Simple Solutions for Complex Transfer Pricing Cases: A Possible Comeback of Rules of Thumb?

Multinational enterprises with a digital business model represent an increasingly important business type with challenging value chains. The recent OECD attempts are aiming to methodologically tackle the transfer pricing issues arising from these value chains – but did not come up with satisfying results, yet. This article discusses these developments and compares complex transfer pricing approaches to rules of thumb, finding that simplistic solutions can offer promising and efficient improvements also for complex (digital) scenarios.

1. Introduction

Whilst acknowledging the great wealth contributions of digitized multinational enterprises (DMNEs), the OECD has also identified them to be a challenging and radically distinctive group with regard to taxation. Its answer to the unprecedented taxation issues that DMNEs raise is to try to holistically comprehend them. For transfer pricing, this means the need to identify, define and standardize the processes regarding intangibles, risk and capital, as well as all other aspects regarding the wealth creation of the respective DMNE. The OECD recognizes that the digital economy is on its way from being a part of the economy to becoming the very “economy itself”. In the future, almost all MNEs will have to delineate value contributions in digital value chains. They will have to face more complex business cases that need to be handled according to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines) and the methods laid out therein. That already raises a lot of questions regarding the application of the arm’s length principle in many cases; in the future, the amount of questions regarding the application of the arm’s length principle will only rise further.

As emphasized by the OECD, a comparability analysis, and thus “economically relevant circumstances”, are crucial for the application of the arm’s length principle. Economically relevant circumstances can be roughly divided into (i) the conditions of a transaction; and (ii) the circumstances under which a transaction occurs. To do so, a “broad-based understanding” of the respective industry in which the transaction occurs is needed.

Taking into consideration the vast complexity of the issue at hand, this article firstly raises the question, in section 2., of whether the approach laid out by the OECD (i.e. to delineate transactions and handle them using the methods laid out in the OECD Guidelines) is feasible in light of the growing complexity regarding value contributions. Besides determining the “right” transfer price from a pure technical perspective, the question focusses on the possible means regarding the practical determination of transfer prices. In section 3., the article explains the “25% rule” as an example of a rule of thumb and its possible advantages. Using rather ordinary instead of complex solutions must not necessarily be a mere product of cost-benefit considerations; the result of simpler approaches must also lead to accurate results. In section 4., the article concludes whether transfer pricing has to aim for more and more complex solutions to reflect the value chains that can be observed, or if rules of thumb can offer practical alternatives in that regard. In times when the complexity of transfer pricing issues seems to explode, it seems reasonable for every practitioner who faces growing risks – even when applying highly developed transfer pricing models and budget concerns – to explore this question. Section 5. focusses, therefore, on the applicability of rules of thumb based on supranational and national transfer pricing regulations. Section 6. offers a final summary and conclusion of the analysis at hand.

2. The Complexity of Determining Transfer Prices and the Judgement of Experts

The global economy has changed and developed at a pace that the tax systems have not been able to keep up with. Through digitalization, businesses have come to find ways to create value that are unique and that cannot be compared to common supply chains known since the middle of the 20th century. With this development, intangibles have become the core of these unprecedented business models.

Many businesses, especially DMNEs, can no longer be best described by their transactions, the nations in which they reside or the legal form that they take. Instead, value creation is the outcome of highly interwoven processes and

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1. OECD, Action Plan on Base Erosion and Profit Shifting, p. 10 (OECD 2013), Primary Sources IBFD.
2. Id. at p. 20.
4. OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, para. 1.35 (10 July 2017), Primary Sources IBFD [hereinafter OECD Guidelines].
interactions that cannot be disentangled and described without a deeper understanding of their complex and often unique nature.6

The value chain of a “classic” non-DMNE, even at its highest complexity, used to be reducible to a certain number of inputs, whether physical goods, services or licences. Regardless of the industry, whether it was pharmaceuticals, the heavy industry or the automotive industry, for any kind of output, there was a clear set of input factors with a tacit nature, i.e. the factor had a direct and comprehensible impact on the quality of a resulting good or service. Despite innovation constantly changing the make-up of pharmaceuticals, automobiles and other outputs, there was a straightforward connection between the input and the output.

A DMNE’s intangibles, customers and functions are extraordinary with regard to their mobility (and thus not comparable to the value chains of “common” business models). Additionally, DMNEs gain a lot from their (potentially global) users’ data and the corresponding network effects. Furthermore, DMNEs show tendencies towards multi-sided business models and oligopolies/monopolies. Simultaneously, their technological progress occurs at a higher pace, showing only a limited degree of comparability, if any. These and other factors must be taken into account when dealing with DMNEs.7

From a practical perspective, any kind of DMNE might generate an output that has its own business administration, technologies, servers, licensors, and licensees or users in different nations whilst still occupying technological niches, making their resulting output barely comparable to that of any other business. Simultaneously, the strong business dynamics of the digitalized economy may change the set-up of the particular business within a fraction of a fiscal year. Thus, the chance of a major replacement or mere changes with regard to any of the aforementioned factors, whether they be the users, the licences or one of an unlimited amount of software that makes the output what it is, has become a constant for an entire business field.

Additionally, this field is becoming an integral part of almost every industry. The aforementioned examples of the pharmaceutical and automotive industries have been integrating digital elements into their value chains and even portfolios for over a decade. Thus, there is no way that one could avoid the question of how to deal with the tax issues of DMNEs.

In any case, there are only two realistic ways to go: (i) trying to intellectually conquer the value chains of DMNEs, taking into consideration all of the mentioned aspects thoroughly; or (ii) finding more simple ways to solve the problem.

In many cases, the determination of transfer prices is therefore dependent on expert opinions and the documenta-

nerated with 25% of the profits that were generated from a product (which includes the IP).  

Originally, the 25% rule was brought into discourse by Robert Goldscheider, an American lawyer, in 1971. When working for a US company in Switzerland throughout the 1950s, Goldscheider saw how the company was licensing different bundles of patents, know-how and trademarks to its licensees. The license fee would usually make up 5% of the licensees’ revenues. Simultaneously, their returns on sales would average around 20%. Thus, Goldscheider concluded that a licence rate of 25% on profits may be appropriate, arguing that the licensees who usually carry the bigger share of business risks could keep 75% of the profits made. According to Goldscheider, the 25% rule should be applied to licences in a revenue-based manner, taking into consideration a particular product of which the returns on sales would have to be multiplied by 25% to arrive at the actual licence fee.  

Thus, a company that is making use of a licence to integrate, for example, a technology into its product to ultimately achieve returns on sales of 30% would effectively pay 7.5% (25% of the returns on sales) as a licence fee. In recent years, the approach has been subject to criticism in various forms. As a matter of fact, there are differing conceptions of the rule because, for example, some authors use gross profits whilst others choose net profits as a basis for the 25%. This, in turn, means that the base to which the 25% rule is being applied has still not been agreed upon. Also, the 25% figure is frequently discussed, as there has already tax literature been published in which the rule’s percentage was described as a range from 10-35%.  

In addition to this criticism regarding the structure of the rule, there has been further critique regarding its applicability. Firstly, there is no standard for how to apply the rule in practice. It may be hard to allocate IP to specific exceptions of the rule because, for example, some authors make use gross profits whilst others choose net profits as a basis for the 25%. This, in turn, means that the base to which the 25% rule is being applied has still not been agreed upon. Also, the 25% figure is frequently discussed, as there has already tax literature been published in which the rule’s percentage was described as a range from 10-35%.  

In principle, it resembles the approach by Kahneman, as it consistently ignores potentially relevant factors. Could it still be possible that the rule manages to outcompete more sophisticated profit-splitting approaches despite its obvious shortcomings?  

Most recently, the method was not receiving much appreciation by tax authorities, just as the Knoppe formula (an approach similar to the 25% rule) was rejected by a German court. Also, for example, the 2011 ruling of the US Court of Appeals for the Federal Circuit (CAFC) in Uniloc v. Microsoft has been identified as a ruling favouring the profit-split method based on more complex splitting mechanisms over such rules of thumb. Microsoft had used a registry system that included software made by Uniloc. Despite having been accepted by a jury earlier, in the appeal, the CAFC rejected the 25% rule strongly, seeing the rule to be “arbitrary, unreliable and irrelevant”, declaring it inadmissible “because it fails to tie a reasonable royalty base to the facts of the case at issue”. Additionally the method was deemed to fail “to account for the unique relationship between the parties”. The CAFC thus stood with the critics, making the biggest economy of the world officially reject the rule. The decision clearly reflects the tendency to use economic methods to estimate the outcomes of hypothetical negotiations. Therefore, in the last years, rules of thumb in general and the 25% rule as a single rule have faced a decline in their relevance regarding their application for transfer pricing cases.

15. Voge, supra n. 12, at p. 613.  
18. DE: FC Münster, 14 Feb. 2014, Az. 4 K 1053/11 E, Ansetzung einer Gewinnerhöhung nach § 1 Abs. 1 des Außensteuergesetzes (ASiG) für die unentgeltliche Überlassung eines Markenzeichens an eine polnische Kapitalgesellschaft p 493.  
4. Applicability via Simple Adjustments to the 25% Rule

Based on the arguments outlined before, the application of the 25% rule without any further adjustments will lead to accurate results only in a small number of cases. In that regard, the parallels to the application of the comparable uncontrolled price (CUP) method should be highlighted. Also, only in very few cases of applying the CUP method will unconditional, full comparability be achieved.

In most cases, comparability is, to a certain extent, limited, and as a consequence, statistical results will be handled differently, for example, by calculating interquartile ranges or by assessing comparability adjustments. Therefore, comparability adjustments are common practice regarding transfer pricing cases and could also enhance the applicability of rules of thumb. The OECD recognizes, for any method, that there may be a possibility or necessity to improve the comparability by adjusting for accounting, capital, functions, assets or risks involved with regard to the comparable under review.21

The OECD has thus already been dealing with the boundaries by which any methodology may be restricted and is encouraging in respect of finding ways to overcome limited comparability. Reasonably, the OECD Guidelines state that adjustments should only take place when they are able to improve the comparability.22 Nevertheless, the OECD Guidelines also describe that there may be situations in which there is a range of more or less reliable figures. Stating that “transfer pricing is not an exact science”, the OECD Guidelines thus require a methodology as precise as possible, whilst still acknowledging that there is a certain “room for manoeuvre” with regard to the question of what may actually be at arm’s length.23

In that regard, it should be considered that in Uniloc v. Microsoft, the 25% rule was already applied in combination with certain comparability adjustments, taking into account the “Georgia-Pacific factors”. The CAFC did not criticize the Georgia-Pacific factors that had been used in combination with the 25% rule, but rather the 25% rule as a basis for estimating the arm’s length fee.24 The Georgia-Pacific factors represent a group of different aspects that may influence the price of a licence. Amongst others, they include the possible time limitation of a licence, its specifications with regard to its exclusivity or territory and its advantages in comparison to older, comparable methods/devices or the statements of experts.25 Means such as the Georgia-Pacific factors can help ensure that the 25% rule (ideally) reflects all of the relevant price-determining factors of a transaction.

Despite the rejection of the 25% rule in this case, the ruling can be seen as an illustration of the aforementioned “room for manoeuvre” regarding the arm’s length principle. As stated by the OECD, tax policies should ideally embody “neutrality, efficiency, certainty and simplicity, effectiveness and fairness, as well as flexibility”.26 An application of the 25% rule in combination with necessary comparability adjustments fulfils these requirements when the application is not based on expert opinions. It could be argued that any enhanced transfer pricing model that is based on experts opinions (for example via a scoring model for the application of a profit split) at least would not be neutral in nature and, moreover, would lack efficiency oftentimes. Compared to those methods, an adapted application of the 25% rule seems superior when implemented properly. Instead of setting up global, multi-dimensional transfer pricing systems based on various assumptions, such a “shortcut” could be considered for many cases in the future. At least it could provide an easily adaptable whilst also comprehensible approximation to find a range of figures that could potentially be at arm’s length. The question of the exact arm’s length point in the range (given that it exists) may be determined from this approximation. Alternatively, it could be agreed that the entire range as such is in line with the arm’s length principle.27

In any case, it would give taxpayers as well as tax administrations an assessable basis for determining transfer prices. This would be handy and efficient in so far as, due to the very nature of transfer prices, any kind of solution needs to work equally as well in a global context. Thus, any given method should be (more or less) handy for any nation wishing to assess transactions. Therefore, also the potential and limitations of developing countries need to be taken into account. The OECD has already recognized that, amongst others, these nations may face difficulties in accessing information and taking the right legislative approaches. This affects both their public and their private sectors. After all, some nations have roughly one tenth of the world’s average (tax/customs) personnel at their disposal.28

There is thus a disproportion in the ability to process the content of the OECD Guidelines. Apart from this problem, many Sub-Saharan African nations are additionally struggling with the implementation just because of the parallel lack of comparables29 and the complex nature of transfer pricing documentation.30 Therefore, even common approaches are limited in their applicability, not to mention the more sophisticated ones.

Simultaneously, transfer pricing has developed documentation requirements that go beyond what is actually needed for tax authorities in order to assess the arm’s length nature of transfer prices. It can be assumed that large parts of the provided documentation are not being processed, which makes sense, as the transfer pricing doc-

22. Para. 3.53 OECD Guidelines.
23. Para. 3.55 OECD Guidelines.
24. Vögele, supra n. 12, at pp. 610 and 615.
25. Id., at p. 611.
27. Para. 3.62 OECD Guidelines.
umentation can exceed the capacity of an audit. Besides the question of the necessity of particular requirements, some of them have become challenging for the tax authorities of developed economies as well: being confronted with hard-to-value-intangibles, the United States Internal Revenue Service had to hire external advisers for USD 2 million, as they needed help with their Microsoft audit. By doing so, the authorities of a developed economy showed limitations in their capability to apply the law using their own resources. Furthermore, the sum itself, as well as the time and human resources behind it, make it clear that there are limitations to the applicability of rather holistic approaches, which, in comparison, should favour the application of rules of thumb, also from a merely practical perspective.

5. Rules of Thumb and Their Applicability Based on Supra-National and National Transfer Pricing Regulations

In 1998, the OECD articulated that “the tax rules should be clear and simple to understand so that taxpayers can anticipate the tax consequences in advance of a transaction, including knowing when, where and how the tax is to be accounted” with regard to e-commerce. The outcome 20 years later appears to be starkly contrasting with this valuable and rational intention. Value chains have become more complex at a rising pace without showing any signs of an end to this development. Empirical evidence from audits has shown that a variety of approaches, despite their handiness for other transactions, are not suitable for analysing DMNEs. Whilst one-sided methods are too limited, the profit-split method, based on highly sophisticated economic models, is not only complex and costly, but also bears the same risk of disputes with the auditors as with other approaches.

One should, however, not make the mistake of thinking that criticizing the transfer pricing approaches of the OECD equals “being against” the OECD Guidelines. The Guidelines themselves state that in cases in which the known methods happen to be insufficient, “other methods” satisfying the arm’s length principle may be applied. By doing so, the OECD Guidelines do not only acknowledge the limits of the methods introduced so far, but also encourage businesses to develop alternative approaches.

In fact, this is in line with the national legislations of some OECD member countries that have actually granted the right to choose other methods. For example, the United States, with its “best method” rule, specifically articulates that there should not be any hierarchy amongst rules, but a preference for the method that is most suitable for satisfying the arm’s length principle. Simultaneously, in Germany, the law states that, given that the common methods cannot lead to arm’s length transfer prices, limitedly comparable values stemming from a suitable transfer pricing method may be used. Since a “suitable transfer pricing method” is not defined, German law also appears to leave some space for other approaches. Meanwhile, in Poland, in 2018, a draft bill was issued stating that “other methods” may be used for finding transfer prices.

The laws of Germany, Poland and the United States may differ in their wording, but these three examples illustrate how not only the OECD, but also national legislations have made space for new methods in transfer pricing. Apart from these OECD member countries and the OECD Guidelines themselves, the United Nations also mention alternate approaches in their Practical Manual on Transfer Pricing for Developing Countries. Whilst showing no preference for a particular method, the only requirement of the United Nations regarding different methods is their adherence to the arm’s length principle. Thus, there actually seems to be broad consensus regarding the desire to improve the way in which transfer prices are computed, whether expressed by the OECD, its member countries, the United Nations or businesses themselves.

6. Summary and Conclusions

As a final result of the described developments, tax auditors, businesses and tax advisers may thus bear in mind that there is not only a necessity for change, as value chains have changed over time, but also a political and legal encouragement to work with more suitable – i.e. different – approaches. Research has already begun working out what the future solutions might be.

There is, for example, the possibility of making use of actuarial analysis for transfer pricing. Despite all of the advantages it may have to offer, however, it fails to take into consideration market forces, as well as relevant differences between the entities involved in the market. Of course, unitarian taxation is part of the discussion as well, but besides its implications for the arm’s length principle, it appears to be quite unfeasible to invent a most appropriate formula that will achieve large-scale international acceptance.

Hence, despite the necessity of new and better approaches, one should bear in mind that, just as these examples show,
any change in methods is most likely going to come with new limitations and problems. In a way, they thus reflect the criticism to which simple rules of thumb have also become subject. Arguably, one should not dismiss more simple and intuitive approaches just for the sake of complexity, as the rise in complexity of value chains has created the methodological gap in question in the first place. Solutions that are easy to comprehend and adapt as well as simple to implement are thus highly desirable, if just to close the gap. A certain open-mindedness in that regard is preferable for all parties involved.