Statement of the U.S. Chamber of Commerce

ON: **TRANSFER PRICING**

TO: **THE HOUSE COMMITTEE ON WAYS & MEANS**

DATE: **AUGUST 5, 2010**

The U.S. Chamber of Commerce is the world's largest business federation, representing the interests of more than three million businesses and organizations of every size, sector, and region.

The Chamber's members are businesses of all sizes. Our membership consists of small businesses with 100 or fewer employees, 70 percent of which have 10 or fewer employees. Yet, virtually all of the nation's largest companies are also active members. We are cognizant of the problems and challenges facing the business community at large.

Besides representing a cross-section of the American business community in terms of number of employees, the Chamber represents a wide management spectrum by type of business and location. Each major classification of American business -- manufacturing, retailing, services, construction, wholesaling, and finance – is represented. Also, the Chamber has substantial membership in all 50 states.

The Chamber's international reach is substantial as well. It believes that global interdependence provides an opportunity, not a threat. In addition to the U.S. Chamber of Commerce's 105 American Chambers of Commerce abroad, an increasing number of members are engaged in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Positions on national issues are developed by a cross-section of Chamber members serving on committees, subcommittees, and task forces. More than 1,000 business people participate in this process.

Introduction

The Chamber thanks Chairman Levin and Ranking Member Camp for the opportunity to comment on transfer pricing issues.

Transfer pricing is a complex issue, which seeks to address how to allocate profits for tax and other purposes in international business transactions among different parts of the same multinational corporate group. With increasing globalization and increasing numbers of multinational corporations, the importance of transfer pricing is unquestionable. Attempting to mitigate many of the complexities surrounding transfer pricing issues, the Organisation for Economic Co-operation and Development (OECD) has adopted the arm's length principle (ALP) for evaluating transfer prices in these international transactions.

The Chamber believes that before this Committee considers any deviation from this globally accepted principle, it must give serious consideration to the impact of this deviation. The Chamber has significant concerns that departure from this standard would subject these groups to an increased potential for double taxation, have negative implications for the competitiveness of U.S. multinational groups, and have detrimental impacts on the job creating capabilities of these groups.

Transfer Pricing

"Transfer pricing" refers to the prices charged, or the process for arriving at them, in cross-border transactions among related entities. It is the means by which multinational corporate groups apportion their income for income tax and other purposes among the different countries in which the businesses operate.

For example, assume a U.S. based multinational corporation manufactures and sells pharmaceuticals. The U.S. parent corporation has two subsidiaries: one located in Ireland and another located in Canada. The U.S. corporation provides product research and development. The Ireland subsidiary provides manufacturing and logistical support. The Canadian subsidiary provides marketing and distribution services in connection with sales made by the U.S. corporation to the Canadian market. Transfer pricing is used to allocate the overall profits from this endeavor among the three related entities.

Transfer Pricing, the Threat of Double Taxation, and Impacts on Competitiveness and Job Creation

Transfer prices serve important purposes. They can help the group identify what parts of its operations are performing well and what parts are underperforming. Further, without proper transfer pricing, the group could be subjected to double taxation. When groups are subject to double taxation, their ability to compete is hindered, and their ability to create jobs is stunted.

For example, consider a French bicycle manufacturer that distributes its bikes through a subsidiary in the Netherlands. The bicycle costs $900 to make, and it costs the Dutch company $100 to distribute it. The company sets a transfer price of $1,000 and the Dutch unit retails the bike at $1100 in the Netherlands. Overall, the company has thus made $100 in profit, on which it expects to pay tax.

But suppose the Dutch company is audited by the Dutch tax agency, and they notice that the distributor itself is not showing any profit: the $1000 transfer price plus the Dutch unit's $100 distribution costs are exactly equal to the $1100 retail price. The Dutch tax agency wants the transfer price to be shown as $900 so that the Dutch unit shows the group's $100 profit (that would be subject to tax in the Netherlands). But this poses a problem for the French company, as it is already paying tax in France on the $100 profit per bicycle. Because it is a group it is liable for tax in the countries where it operates and in dealing with two different tax authorities it cannot just cancel one out against the other. Nor should it pay the tax twice.

Double taxation is not an isolated detrimental effect of inconsistent transfer pricing rules. When companies face double taxation, this increases the costs of doing business for companies and undercuts their ability to compete. When companies cannot compete, they simply cannot give back to the economy, and, thus, job creation is stunted and investment is limited.

<u>The Global Standard: The Arm's Length Principle (ALP)</u>

To avoid the issue of double taxation and its ensuing negative ramifications, OECD international guidelines provide that a transfer price must meet an arm's length principle (ALP), which means generally that a transfer price should be the same as if the two companies involved were indeed two independents, not part of the same group. The OECD transfer pricing guidelines were first issued in 1995 and established the ALP as the international norm, which most countries accept and follow. The ALP is found in Article 9 of the OECD Model Tax Convention and serves as the framework for bilateral treaties between OECD countries and many non-OECD countries as well. The Internal Revenue Code, Treasury regulations, and U.S. case law all encompass the ALP.

The ALP represents the global standard for evaluating transfer prices in international transactions. Over the past several years, the OECD has focused significant attention on the ALP as embodied in its transfer pricing guidelines. The OECD undertook a detailed review based on the experience that tax agencies and taxpayers have gained since 1995 in applying the guidelines. This work culminated in the release last year of proposed revisions of the transfer pricing guidelines. This discussion draft reflects a reaffirmation by the OECD of the ALP.

The proposed revisions reflect a renewed commitment by the OECD to maintaining the ALP as the international consensus. Armed with 15 years or more experience since the guidelines were first issued and cognizant of the global economic developments that have made the world more interconnected than ever, the OECD continues to endorse the ALP as the right standard. Thus, the ALP will continue to govern the evaluation of transfer prices in the global community.

Departure from the ALP

The Chamber believes that the ALP represents a balance between the interests of corporations trying to compete globally with tax agencies seeking to receive a fair share of the tax base. The Chamber acknowledges that applying the ALP is not always simple and finding comparable market transactions to set a transfer price can be both challenging and time consuming. However, the Chamber believes that currently proposed replacement systems or modifications deviating from the ALP would be extremely complex to administer and would increase the risk of subjecting companies to double taxation, thus hurting their competitiveness and job creating capabilities.

The most commonly suggested alternative to the ALP is a formulary apportionment system, which splits entire profits of a corporate group among all of its subsidiaries, regardless of location. However, the Chamber believes this approach has not been proven to be better than the existing ALP since the mere act of building of this formula makes it clear what the outcome is intended to be and who would win and lose under any given set of factors.

Tax agencies would want the formulaic inputs to reflect their own assessments of profit and more challenging issues, such as how to apportion intellectual capital and R&D, would likely become highly contentious. Further, if the apportionment were based on something like the percentage of payroll paid in the United States versus abroad, such a system might create a perverse incentive to relocate jobs overseas to lower companies' overall tax burden, an objective completely contrary to stimulating U.S. job creation and economic growth.

Compounding these challenges is the fact that no alternatives to the ALP have been shown to be capable of winning international consensus. Unless foreign countries adopted a similar formula – and, as noted, virtually all use the current ALP – the result could be double taxation.

The Chamber believes the ALP avoids these problems as it is based on real markets. It is a longstanding principle, has been continuously studied, and provides both multinational groups and tax agencies a single international standard for agreements that provide these agencies a fair share of tax revenues while simultaneously avoiding double taxation problems. Further, the Chamber believes that the ALP is flexible to meet new challenges presented by both globalization and e-commerce.

Conclusion

The Chamber appreciates the opportunity to comment on the transfer pricing rules. The ALP is a global standard, which strikes the right balance between the need of countries to protect their tax base and allowing companies to avoid double taxation. If the U.S.

departs from this standard there is a risk of saddling companies with double taxation, hampering their competitiveness and hurting their ability to create jobs.

The Chamber looks forward to working with Congress and the Committee to help keep American worldwide companies competitive in a tax and regulatory environment that is pro-economic growth and pro-business.