Developing-Country Revenue Mobilization: Suggested Revisions to the "TNMM" Transfer Pricing Method

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Summary

- This presentation recommends a change to one of the OECD's transfer pricing methods, the Transactional Net Margin Method (TNMM).
- The proposed revisions are based on the observation that TNMM in its current configuration may be excessively limiting corporate tax revenues in countries around the world, including many developing countries.
- In particular, these proposals address problems raised by a particular tax planning strategy used widely by MNEs, the "zero-tax hub" structure using "risk-limited subsidiaries."
- The proposed modifications to TNMM also would seek to reduce profit-shifting through the use of related-party debt.

The “Hub” Tax-Planning Structure

- Multinational group establishes one or more subsidiaries (which might be shell or near-shell companies) in zero- or low-tax jurisdiction (e.g., Bermuda or the Cayman Islands).
- Group will, of course, already have in place subsidiaries in countries around the world performing various functions including distribution, manufacturing products to the group’s specifications (“contract manufacturing”), and performance of services for the group like R&D, data processing, and the operation of customer call centers.

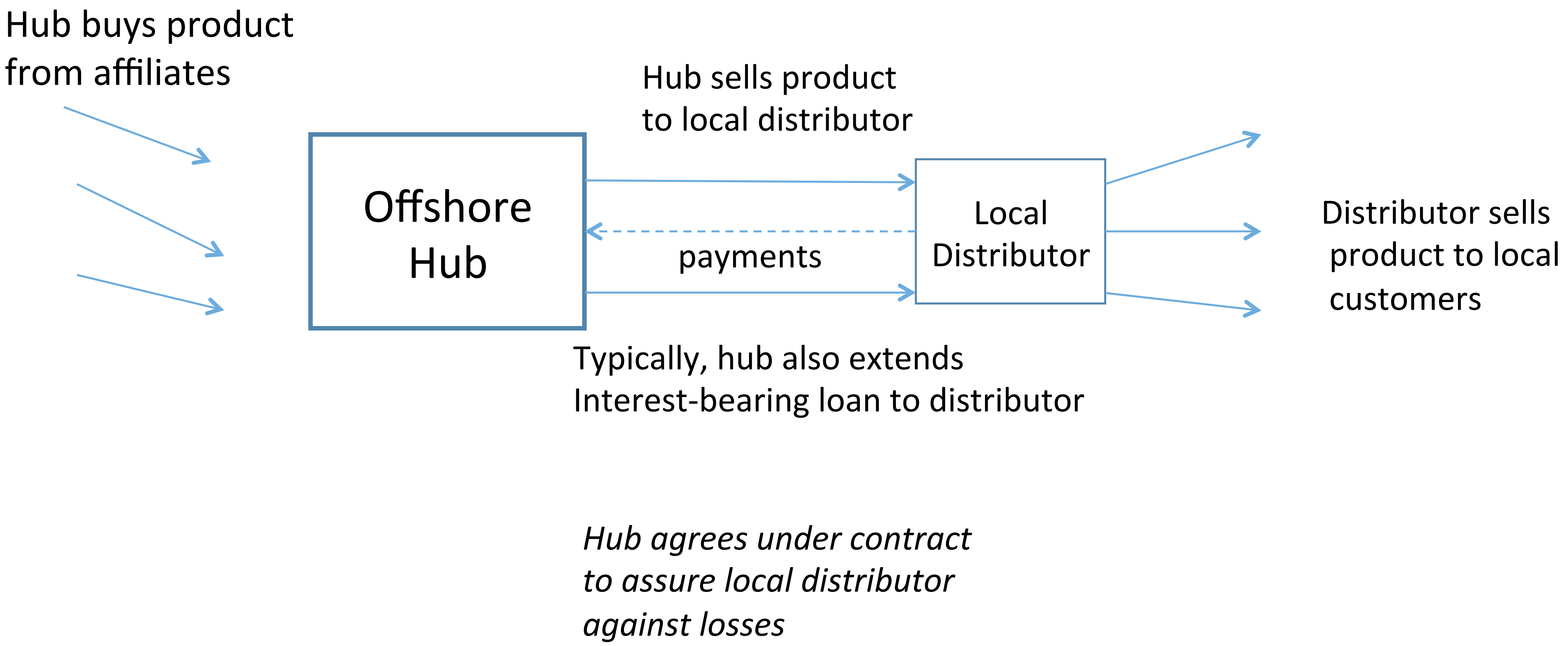
The Hub Structure (cont’d)

- The members of the group will enter into contracts establishing (i) the hubs as “principals” in overseeing and funding the group’s global business, and (ii) the various distribution, manufacturer and service provider subsidiaries essentially as paid servants of the hubs.
- Under the contracts, the subsidiaries are provided relatively low but steady levels of profit, consistent with the notion that they are corporate servants incurring little business risk. The rest of the group’s profits (the “residual”) is treated as earned for tax purposes by the zero-or-low tax hubs.
- In addition, the hubs will typically extend loans to the operating subsidiaries; the subsidiaries will reduce their incomes further through payment of interest to the hubs.

The TNMM

- The TNMM was added to the OECD Transfer Pricing Guidelines in 1995 as a method for determining reasonable minimum levels of operating profit for relatively simple distribution, manufacturing, and service-provider subsidiaries within multinational groups.
- Under TNMM, the subsidiary is supposed to consult “comparables” for its local operations (for example, a distribution subsidiary might seek financial data on independent distributors of similar products operating in the same market). The taxpayer is then to conduct its activities so that it earns operating profits at least as high as those of the comparables.

Simplified Diagram of Hub/Limited-Risk Distributor Arrangement



Example of Application of TNMM

- Globalco, a global manufacturer and seller of high-margin brand-name groceries, establishes a distribution subsidiary, Sellco, in Country A. Sellco's activities consist of buying products from Global affiliates around the world and reselling them to retail outlets in Country A.
- Globalco's tax advisers perform a comparables search of independent distributors in Country A, which, according to the advisers, suggests that an independent would earn operating profit margin of, say, 4.0 percent.
- Globalco then arrange affairs of Sellco so that it earns operating profit margin of at least 4.0 percent.
- Country A's tax authority, on audit, is entitled to challenge sufficiency of Globalco's comparables search.
- *Note: Application of TNMM is slightly different, technically, when applied to subsidiaries other than distributors, although basic structure and underlying theory remain the same.*

Central Difficulties of TNMM in Practice

- As economic theory would suggest, it is difficult to identify independent comparables with functions and profit potential similar to those of subsidiaries of multinational groups. This difficulty appears to be especially pronounced in developing countries.
- TNMM (and other OECD transfer pricing methods) require subsidiaries to earn minimum levels of "operating profit," which is a measure of income *before* payment of interest. Thus, even after meeting TNMM's requirements, a subsidiary can reduce its taxable income through payment of related-party interest. Countries often have rules (separate from their transfer pricing rules) limiting payments of related-party interest, but those rules tend to be porous.

Shortcomings of Current Version of TNMM in Responding to Hub-Based Tax Planning

- Multinational groups are able to prevail on TNMM analyses that reduce to very low levels the income that must be earned by distribution, manufacturing and service-provider subsidiaries.
  - Argument is that "risk-stripped" subsidiaries should be required to earn only the lowest levels of income that might plausibly be supported by the comparables analysis.
  - Owing to inherent difficulties of conducting persuasive comparables analysis, revenue agencies typically cannot convincingly challenge the groups' assignments of low levels of income to local subsidiaries.
  - Subsidiaries typically can reduce income even below levels suggested by comparables, through payment of interest to hubs.

Proposed Modifications to TNMM Rules

- Two central elements:
  - Instead of attempting to benchmark under TNMM by reference to comparables, require distribution, manufacturing and service-provider subsidiaries to earn profit margins equal to *25 percent of group's consolidated profit margin.*
  - Instead of using operating profit as basis for application of TNMM, use *earnings before tax (EBT),* which is a measure of income *after* payment of interest.

Example of Application of Revised Method

- A distribution subsidiary, Sellco, earns $1 billion during taxable year.
- Multinational group of which Sellco is member earns consolidated EBT margin of 15 percent during year.
- Sellco thus must earn EBT margin of .25 x 15, or 3.75 per cent.
- Sellco's required income for the year is therefore .0375 x $1 billion, or $37.5 million.

Some Limitations of the New Method

- Modified TNMM would apply only to kinds of businesses that, under prevailing transfer pricing practices, currently are benchmarked under TNMM. Therefore, important categories of businesses, like banks and insurance companies, would not be affected.
- Protection against excessive interest deductions would be imperfect; taxpayers could shift their payments of interest to portions of their local operations that are not covered by TNMM analysis.

Political Considerations

- By relying on group-wide margins instead of comparables data, and by incorporating control of interest payments into transfer pricing rules, proposal would require shift from long-established paradigms under arm's-length transfer pricing rules.
- Given realities of tax competition, proposal would require political restraint, by multinationals and their home-country governments, in favor of fiscal interests of developing countries.

Next Step

- Revenue estimates of proposed modifications, which would need to be performed by OECD, and perhaps other international bodies, working with developing-country revenue agencies.