The FfD Chronicle

CIVIL SOCIETY FINANCING FOR DEVELOPMENT Mechanism

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TRANSFER PRICING: THE TIME HAS COME TO THINK "OUT OF THE BOX"

As discussions on Protocol 1 continue, and the obsolescence of the notion of permanent establishment finally emerges in the debates, we must not lose sight of the bigger picture: the deeply flawed transfer pricing system, which goes far beyond the narrow issue of taxing cross-border services in a digitalized world.

One truth is worth being repeated again and again: as long as we remain trapped in a system based on transfer pricing – a reflection of one of the greatest fictions of the 20th century, namely that a multinational and its subsidiaries are independent entities – each country is left to fend for itself in raising tax revenue that it should rightfully be able to collect. This is perhaps the most expensive fiction in modern history.

France's digital services tax (DST) is a telling example in two ways. First, it represents a successful short-term attempt to move beyond the constraints of physical presence and permanent establishment in order to collect more resources. Second, it is proof that by envisioning new nexus rules and by taxing a multinational based on its real economic activity within a territory, it is indeed possible to mobilize additional tax revenue.

In a digitalized world, where physical borders no longer matter for digital activities and many services, such an option should, in the short term, be available to all countries. But are DST a panacea, the cure to all fiscal ills? Obviously not!

In the longer term, the main goal of the Framework Convention must be achieved: ensuring fair and effective taxation of all multinationals. And to do so, the only real solution is to end this century-old fiction, to turn the page on transfer pricing, and to build a system that taxes multinationals for what they truly are: global entities. A system based on their worldwide profits, allocated fairly among countries according to the real share of their economic activity. In other words, it is time to move to unitary taxation with formulary apportionment.

In this respect, the work under Protocol 1 should support this much broader ambition and complement the structural reform envisioned under Workstream I and the Framework Convention.

"Developed countries often argue that the key to improving domestic resource mobilization in developing countries is capacity building and technical assistance so that they can apply transfer pricing rules."

Seasoned readers will recognize this line from the Workstream 2 Issues Note. But – spoiler alert – this statement is simply false! If, as some Northern countries claim, the problem was merely one of capacity, then these same countries should by now have demonstrated that they have the capacity to make the transfer pricing system work at home – to effectively tax multinational activities, and to collect revenues commensurate with them. Yet they, just as much as countries in the Global South, are INCAPABLE of doing so when faced with the absurdities of the transfer pricing system.

A brief look at Europe makes this clear. Famous cases on tax state aid have exposed the failures of this system and the inability of Northern countries to make transfer pricing work. The Starbucks case, for example, showed the impossibility – within the transfer pricing fiction – of finding "comparable" prices. The Apple case, meanwhile, laid bare the absurdity of advance pricing agreements.

In short, what needs to be "transferred" is not capacity, but rather the courage to end a fiction – to abolish a system, transfer pricing, that simply does not work. For this, it is high time to think "out of the box," because outside that "box" lies, without a doubt, the key to ensuring fair and effective taxation of all multinationals: unitary taxation with formulary apportionment. And, while Protocol 1 has an essential role to play in this area, it is within the framework of Workstream I, and thus the framework Convention that this new key must take shape – notably by giving a clear mandate to the Conference of the Parties to implement genuine unitary taxation.

LOST IN ARBITRATION

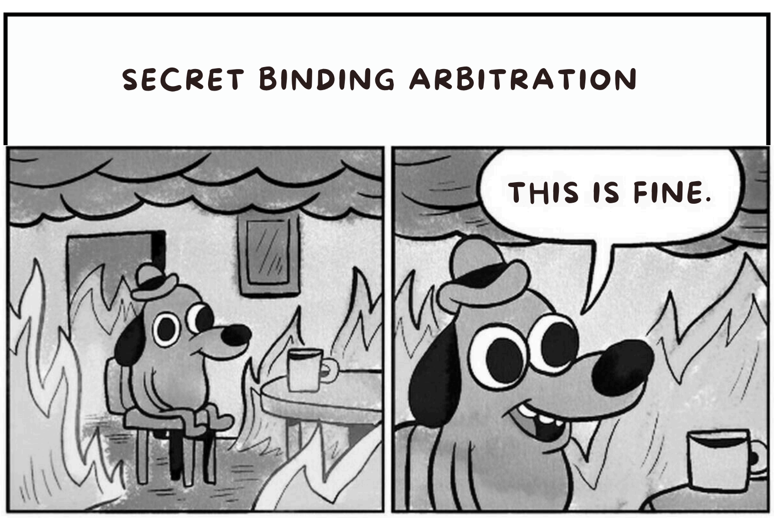
In 2022, the European Union (EU) adopted a “regulation on an emergency intervention to address high energy prices” – including the so-called “solidarity contribution”. For a limited period of two years, the legislation introduced windfall profit top-up levies on energy undertakings in the oil, gas, coal and refinery sectors in the EU.

This kind of initiative provides an interesting and important example for how a “polluter pays tax” on profits from environmentally damaging business activities could be designed. In fact, the attentive reader will recall that a proposal for such a tax – including at the global level – was presented in the FfD Chronicle already last week.

But alas, it turned out that the idea of “solidarity” did not appeal to the fossil fuel industry. During their short lifetime, the temporary EU levies managed to become subject to several lawsuits and – you guessed it – arbitration!

Faced with the prospect of increased taxation on its highly profitable oil refinery business in Europe, the Jersey-based Klesh Group Holdings Limited dug out the old “Energy Charter Treaty” of 1994 and started an arbitration case targeting Germany, Denmark and the EU.

While the process is still ongoing, the Tribunal issued a decision on provisional measures in July 2024. Specifically, Germany was ordered to refrain from collecting the contribution from the Klesch Group’s refinery in Germany while the case is ongoing. The decision also notes that Denmark had already decided to put the collection of the solidarity contribution on hold.



The concerns with the Energy Charter Treaty are not new, and in June 2024, the EU decided to leave. Sadly, breaking up with the Treaty is complicated by a ‘sunset clause’, which states that existing investments are protected for a period of 20 years after withdrawal. The EU is currently discussing potential ways of neutralizing this clause and meanwhile, a number of countries from Europe, the Middle East and Asia remain parties to the controversial treaty.

Now, the tax specialist might argue that the Energy Charter Treaty is an investment agreement – not a tax agreement. True that. But the core approach of handing over a country’s tax sovereignty to a small closed club of “arbitrators” is concerning regardless of which treaty forms the basis. The UN Tax Convention negotiations must learn from the past, and reject the idea of secret binding arbitration.

TIME TO THINK OUTSIDE OF THE BOX...