Tax Treaties: Transferring Taxes in a Global Economy

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I. Introduction

In the 1990s, Congress passed legislation that currently affects transactions between a parent company and its foreign subsidiary, also known as a transfer pricing transaction. This legislation prevented international companies from illegally circumventing U.S. laws and evading income taxes rightfully owed to the U.S. government. Concurrently, the world economy enjoyed success and companies' financial statements proved it. Despite staggering profits, many multinational companies wanting even more income found a subtle break in the tax code which allows them to pay very little in federal income taxes. For example, in 1998, General Motors Corporation reported a staggering $4.61 billion in pretax income; however, the automaker owed just $36 million or just 0.8 percent of its global pre-tax income, and of that $36 million, General Motors paid only 13 percent or $4.68 million to the United States tax collectors.2 According to section 11 of the Internal Revenue Code, if a corporation's taxable income is greater than $10,000,000 the minimum income tax percentage is at least 35 percent.3 If the 35 percent burden rate was applied to General Motors's pretax income, then it should have paid the U.S. government $1.6 billion in taxes instead of just $4.68 million. Similarly, Motorola Incorporated is in the middle of transfer pricing tax disputes with the Internal Revenue Service (IRS) for a sum of $800 million in back taxes due to same misuse of transfer pricing

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also practiced by General Motors.4 These companies employed an income tax scheme called transfer pricing among their multinational subsidiaries that was not only dynamic, but legal to a certain extent.

An explanation of transfer pricing and its loopholes prior to the revisions in the United States tax code will be presented. Furthermore, tax code revisions from the 1990s will be explored including their benefits as well as their deficiency in establishing equality for global commerce. Critics assert that the current state of international tax treaties is sufficient in alleviating multinational corporations from double taxation and in securing corporate income taxes for the appropriate government. On the other hand, opponents of big business argue that loopholes in the current tax code still exist and further regulations should be instituted. While multinational corporations must be fairly taxed for all business transactions with their foreign subsidiaries, they must not be suppressed through exorbitant double taxes in both the United States and abroad. This equilibrium is best attained through the utilization of further cross-border transfer price recognition, or tax treaties, among countries.

II. TRANSFER PRICING LOOHOLES

Transfer pricing “occurs when a parent company sells a product below or above the market prices to its affiliate to reduce taxes or strip profits from one company to another.”5 Julian Heslop, the chief financial officer of the British Pharmaceutical company GlaxoSmithKline, called “transfer-pricing disputes among the toughest issues for corporations to resolve with tax authorities.”6 Since there is no market price within a company it is difficult to establish a reasonable price threshold.7 One

6 Matthews & Whalen, supra note 4 at A3.
7 See id.
advantage to the parent company is that implementing the strategy "can reduce its reported U.S. income – and increase its subsidiary’s profit." In essence, transfer pricing is a creative way of disbursing costs and profits among scattered business subsidiaries within a multinational company. Since the amount of income tax that a corporation pays is proportional to the amount of taxable income it earns, increasing transfer prices from a subsidiary and to its parent will result in a lower amount of taxable income, and consequently, a lower amount of taxes owed by the subsidiary. By strategically attributing costs and profits to the appropriate business segment through transfer pricing, multinational businesses are able to generate substantial tax savings.

Before adopting new transfer pricing legislation, companies’ profits were unjustly inflated through exploitation of loopholes in the United States tax code. For example, Symantec Corporation owns Veritas Software Corporation in Ireland and began paying large licensing fees in 2005 to its Irish subsidiary where the corporate income tax rate is significantly lower than in the United States. During the course of operations, Symantec’s financial officers realized that if they could pay large licensing fees, they could increase “the income of the subsidiary in Ireland – a lower-tax country – at the expense of income in the United States, lowering the company's overall tax bill.” By using this ingenious tax-planning scheme, Symantec Corporation was able to display a healthy profit by its Irish subsidiary and reduce its income tax liability in the United States parent company.

Transfer pricing merits investigation because understanding how companies exploit it as a tax loophole will preclude multinational companies from evading federal income taxes and from deceiving potential investors. In 1999, Heiko Thieme, a columnist for the Wall Street Journal, dealt with reducing the tax burden on foreign companies that own subsidiary business segments here in the United States. When considering national tax reform, Thieme said “to stimulate and not to discourage should be the philosophy toward corporations and

8 Phillips, supra note 2.
9 Matthews & Whalen, supra note 4 at A3.
10 Id.
individual investors alike.” 11 Since investors use financial statements of multinational companies to make investment decisions, transfer pricing should not unjustly inflated companies’ financial statements. As a case in point, a 1998 tax study showed a $35.6 billion loss in federal revenue in that fiscal year. “Through anonymous customs records, the researchers found $18,000 dot-matrix printers being imported from Japan and $2,600 radial tires coming from Indonesia.” 12 In addition, they discovered someone “exporting $12,000 helicopters to Italy and $135 howitzers to South Africa.” 13 These previous figures represent blatant transfer pricing exaggeration between multinational companies and their foreign subsidiaries. The evidence against multinational companies necessitated new pragmatic tax laws in order to prevent multinational companies from evading taxes owed to the federal government.

Before 1990, the tax code required companies that used transfer pricing for products and services to provide only a calculation of how the transfer price was determined. This left the burden of actualizing calculations to the IRS. 14 In addition, the IRS used a tangible asset transfer price threshold between 50 percent less than and 200 percent more than the market price. 15 Errors in adjustment that exceed $5,000 are subject to investigation. 16 In a case between Yukos Oil Securities, a Russian oil company, and the United States District Court of Southern New York, the Russian Tax Office gave a summary of previous litigation, including an accusation of transfer pricing inflation. According to Russian tax law, a transfer price is too large if it is outside the threshold of 20 percent the market price for the tangible asset. The defendant’s tax strategy did not violate Russian Federal Tax Code. 17 In the United States, this transfer price issue would have been irrelevant due to the freedom that the U.S. tax

12 Phillips, supra note 2.
13 Id.
14 Matthews & Whalen, supra note 4.
16 Id.
17 Yukos Oil Company Securities, supra note 5.
code accorded to multinational corporations at that time; the old tax code was too lax on corporations that embellished transfer prices and their taxable income to countries with lower corporate taxes. The IRS had the power to levy fines, but these fines were not sufficient enough to deter multinational companies from abusing transfer pricing. Foreign subsidiaries and their U.S. parent companies have taken advantage of the inherent enigmatic nature of previous tax law.

III. TAX CODE REVISIONS

Throughout the 1990s changes in transfer pricing regulation assigned and tightened corporate cost-sharing arrangements; the government forces companies to evaluate intangible assets as if the parent company had sold them to an unrelated company, ensuring that both the buyer and the seller remain free to pursue their own interests. In his book, Transfer Pricing Under US Law—The New Regime, John McDermott outlines the evolution of section 482 of the tax code with respect to transfer pricing. In 1986, Congress commissioned the IRS to analyze Section 482 of the U.S. tax code and make appropriate recommendations in order to close tax loopholes found therein. Subsequently, in 1992, Congress incorporated the IRS's income-based method for determining the transfer price of "high-profit" intangible assets into the U.S. tax code. In the new income-based approach, the value of tangible and intangible assets is proportional to the amount of income the asset generates. Later in 1993, the proposed final regulations took precedence over the majority of previous regulations, taking effect in October 1994. The regulations focus on the following alternative price methods: income, comparable uncontrolled transactions, and other factors. This 1994 addition is classified as the "best method" rule. Its aim is to produce the most reliable measure of an arm's length result or market-place value.

As previously discussed, the United States revolutionized its corporate cost-sharing arrangements and thus led the way toward a new model of dispute resolution for transfer pricing among foreign countries. This stream of legislation during the 1990s led to the creation of the Advanced Price Agreement or APA program. The APA process is an alternative to the standard taxpayer path of completing—transactions, filing a return, facing audit (some level of audit is more likely with larger taxpayers), and possible appeal with settlement or litigation. The general requirements of an APA comprise the following: an indication of the currency used for transactions, statutory provisions, tax treaties, court decisions, regulations, and revenue rulings or procedures. The taxpayer initiates the APA process by approaching the IRS (and typically the corresponding tax authorities in the other relevant jurisdictions) before engaging in the related party transactions potentially at issue. At this point, the taxpayer voluntarily provides detailed information to the governments regarding its business activities, plans, competitors, market conditions, and prior tax circumstances. The critical piece of this presentation is the taxpayer’s explanation of his or her planned pricing method. Following discussion and negotiation, the parties hopefully reach agreement on how the taxpayer should handle the pricing of these anticipated related party transactions. Furthermore, the IRS may now levy a penalty from 20 to 40 percent of the transfer price, in addition to back taxes commensurate with the infringement, when the infraction results in a “gross valuation misstatement” in order to discourage further exploitation of transfer pricing laws. Yet, if companies can show they made a good-faith effort to formulate a reasonable transfer price, the IRS will avoid attributing a penalty.

Although these new regulations to the tax code effectively inhibit companies from evading taxes they owe on tangible assets, it is still difficult to regulate the transfer price a company assigns to its intangible assets. The new tax code addresses abuses in the valuation

21 McDermott, supra note 19, § 3.1.4, at 127.
22 Matthews & Whalen, supra note 4.
of intangible assets such as brand names, patents, and research and development costs that a company assigns to its products. For example, the value of a French research team would be considered a pre-existing intangible asset; others who purchase the drug that the research team developed, including a subsidiary company, would have to buy the asset at a price that includes the cost of the French research team. Some may argue the new transfer pricing rules are more effective than those preceding them; however, it is still impossible to assign a value to intangible assets that are involved in transactions between foreign subsidiaries and their parent companies. Assigning a price to a new and revolutionary product can be difficult. Nevertheless, the new code includes specific valuation methods permitting a more accurate transfer price assignment to innovative intangible assets. For example, prior to the new transfer pricing regulations U.S.-based multinationals recurrently developed a patent for a valuable drug in the United States. After they concluded that the drug would be a worldwide winner, they would confer the patent to an offshore affiliate. The new code requires a comparison of the patent’s transfer price to a similar patent’s transfer price. In order for the intangible asset to be comparable, one of the following conditions must be met so that the intangible asset is comparable: both must be in the same general industry, both must have a similar profit margin, or both must be used in the same general process.

Even if the company takes a somewhat liberal approach to determine the transfer price for a revolutionary intangible asset for which no comparable products exist, the IRS will avoid levying a penalty if the company has documented research used in calculating the transfer price. The IRS’s new valuation method is not only dynamic but progressive because it allows companies to estimate when creating a transfer price for an intangible asset that may have

23 Wells, supra note 18.
26 Matthews & Whalen, supra note 4.
never before existed. Opponents of this type of valuation system might argue it accords too much liberty to multinational companies when determining a transfer price. However, the transfer pricing study that the IRS requires measures an intangible asset, which is often unique in purpose, and therefore any efforts made to determine its price are better than none at all. If this new law on intangible asset valuation were not in place, multinational corporations in the United States would still be exploiting loopholes in the tax code and grossly understating their taxable income. Although they are more difficult to valuate because of the new tax code, a corporation’s intangible assets are subjected to more scrutiny than in the past.

IV. US TAX PROGRESS

The IRS is fighting the battle against multinational corporations who have misused transfer pricing in the past, evidenced by their recent out-of-court settlement with GlaxoSmithKline PLC, a pharmaceutical company based in the United Kingdom, and its United States subsidiary. Glaxo v. Commissioner was originally filed in 1992 when “the Commissioner began an examination of Glaxo’s tax returns for 1989 and 1990,” and the parties settled out of court in February 2006 in light of the new ameliorations in the U.S. tax code concerning intangible assets being traded at “arm’s length” between parent companies and their subsidiaries. The case was the largest transfer price tax case in U.S. history and highlighted the IRS’s new-found resolve to crack down on transfer pricing offenders by proving that Glaxo’s United States subsidiary had grossly overpaid its British parent for drugs, significantly reducing its tax bill. The settlement constitutes $3.4 billion including back taxes owed and also a 40 percent penalty based on the total amount of back taxes.

Many contest that the performance of the IRS’s prosecuting attorneys was negligible despite their utilization of the new tax laws. Philip R. West, a tax partner at Washington law firm Steptoe & Johnson

stated "over the past ten to twenty years, the government has brought a good number of transfer-pricing cases and come away with clear victories in very few of them."\textsuperscript{28} Leon Harris, a tax expert from Ernst & Young Multinational pointed out that transfer price cases litigated against Asian corporations in the 1980s did not succeed.\textsuperscript{29} It is important to note the majority of transfer price cases settle out of court and therefore are not prone to have a clear-cut victory for either side. In spite of all this, the IRS is confident that with the new tax code it can win the majority of transfer price cases it will litigate against major corporations in the future. With respect to the Glaxo case, IRS Commissioner Mark Everson said, "The settlement of this case sends a strong message of our resolve to continue to deal with this issue."\textsuperscript{30} Clearly, the IRS has begun to be victorious in litigating and reaching favorable settlements against multinational corporations who have exploited transfer pricing loopholes because of the tax code's revision during the 1990s.

V. FUTURE PROGRESS NEEDED

The U.S. tax code must continue its strict regulation of multinational companies' transfer prices, without suffocating them through excessive double-taxes in both the United States and in the subsidiary's country. Some believe it would be more beneficial for the United States to isolate itself from foreign competition by levying high taxes on foreign multinational companies which employ transfer pricing. While this belief is convincing, it is not entirely based on facts. When the IRS issued its new regulations requiring subsidiaries' transactions to be at "arm's length," many multinational companies started shifting their inter-company transfer prices in favor of the United States at the expense of the treasuries from their native countries. This was harmful to foreign economies because foreign subsidiaries shifted an unequal portion of their profits toward their

\textsuperscript{28} Matthews & Whalen, \textit{supra} note 4 at A3.
\textsuperscript{29} Leon Harris, Transfer Pricing Proposals, Jerusalem Post, June 28, 2006, at 18.
\textsuperscript{30} Matthews & Whalen, \textit{supra} note 4.
parent companies in the United States.\textsuperscript{31} Consequently, most first world countries have developed their own transfer pricing regulations in order to prevent their respective multinational companies from unjustly reducing their taxable income, which reduces the amount of income tax the company will pay to its respective government.\textsuperscript{32} These circumstances create a bothersome situation for subsidiaries and their parent company in all countries, called double-taxation, which exposes multinational companies to taxes in both the subsidiary's country and the parent's country. This is especially detrimental to the U.S. economy because it has traditionally possessed a 35 percent corporate income tax rate which impedes growth in multinational companies, and therefore creates a serious incentive for multinational corporations to leave the country with the highest tax burden.\textsuperscript{33}

In the United States, when the IRS adopted its 1990 tax code revisions it also proliferated the international transfer price double-taxation dilemma. Fortunately, the United States has addressed this problem with other countries by initiating cross-border transfer price recognition, also called "tax treaties." Tax treaties are conceived for the following two reasons: to avoid double taxation by the two treaty countries of the income of a resident of either country, and to prevent the fiscal evasion of either company to its respective country.\textsuperscript{34} In addition, tax treaties "also serve a third purpose, the reciprocal reduction of tax impediments to cross border investment and trade."\textsuperscript{35} In her article published in the New York University Law Review, Dr. Ruth Mason stated that tax treaties help combat tax avoidance through exchange of information among multinationals

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\item \textsuperscript{31} Harris, \textit{supra} note 29.
\item \textsuperscript{32} \textit{Id.}
\item \textsuperscript{33} Phillips, \textit{supra} note 2 at A1.
\item \textsuperscript{34} Present Law and Certain Issues Relating to Transfer Pricing (Code Section 482): Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways And Means, 101st Cong. 17 (1990) (prepared by J. Comm. on Taxation).
\item \textsuperscript{35} Pending Bilateral Tax Treaties And OECD Tax Convention: Hearing Before the Comm. on Foreign Relations, 101st Cong. 9 (1990) (statement of Kenneth W. Gideon, Assistant Secretary for Tax Policy, U.S. Department of the Treasury).
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and their respective countries. In order to promote these causes, tax treaties stipulate that if the parent company’s country to which the asset is sold recognizes the tax already paid by the subsidiary to its respective country, then the parent company avoids double taxation. Tax treaties “include provisions intended to ensure that cross-border investors do not suffer discrimination in the application of the tax laws of the other country.” Tax treaties benefit both countries that use them because they determine where transfer price penalties are paid if an infraction does occur, with respect to both countries’ tax laws.

Although many tax treaties exist with a large number of foreign countries, the United States must endeavor to establish tax treaties with groups of associated foreign countries and unions in order to maximize economic gains by foreign governments and their businesses. In a case study published in the *Brooklyn Law Review*, Professor Allison Christians, who does not endorse tax treaties, states that the United States has not yet enacted tax treaties with every foreign country:

Not all countries have tax treaties, and no country has tax treaties with all the other countries of the world. The average individual tax treaty network comprises just 17 treaty partners, and over half of all countries have tax treaty networks of five or fewer treaty partners. In addition, the benefits of treaties are typically limited to activities conducted between the two signatory countries. As a result, there would have to be over 32,000 bilateral tax treaties to cover every possible cross-border transaction. The U.S. would

have to enter into new treaties with over 160 countries to ensure that its coverage spanned the globe.\textsuperscript{38}

The United States could attempt to establish tax treaties with each and every remaining country, a time-consuming task, or the United States could develop tax treaties with groups of associated countries. Indeed, this method would conserve time and promote world trade among the United States and the foreign countries with which it already does business. Although tax treaties exist between the United States and most member countries of the European Union, the utility of cross border transfer price recognition treaties with European Union members is suspect. For example, the European Court of Justice ruled that the French government was not required to grant a cross-border transfer price credit to one of its citizens who earned income in Germany; therefore, Germany and France both taxed the citizen’s transaction.\textsuperscript{39} “Following such an adverse ruling...the Member States presumably would pressure the United States to remove the offending provisions from their tax treaties.”\textsuperscript{40} Unless the United States accommodates the European Union and its members by establishing multilateral tax treaties covering the European Union as a whole, transfer pricing penalties in absence of such treaties will suppress global economic prosperity. Although a multilateral tax treaty with the European Union was discussed, this is merely one type of tax treaty the U.S. Government must strive to establish with foreign unions and individual countries in order to ensure that multinational corporations are taxed fairly.

VI. CONCLUSION

Transfer pricing in today’s global economy is a controversial subject that continues to be a source of litigation in the United States tax

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39 Mason, supra note 36, at 93.
40 Id. at 104.
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court. Now multinational companies have little hope of circumventing the transfer pricing tax code, whereas before the 1990s tax reform, multinational companies utilized transfer pricing schemes in order to transfer taxable income to countries where the corporate income tax rate was much lower, and complicated topics in the domain of tax law due to its enigmatic nature. Before the 1990s tax reform, legislation allowed multinational companies to calculate their own transfer prices for transactions between parent companies and foreign subsidiaries. But with the advent of progressive tax laws, multinational companies must now assign a reasonable estimate to all transferred assets. Furthermore, transfer prices for intangible assets must be derived from a number of valuation methods: both assets must be in the same industry, both must have a similar profit margin, or both must be used in the same general process. Because of this evolution in the tax code, the IRS is fighting and winning many transfer pricing cases as these multinational companies continue to stretch the tax code to its limits.

The IRS’s most recent tax case against Glaxo Smith Kline highlights the pragmatic nature of the United States’ tax code against multinational companies that infringe transfer pricing tax law. Yet even as it punishes tax-deviants, tax legislation must deal with multinational companies fairly and avoid submitting them to double-taxation by neglecting to form tax treaties. By coordinating with foreign governments to establish in which country, and under what conditions, a multinational will pay back taxes and penalties for transfer pricing infringements. The United States must continue to form tax treaties with countries individually or in groups in order to regulate transfer prices and all the while eliminating double-taxation. As tax evasion strategies of multinational companies in the United States evolve, the tax code must adapt with transfer pricing legislation to establish equality for global commerce among multinational companies and their respective governments.