Taxation amounts to a deprivation of property and there is a constitutional right that taxpayers may not be deprived of property except if required by law. It is to be noted that in a South African case law of *First National Bank of South Africa Ltd t/a Wesbank v. CSARS and Another* [26], court has interpreted the term “deprived” to extend to situations where the right to property is interfered with and not only where the property is taken away and that to fully realise the protection of the rights of individuals, property rights of companies and other juristic persons had to be afforded constitutional protection. As such, it does not necessarily mean that the right to avoid tax is not constitutional, and there is no law that state those taxpayers have no right to use legal mechanisms to avoid or limit taxes that are required to pay.

Evolution in case laws has somehow changed the manner in which tax cases are dealt with. In UK, the case of *IRC v. Duke of Westminster* was often cited as an authority in support of a taxpayer’s ability to order his affairs to reduce his tax liability, however, this ability was curtailed by the House of Lords in the case of *Ramsay v. IRC* [27] where Lord Wilberforce stated that it is the task of the court to ascertain the legal nature of any transaction to which it is sought to attain a tax or a tax consequence and if that emerges from a series or combination of transactions, intended to operate as such, it is that series or combination which may be regarded. The Commissioners of income tax are not bound to consider individually each separate step in a composite transaction intended to be carried through as a whole but the Commissioner should find the facts and then decide as a matter of law whether what is in issue is a composite transaction (a transaction which makes sense) or a number of independent transactions (with only form but without substance or justification). In other words, courts now consider whether a pre-ordained series of transactions works towards the achievement of a legitimate commercial end, or whether they are mere steps that have no commercial purpose apart from the avoidance of a liability to tax which would in the absence of those steps, have been payable. The ruling of the Ramsay case may be applied in the international sphere for trade transactions between various countries but a proper monitoring from the revenue authorities of the respective countries is required to identify the independence of the transactions, their occurrence levels and the facts underlying each case.

Impermissible tax avoidance: Case laws have brought about diverging views as to the exact scope of tax avoidance, for instance, Lord Normand said in the case of *Lord Vestey’s Executors and Another v. IRC* [28] that tax avoidance is an evil but it would be the beginning of much greater evil if courts are to overstretch the language of the statute in order to subject to taxation people of whom they disapproved. Kanamugire (2013) further advances that people who practice tax avoidance deprive a country a proportion of income which could well be spent to discharge a state’s responsibility to its people. Consequently, some countries have enacted anti-avoidance rules in their legislations for the purpose of eliminating tax avoidance and therefore, allowing the government to acquire more resources.

Practices that are the target of anti-avoidance rules are struck down by courts if these are prescribed by law or they have been successfully proved. For instance, in Mauritius, Section 86 of Part VII of the Anti-Avoidance Provisions of the Income Tax Act caters for a situation where tax avoidance is practiced through the payment of excessive remuneration to a shareholder or director of a company. In that case, the said Act empowers the Director-General of the MRA to tax the excess or if not all of the amount which in his opinion is not

reasonable to be paid. For practices that are abusive or impermissible, Lord Templeman stated in the case of *Matrix Securities Ltd. v. Inland Revenue Commissioners* [29] that every tax avoidance scheme constitutes of a trick and pretence, and it is the task of the revenue authorities to unravel the trick and the duty of the court to ignore the pretence. Similarly, in *Craven (Inspector of Taxes) v. White*, an artificial tax avoidance scheme to reduce or postpone payment of tax through transactions that serve no business purpose apart from the avoidance of tax, was classified as an impermissible tax avoidance. The absence of business purpose is one amongst the most common features of impermissible tax avoidance.

In South Africa, abnormality in a transaction is an indicator of impermissible tax avoidance. The abnormality test considers whether the arrangement is entered into in a manner that would not have been employed for a bona fide purpose other than to obtain a tax benefit. Judges often refer to the reasoning of Schreiner JA in *CIR v. King* [30] referring to the normal and ordinary course of expectations whereby an owner of an asset is likely to receive income from his asset while a manual worker obtains income from his labour. It is only when this order of events is trampled with that a doubt arises and if the main purpose is found to avoid tax, then the practice is classified as impermissible tax avoidance. Another feature of impermissible tax avoidance practices is the misuse or abuse of tax laws. This requires the involvement of tax experts who have a deep understanding of tax laws and then find out mechanisms to get around with the statutory provisions. In addition, the tax avoidance technique needs to be in line with the parliament’s intention otherwise, simply abiding by the text or literal terms of the law may amount to abuse of law, and in turn, giving rise to impermissible tax avoidance. In addition, impermissible tax avoidance is often characterised by the involvement of multiple parties in a transaction that would ideally involve fewer persons and also, the presence of unnecessary and complex steps that are created to obtain tax benefits.

While it is clear that impermissible tax avoidance can be easily identified from practices that have been prescribed by anti-avoidance provisions in legislations, the difficulty on the other hand lies in identifying those techniques are not provided for in rules and regulations. Kujinga has critically analysed the above-mentioned indicators of impermissible tax avoidance by advancing that those indicators if applied strictly and in isolation would result in overriding statutory purpose [31]. For instance, there is no breach of law if a person engages in an activity for the purpose of obtaining a tax benefit which is legal even if there is no business purpose. In addition, the concept of abnormality is a subjective issue which differs amongst tax experts. Again, a taxpayer has the freedom to choose the most appropriate manner in which he conducts his affairs even if this would mean to differ to the normal ways of doing business provided that such actions are legal. Similarly, for the misuse of laws indicator and the presence of unnecessary and complex steps, it is very difficult to determine with certainty whether these factors would render a tax avoidance scheme as impermissible since the taxpayer’s intention may be hard to decipher. Therefore, there is no fast track rule to consider cases of impermissible tax avoidance, a number of other factors need to be considered as a whole.

Conclusively, it is an undisputed fact that taxpayers aim to reduce their tax liabilities to the maximum and in doing so, some overzealously engage in actions that cross the line demarcating permissible tax avoidance from impermissible tax avoidance. In the realm of international taxation, the issue is most pressing in the arena of transfer

pricing elaborated further below, in the absence of anti-avoidance rules application to all countries. In that case, revenue authorities of each country concerned either rely on indicators of abusive transfer pricing or their own domestic anti-avoidance provisions in their tax legislations. In either case, due to differing jurisdictions and subjective interpretations of the law, the parties in the international transaction are not able to arrive at a common consensus and this gives rise to numerous tax disputes.

Transfer Pricing in International Tax Avoidance

While on one hand, the number of multinational corporations has significantly increased over the years, on the other hand, such emergence has led to the issue of transfer pricing. Cianca argues that multinational enterprises set up subsidiaries in various parts of the globe so as to gain efficiency, economies of scale and to exploit the differences between national tax rates [32]. The ability to relocate profits and expenses within enterprises comprised of a group is known as transfer pricing. The United Nations has also defined transfer pricing as the practice of setting of prices at which transactions occur involving the transfer of property or services between associated enterprises forming part of a multinational group [33]. This practice has become a tax issue when tax authorities start noticing that multinationals are manipulating the transfer prices so as to benefit from low tax liability (Cianca, 2001). Viewed from this perspective, the OECD defines abusive transfer pricing as the improper allocation of income and expenses for the purpose of reducing taxable income [34]. Transfer pricing is therefore a tool used by businesses to achieve the meaningful purpose of profit maximization while at the same time, this may be detrimental to the country that has suffered a loss in potential tax revenues [35]. In this light, this study will elaborate on some existing literature reviews on the implications of transfer pricing, and the main reasons for transfer pricing malpractices as identified by some researches.

Implications of transfer pricing

Easson argues that transfer pricing has more detrimental effects on developing countries than on developed ones since the former are more vulnerable due to the limited knowledge on the subject matter, lack of information, expertise and staff to tackle the issue [36,37]. Viewed from this perspective, a study by Global Financial Integrity (2008) estimates the average tax revenue loss to all developing countries was between \$98 billion and \$106 billion annually during the years 2002 through 2006, which is also equivalent to a loss of around 4.4% of the entire developing world's government revenue [38]. The study analyses the evolution of illicit money flows moving out of the developing countries that have been illegally earned, transferred or utilized and the practice of trade mispricing which refers to the deliberate over-invoicing or under-invoicing of goods and services with a view to evade taxes. The study concludes by arguing that increasing transparency in the global financial system is vital to curb trade mispricing in order to prevent illicit money outflows from developing countries. Coming back to the context of this paper, transfer pricing does not necessarily involve money gained from illicit activities, it may simply refer to the manipulation of prices when dealing with related parties. However, transfer pricing is closely linked to the concept of trade mispricing which somehow related to the Global Financial Integrity's findings of losses to government revenues. Nevertheless, the study was conducted in 2008 and suggestions provide that the statistics have rapidly expanded since then especially with the sharp rise in global foreign direct investment flows of around \$1.8 trillion in 2015 [39].

Another study conducted by Mold estimates that governments

of developing countries lose approximately \$35 billion a year due to tax avoidances practices, and further argues that such nations are more vulnerable to the practice of income shifting than developed countries [40]. This is mainly due to the fact that most developing countries have the primary industries as their primary economic pillar such as the oil and gas industry, which in turn facilitate the shifting of funds through large volume of cross-border transactions in and out of countries, thereby encouraging transfer pricing practices. The issue is on the rise further to the lack of resources of developing countries to control and monitor transfer pricing activities. The study further advances some factors which act as incentives that encourage MNEs to engage in abusive transfer pricing activities in developing countries and the author concludes by putting forward a case for having unitary taxes as a way to avoid tax evasion. Mold (2004) suggest that imposing taxes on the consolidated results of the MNEs as a group and thereafter distributing the tax burden on each entity in the group on the basis of some quantifiable variables like property, sales, labour or capital, would eliminate the incentive to transfer profits to low tax jurisdictions. This method is also known as formulary apportionment, but there is an on-going debate as to whether this type of allocating profits is more efficient than the OECD suggestion to fix transfer prices on the basis of arm's length principle which provide for various types of calculation. The OECD has made it clear that the member countries do not accept formulary apportionment as a realistic alternative to the arm's length principle.

It is to be noted that very few recent systematic researches have been carried out to demonstrate that transfer pricing is used to the detriment of developing countries. One early study carried out by Vaitos in 1977 analysed the pharmaceutical industry in Columbia and revealed that MNEs had overstated transfer prices by rather extraordinary margins [41]. As a result, the additional cost of imports for the pharmaceutical industry alone was estimated at \$20 million annually, thereby giving rise to a substantial loss in government revenue by \$10 million per year. A recent study conducted by the United Nations University World Institute for Development Economics Research (UNU-WIDER) in 2017 and published by Tax Justice Network reveals that the estimated amount of global tax losses due to profit shifting behaviours amongst MNEs amount to approximately \$500 billion annually. The methodology published by researchers at the International Monetary Fund in 2016 has been adopted for the new estimates research and the data shows that countries like Argentina lost 4.42% of their Gross Domestic Product (GDP) due to profit shifting while in Pakistan; the losses were 40% of their tax revenues. The report concludes that in terms of largest tax losses, the rich economies suffer most from profit shifting whilst the lower income countries are the biggest victims of profit shifting. Common consensus amongst the studies enumerated herein agrees that transfer pricing malpractices causes great harm to government revenues which could be used to invest locally in order to promote economic growth and therefore, enhance the standard the living of people living in developing countries. In addition, there is also the issue of ethics involved in the process of transfer pricing.

Some very few literatures elaborate on the link between ethics and transfer pricing practices but the studies each focuses on the assumption that transfer pricing is morally wrong because it harms the society at large. For instance, Mehafdi argues that on one hand, transfer pricing is viewed as a legitimate business opportunity by transnational enterprises but on the other hand, it is used to misrepresent financial success and evade taxes [42]. Mehafdi illustrates the aforesaid argument by advancing the negative impacts experienced by the host developing country through transfer pricing practices namely the loss

of income tax and custom duties, the depletion of natural resources, environmental damage health hazards, while at the same time, the host country is also harmed by psychological feelings of betrayal and loss of trust in multinationals [42]. Consequently, the pursuit of economic opportunity by developing nations has somehow compromised the concept of ethics in business since transfer pricing is causing economic hardship and resource plundering in host countries, thereby leading to unsustainable growth. Sikka and Willmott [43] further supports this view and extends the argument to demonstrate that transfer pricing practices enrich a few people but also deprive millions of people of the developing countries from clean water, sanitation, education, healthcare, pensions, security, transport and public goods [43]. The idea of ethical neglecting is seen through transfer pricing practices that are aimed at enhancing private gains while contributing to social impoverishment by avoiding the payment of public taxes. However, Hanson, Crosser and Laufer examines the relationship between ethics and transfer pricing from a tax perspective, in that as long as the tax reduction method is legal and disclosed to the appropriate tax authority, transfer pricing is deemed to be sound business planning, and the MNEs are not obligated towards the host country in any other way. The same study has also been conducted from a moral ethical perspective and the authors conclude that although tax minimisation is legal, it is imperative for MNEs to consider the impacts of transfer pricing in terms of societal well-being. The literature on the topic of ethics of transfer pricing is however limited to the impacts on the society but little research is based on the ethical dilemmas faced by the MNEs themselves, which may be considered as potential focus areas of research in the future [44].

Factors contributing to transfer pricing

Further to an identification of the impacts of transfer pricing on the host countries, it is vital to consider the factors that give rise to such practices. A study conducted Buckley and Casson highlights the main motivating factor that causes MNEs to engage in transfer pricing being the benefits derived from internalisation [45]. Asquer defines internalisation as the process through which a firm expands its business outside the national or domestic market [46]. Internalisation benefits enterprises within the same group in terms of reduction in transaction costs such as the research, negotiation, monitoring and dispute settlement expenditures which are obstacles to trade dealings between unrelated firms. Differences of cultures and language between various countries are also hampering international trade but through internalisation, multinationals can easily integrate and also, benefit from economies of scale while at the same time taking advantage of the differences in prices and endowments across countries [47]. Nevertheless, a study conducted by Rugman and Eden shows that internalisation across countries has created the opportunity for multinationals to take advantage of the differences in government regulations across nations by transferring profits or activities to less taxed or regulated locations [48]. This practice has been a major cause of concern for developing countries especially since this has also accelerated challenges in the domestic economy of the host country such as cartels or anti-competitive behaviour due to the lack of legal and regulatory framework of competition practices [49].

Apart from internal motivations, other literatures have focusses on some external factors that contribute to transfer pricing techniques. Several economists such as Bartelsman and Beetsma [50], Clausing [51] and Eden and Rodriguez (2006) have put forward the tax reduction motivation for countries to establish and operate part of their business activities in developing countries and to in turn engage in transfer

pricing practices to shift profits. Viewed from this perspective, governments of developing countries have endeavoured to come with a strict enforcement of the tax legislations on the subject matter [51]. However, the study conducted by Bartelsman and Beetsma [50] suggests that while the tax revenues from a more severe enforcement of the rules on transfer pricing can be quite high, this would also mean that the net return on investments of the multinational group falls, and hence, there is a risk that the activity is shifted to other countries with lower tax rates or poor tax enforcement regimes. The authors therefore recommend that the international coordination of all countries is required to fix for a minimum enforcement standard of transfer prices since differences in corporate tax rates between nations create opportunities for multinationals to engage in transfer pricing manipulations.

The determination of transfer prices

Having elaborated on the implications and the main reasons for transfer pricing practices, this part of the literature review aims at referring to the determination of the transfer price. Eden acknowledges that the fixing of an optimal transfer price is a complex decision-making process, and in this pursuit, it is unlikely that MNEs follow the OECD or UN guidelines regarding the determination of an arm's length price, that is the price which is traded between independent unrelated parties in a transaction. Tang conducted a survey during the years 1997-1998, and found that the majority of firms delegate the responsibility for transfer pricing decisions to the parent company, and more precisely, 69% of the MNE respondents have left the determination of transfer prices to the top executives of the parent company without prior consultation with each group companies' executives. Therefore, one could argue that it is the parent company that controls the subsidiary's internal management functions, and Elliot and Emmanuel and Elliot have provided justifications for such practices [52]. Their survey comprised of interviewing 12 UK MNEs that collectively aver that the commercial reality of a transaction requires the inter-connectedness of the parts of the group, and that one single intra-group transaction cannot be considered in isolation from the group's operations as a whole. There is thus a need to centralise the transfer price fixing process and the authors also note that the parent company has the capacity to adjust transfer prices in order to cater for local conditions, for instance, in circumstances where the subsidiaries are in start-up situations, or for fiscal reasons.

Nevertheless, even if the price fixing is carried out at the level of the parent, it is the subsidiary situated in a particular country that will be answerable to the revenue authorities of that country where prices do not meet the arm's length standard or are in contradiction with the local transfer pricing rules and regulations. To combat issues of transfer pricing abuses and to regulate such practices, some countries have legislated provisions that empower the revenue authority to adjust profits or income in transactions between related parties in order to arrive at the arm's length price, which would otherwise be normally concluded in dealings between totally independent parties. Others have come up with more rigid frameworks and solid rules to regulate the fixing of prices in related party transactions.

Transfer Pricing Rules

The scope and structure of transfer pricing rules differ substantially across countries in that some emphasize on the requirements to follow the arm's length principle while others complement these measures by mandatorily requiring corporations to submit documentations to the revenue authorities to justify the prices set. While the methods of profit

shifting and the reasons behind such practices are well document, there is very limited literature available as to effectiveness of legislations to curb transfer pricing abuses.

The effectiveness of transfer pricing rules to limit transfer pricing

Some MNEs engage in profit shifting to low tax jurisdiction through the use of debt instruments. For instance, finances are provided to an affiliate or a subsidiary in the form of loan and in return, interest payments are imposed in a manner that would maximize tax savings for the group as a whole while at the same time affecting a country's tax base. In this respect, some countries have introduced thin capitalization rules as both a corrective and preventive measure to limit profit shifting through debt structuring in a group. Such rules determine the amount of interest that is paid on debt that may be deductible for tax purposes. Buettner et al. has investigated on the impacts of the thin capitalization rules by conducting an analysis of leverage and investment reported for affiliates of German multinationals in 24 countries between the years 1996 to 2004 [53]. The theoretical analysis of the research shows that the restriction of the deductibility of interest payments further to the enactment of thin capitalisation rules limit MNEs ability to shift profits or income with a view to avoid taxes.

Similarly, Blouin et al. conducted a study on the capital structure of foreign affiliates of US MNEs by analyzing thin capitalization rules in countries for the period 1982 to 2004, and found that such rules limit the tax deductibility of interest on the capital structure of the foreign affiliates [54]. Lohse and Riedel added on to this literature by analyzing whether transfer pricing rules reduce profit shifting activities [55]. The authors have collected data on the scope and evolution of transfer pricing laws in 26 European countries, the evidence of profit shifting behaviors in such countries and then merged the information with data on MNEs and corporate tax rules in Europe. Some key highlights of the conclusion of the study show that:

1. Transfer pricing legislations reduce profit or income shifting;
2. The implementation of transfer pricing documentation is found to reduce profit shifting behavior by around 50% on average; and
3. Transfer pricing penalties are likely to exert a limiting effect on shifting behaviors.

While there is common consensus that MNEs engage in transfer pricing to reduce their tax liabilities, one cannot deny that penalties imposed on the respective affiliate or subsidiary is most likely to exceed the tax savings of the group as a whole further to breaches of transfer pricing legislations. Therefore, having a strict system of rules and regulatory framework acts as deterrent to transfer pricing abuses and this is in turn beneficial to the economy as well as the reputation of any country. However, one must also expect the accompanying costs of establishing transfer pricing framework in terms of high administrative burden, compliance costs, tax disputes and thus, a country must be on its guard to look out for transfer pricing mechanisms that are convenient for both the government or revenue authority and the MNE as well for fear that the costs of such rules exceed the benefits obtained. In this light, countries across the globe are struggling to come up with the most appropriate transfer pricing rules and framework, and some countries have adopted the OECD principles on the subject matter.

The OECD suggested approach

Back in 2011, the OECD has issued a suggested approach to the

drafting of transfer pricing legislation which many countries have adopted [56]. The OECD paper sets out the reasons as why transfer pricing rules are required in a country's domestic legislation and emphasises on the arm's length principle as the suggested approach and the basis for regulating transfer prices. Taxes are then imposed on the arm's length prices. Different methods of calculating the arm's length price are provided such as the comparable uncontrolled price, resale price, cost plus, transactional net margin and transactional profit split method. However, all the methods compare prices set in transactions between related party known as "controlled transactions" to that of completely independent parties referred to as the "comparable uncontrolled transaction". Viewed from this perspective, the arm's length approach has been subject to various criticisms one amongst which is the need to identify comparable unrelated party transactions in the hope of using those transactions to determine the terms for the related party transactions [57]. This technique poses much more problems since with the era of globalisation and integration of multinationals, there is an increased economic interdependence of vertically integrated MNEs such as multinational banks, and hence, there would mean that there is very little if not any, comparable transactions [58]. As such, the OECD suggested approach may not be convenient in this current era due to uncertainties and difficulties in conducting comparability analysis.

Sullivan argues that the OECD standard has given rise to futile search for comparable unrelated party transaction which is used as a basis to determine the terms for related party transactions [57]. However, the OECD fails to take into account the economic synergies enjoyed by large corporations namely the economic relationship between entities within a corporate group (the economies of scope) are not the same as those between unrelated parties. Furthermore, the transfer pricing of intangibles which is becoming increasingly popular in cross-border transactions, poses the greatest challenge to the arm's length method. This is mainly due to the fact that intangibles are by their nature unique and this makes it quite difficult to identify transactions between unrelated parties involving the transfer of comparable intangible assets.

Having analysed the results of the application of the OECD guidelines on transfer pricing, Avi-Yonah (2009) points out the following repercussions of the unavailability of useful comparable:

- For the purposes of compliance and enforcement, companies and government channel huge sums of money for the preparation of contemporaneous documentation to evidence the basis of evaluating the arm's length principle. Thereafter, comprehensive examinations have to be carried out by tax officers which make the whole process quite expensive.
- The lack of clear compliance standards along with the ability under the arm's length standard to apportion income to low tax countries through legal arrangements governing the shifting of intangibles and the bearing of risk make it impossible for governments to predict with reasonable accuracy the amount of corporate tax revenue.
- Tax disputes over transfer pricing issues involving billions of dollars are usually settled in either negotiations under tax treaties with foreign governments, or advance pricing agreements, or are settled out of court. This in turn implies that decision making occurs outside the public eye and resolution of issues involving such large amount of money without public scrutiny is not healthy for the tax system.
- Uncertainties in transfer pricing rules degrade the quality of

tax practice from the part of both the taxpayer and the government, thereby resulting in a decrease of publicly perceived credibility of the tax system.

- The application of the arm's length principle is therefore likely to cause losses to both companies and government who spend large sums of money on the preparation of documents to justify the transfer prices and the examinations by revenue authorities' personnels to investigate in each case. The absence of comparable results in uncertain results which not only leaves companies and their investors doubtful about figures in the financial statements, but also degrade the quality and standard of tax practice which is carried out in an arbitrary manner, the cumulative effects of which diminishes the credibility of both the corporations and the government. To address this issue, the OECD along with the World Bank Group has recently issued a toolkit to address the difficulties in performing comparability analysis, which is still at the discussion stage and which is to be used as an illustrative purpose.

Conclusion

This paper has elaborated on literature reviews regarding the losses incurred by a country due to the absence of transfer pricing rules and a strict framework, and the reasons behind MNEs engagement in transfer pricing abuses have also been set out. Since globalisation has entailed with it an increase in foreign direct investment, there is a dire need to control intra-group transactions occurring between locally domiciled MNEs and their foreign affiliates, otherwise, some countries may be blacklisted for facilitating or encouraging tax avoidance techniques due to the lack of appropriate legislations. The paper concludes that there is a dire need for the establishment of a transfer pricing legislation and framework across the globe.

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