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Legislative Measures to Combat Tax Avoidance in Transfer Pricing for International Transactions

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A B S T R A C T

This article explores the role of legislative measures in combating tax avoidance through transfer pricing in international transactions. It examines the system of international standards for regulating transfer pricing, aimed at ensuring tax transparency and preventing base erosion. A comparative analysis of national approaches to transfer pricing regulation in various countries is conducted. Special attention is given to tax control instruments, such as transfer pricing documentation and the automatic exchange of tax information. The article also analyzes high-profile cases of tax avoidance and discusses prospects for legislative improvements in light of the challenges posed by the digital economy.

Keywords: transfer pricing, tax avoidance, international transactions, tax regulation, Base Erosion and Profit Shifting, Economic Co-operation and Development, tax control.

Introduction

Multinational corporations (MNC) engage in many cross-border transactions through their subsidiaries. The role of transfer pricing becomes essential as it guides the distribution of profits through different jurisdictions. In the wake of the stringent transfer pricing regulations under the arm's length concept, some tax evasion tools allow corporations to shift profits to tax havens, thus lessening their overall tax payments. These activities cause significant tax revenue shortfalls for tax authorities and undermine fair competitive terms.

As a reaction to the problem, global institutions such as the Organisation for Economic Co-operation and Development (OECD) and the European Union (EU) formulated guidelines to restrain the use of transfer pricing as a means of tax evasion. The OECD Base Erosion and Profit Shifting (BEPS) program implemented measures to enhance the openness of taxation. They also aim to ensure profits are taxed in countries in which real economic activity actually occurs. The majority of countries adopted the proposed recommendations, incorporating tighter regulation and greater reporting requirements into local taxation laws.

In spite of these efforts, the effect of legislative measures varies between countries, and multinational enterprises (MNE) continue to exploit loopholes in the law. Some governments are unable to compel compliance because they are constrained by scarce funds or incohesive global cooperation. The economy's digitization also bears various complications. Current regulation around transfer pricing is also unable to capture the generation of value in the digital enterprise models. These issues bring out the need for continuous regulatory adaptation and global coordination. The aim of this study is to analyze the legislative measures implemented to combat tax avoidance in transfer pricing for international transactions.

Main part. International regulatory standards on transfer pricing and measures against tax avoidance

Transfer pricing is the evaluation of the value assigned to the exchange between intangible assets, services, and products between different units in the same multinational company. Since the exchange lies between the confines of the same corporate entity, that process can be isolated from outside market forces, making possible the imposition of artificial pricing mechanisms. This condition provides the advantage of profit manipulation, whereby units can strategically establish the exchange pricing to achieve optimal profits in countries with favourable taxation, and, in turn, diminish the overall taxation burden.

The arm's length principle (ALP) is the foundation of transfer pricing regulation. It requires that intra-group transactions be conducted under conditions that would apply in cases when the entities were independent and unrelated. The OECD Transfer Pricing Guidelines provide a framework for ensuring compliance with this principle [1]. These include the comparable uncontrolled price (CUP) practice, the resale price method, the cost-plus approach, the transactional net margin method (TNMM), and the profit split mechanism.

A significant difficulty in applying the arm's length principle comes from the complexity of multinational value chains. In models involving high integration, most commonly in the case of digital and tech industries, standard pricing mechanisms fail to accurately capture value realization. In turn, this has seen the introduction of other strategies, such as formulary apportionment and country-by-country reporting (CbCR) to improve transparency in the frameworks in the area of transfer pricing.

Recognizing the risks posed by profit shifting, international organizations have introduced regulatory frameworks to secure fair taxation. The BEPS Project was led by the OECD and the G20 and has been instrumental in strengthening global tax rules. The BEPS Action Plan, specifically Action 8-10, focuses on aligning transfer pricing outcomes with value creation.

The EU has considerably improved the regulation of transfer pricing practices. The Anti-Tax Avoidance Directive (ATAD) sets up a regime of mandatory law in member states to curb the incidence of aggressive tax arrangements. The EU's DAC6 Directive also obliges the reporting of possibly aggressive tax arrangements, making the agreements internationally more transparent.

Apart from the OECD and the EU, nations have implemented General Anti-Avoidance Rules (GAAR) to resist abusive transfer pricing. Countries like the U.S. follow comprehensive statutory transfer pricing rules, such as Section 482 of the Internal Revenue Code. The developing economies make use of broader anti-avoidance provisions due to a lack of capacity for enforcement. To show the differences in international transfer pricing regulations, the table 1 provides an overview of main regulatory frameworks.

Table 1 - Analysis of international transfer pricing regulations [2, 3]

Regulatory framework	**Key provisions**	**Applicability**
OECD transfer pricing guidelines	Arm’s length principle, five pricing methods, dispute resolution mechanisms.	Adopted by most OECD and G20 countries.
BEPS action plan (8-10)	Aligns transfer pricing with value creation, limits intangible asset shifting, strengthens documentation requirements.	Implemented through national tax laws and bilateral treaties.
EU Anti-Tax Avoidance Directive (ATAD)	Establishes minimum anti-avoidance measures, including exit taxation and controlled foreign company (CFC) rules.	Mandatory for all EU member states.
U.S. Section 482 IRC	Allows tax authorities to reallocate income if transfer pricing deviates from the arm’s length standard.	Applies to U.S. MNE.
UN practical manual on transfer pricing	Provides guidelines for developing countries with limited resources for enforcement.	Used as a reference by non-OECD economies.

The variation in regulatory approaches highlights the complexity of achieving global alignment in transfer pricing enforcement. While OECD guidelines form the basis of many national laws, countries implement them with differing degrees of strictness, leading to regulatory fragmentation.

The success of the transfer pricing regulations is dependent upon the regulations and their enforcement. Both the U.S. and German tax authorities possess strong tax structures where multiple avenues for enforcement exist, such as Advance Pricing Agreements (APA) and heavy penalties. In the developing economies the situation is not the same where less access is available for the same market data and also lacks specialized professionals for conducting the transfer pricing audit.

The U.S. applies a rigorous approach to transfer pricing enforcement. The IRS relies on Section 482 of the Internal Revenue Code, which provides tax authorities broad discretion in income reallocation when intercompany prices fail to meet the arm's length requirement. More recent legislative actions, such as the Tax Cuts and Jobs Act (TCJA), have introduced new regulations, such as the Global Intangible Low-Taxed Income (GILTI) tax, intended to address profit shifting by US-headquartered multinational companies to low-taxed jurisdictions [4].

The EU promotes harmonization among member states through directives such as ATAD and DAC6. While transfer pricing regulations vary between EU countries, the EU Joint Transfer Pricing Forum (JTPF) facilitates coordination and consistency in application [5]. Some jurisdictions, like Germany and France, impose strict compliance requirements. Others, including Ireland or the Netherlands, have historically offered more favorable tax regimes to attract multinational headquarters.

The regulation of transfer pricing can be a bottom line in maintaining tax fairness and preventing profit shifting. Despite the fact that the arm’s length principle remains the global standard, its application varies across jurisdictions and create enforcement challenges. The OECD’s BEPS initiative and EU directives strengthen compliance measures, yet gaps in execution persist, particularly in developing countries.

National legislative measures and law enforcement practices

National governments employ a variety of instruments to monitor and regulate transfer pricing practices to ensure compliance with tax laws. Among the most widely implemented mechanisms are mandatory transfer pricing documentation requirements, tax audits conducted by revenue authorities, and the use of advanced pricing agreements (APA).

A major component of tax control in this field is transfer pricing documentation. It requires MNE to provide detailed records of intercompany transactions. These records typically include a master and local files, which contain transaction-specific details for each jurisdiction. A noticeable support mechanism lies in the automatic exchange of taxation, which ensures the exchange of fiscal information between countries and territories, reducing the scope for taxation avoidance. Multiple countries also have in place bilateral and multilateral arrangements to enhance taxation transparency.

Governments have improved their compliance and auditing mechanisms by having specialized units in the tax office dealing with transfer pricing questions. Advanced use of data analytics to uncover anomalies in financial reporting has become more common in helping the tax office assess high-risk deals at greater efficiency. The U.S., Germany, and Australia, countries having effective taxation enforcing mechanisms, commonly conduct cooperative audits to synchronize cross-border investigations and ensure consistent imposition of taxation laws.

Notwithstanding the availability of tight laws, MNE often attempt to exploit loopholes in the law to avoid taxation. There have been several high-profile cases which made the trial prominent for the tax authorities to maintain compliance and fight aggressive pricing strategies.

A high-profile case is the Apple-Ireland state aid tax controversy, where the European Commission ruled that Apple derived an illegal state subsidy in the form of privileged taxation treatment in Ireland that helped the company significantly reduce its effective tax rate. This case demonstrated how some jurisdictions offer tax incentives that create disparities in global tax enforcement, leading to concerns about fair competition [6].

Another example is the Starbucks tax ruling in the Netherlands, where EU regulators found that the company benefited from selective tax advantages that were inconsistent with EU state aid rules. This ruling emphasized the role of supranational entities, such as the European Commission, in policing transfer pricing practices beyond national authorities [7].

Developing economies have also faced challenges in tackling transfer pricing abuse. According to 2023 statistics [8], India demonstrates the longest average resolution time (35 months), reflecting the complexities of its legal environment, while the Netherlands and Switzerland exhibit much shorter resolution periods (table 2).

Table 2 - Transfer pricing cases by country

Country	Open TP cases at the beginning of 2022	Open TP cases at the end of 2022	% of 2022 closing inventory from pre-2016	Average time to close post-2015 TP cases (months)	Top three treaty partners with largest number of TP cases
Germany	624	677	4	22	Italy, Spain, France
France	564	646	14	23	Italy, Spain, Germany
India	590	557	39	35	United States, Japan, Germany
The U.S.	424	440	5	31	India, Canada, Germany
UK	303	297	1	27	Italy, Germany, France
Switzerland	202	226	3	21	Germany, Italy, India
Netherlands	183	167	1	19	Italy, Germany, Spain

To address these complexities, many governments have introduced **APA**, which allow companies to agree on transfer pricing methodologies with tax authorities in advance (fig.1).

Fig. 1 - APA process

This mechanism provides legal certainty for businesses while reducing disputes and litigation costs. Additionally, it fosters a more predictable tax environment, enabling MNE to plan their financial strategies with greater confidence. By minimizing the risk of unexpected tax adjustments, APA also contributes to improved compliance and stronger cooperation between corporations and tax authorities.

As global business changes, tax authorities also need to evolve their regulations and the way they apply them. One significant domain is the advent of the digital economy, raising some concerns for traditional transfer pricing regulations. Most tech corporations generate significant profits even when they don't even physically exist somewhere, making it difficult to determine how the tax is split. A noteworthy improvement in the area of taxation auditing is the use of big data and artificial intelligence (AI). Advanced algorithms give the authorities the power to scrutinize huge datasets of fiscal details to uncover abnormalities, recognize high-risk deals, and enhance the efficiency of fiscal compliance. Additionally, an increasing variety of countries are making public disclosure requirements tougher for MNE. For example, in the U.S., the Financial Accounting Standards Board (FASB) has proposed new rules requiring MNE to provide country-by-country tax reporting, enhancing transparency in corporate tax practices and reducing opportunities for profit shifting.

National legislative and compliance strategies are constantly updated to match the continually developing means used to avoid taxation. Despite the progress in compliance through regulation, like the introduction of transfer pricing reporting, automatic exchange of information, and cooperative audits, issues remain. Future developments, including the introduction of taxation in the digital economy, the integration of AI into enforcements, and greater public transparency, are expected to support global efforts to combat the mispractice in the area of transfer pricing.

Conclusion

Effective transfer pricing rule-making is instrumental in securing tax equity, curtailing profit diversion, and stimulating fair competition on international markets. While efforts globally, including the OECD's BEPS program and EU directives, have enhanced the regulatory landscape, policy implementation shows high variability across jurisdictions, resulting in persistent challenges. Sophisticated national legal frameworks, supported by robust policies of tax control and advanced means of enforcement, are required to tackle aggressive tax planning strategies of multinational enterprises. The integration of digital tax reforms, the usage of AI in audit practices, and more intense transparency requirements will play a pivotal role in shaping the future of transfer pricing law.

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