Chapter1: An Introduction to TransferPricing

1.1 What is TransferPricing?

1.1.1 This introductory chapter gives a brief outline of the subject of transfer pricing and addresses the practical issues and concerns surrounding it, especially issues faced by, and approaches taken by, developing countries. Many of the issues discussed [illegible]nal transfers of goods and services, capital (such as money) and intangibles (such as intellectual property) within an

consider this to be “mispricing”, “incorrect pricing”, “unjustified pricing” or non arm’s length pricing, and issues of tax avoidance and evasion may potentially arise. A few examples illustrate these points:

- Consider a profitable computer group in country A that buys “flash memory drives” from its own subsidiary in country B: how much the parent company in country A pays its subsidiary company in country B (the “transfer price”) will determine how much profit the country B unit reports and how much local tax it pays. If the parent pays the subsidiary a price that is lower than the appropriate arm’s length price, the country B unit may appear to be in financial difficulty, even if the group as a whole shows a reasonable profit margin when the completed computer is sold.

- From the perspective of the tax authorities, country A’s tax authorities might agree with the profit reported at their end by the computer group in country A, but their country B counterparts may not agree they may not have the expected profit to tax on their side of the operation. If the computer company in country A bought its flash memory drives from an independent company in country B under comparable circumstances it would pay the market price, and the supplier would pay taxes on its own profits in the normal way. This approach gives scope for the parent or subsidiary, whichever is in a low r tax jurisdiction, to be shown making a higher profit by fixing the transfer price appropriately. A computer is À 0A’s [illegible]

to an entity providing a product or service; it would rationally only sell products or services to an associated entity if the sale price was equal to, or higher than, prices paid by unrelated purchasers. Prices should on this basis gravitate towards the so called "arm's length price", the transaction price to which two unrelated parties would agree.

1.1.9 Though the above explanation of transfer pricing sounds logical and innocuous, arriving at an appropriate transfer price may be a complex task particularly because of the potential difficulties in identifying and valuing intangibles transferred and / or services provided. For example, intangibles could be of various different types such as: industrial assets like patents, trade types, trade names, designs or models, literary and artistic property rights, know how or trade secrets. Sometimes such intangibles are reflected in the accounts and sometimes not. Thus, there are many complexities involved which have to be taken into account while dealing with transfer pricing in crossborder transactions between MNE entities.

1.1.10 Transfer pricing is a term used in economics so it is useful to see how economists define it. In business economics a transfer price is considered as the amount that is charged by a part or segment of an organisation for a product, asset or service that it supplies to another part or segment of the same organisation.

1.2. Basic issues underlying Transfer Pricing

1.2.1 Transfer prices serve to determine the income of both parties involved in the crossborder transaction. The transfer price therefore tends to shape the tax base of the countries involved in crossborder transactions.

1.2.2 In any crossborder tax scenario, the parties involved are the relevant entities of the MNE group along with the tax authorities of the countries involved in the transaction. When one country's tax authority adjusts the profit of a member of the MNE group, this may have an effect on the tax base of another country. In other words, crossborder tax situations involve issues related to jurisdiction, allocation of income and valuation.

1.2.3 The key jurisdiction issues are which government should tax the income of the group entities engaged in the transaction, and what happens if both governments claim the right to the same income. If the

resident in another country with a tax rate of 20%, the parent may have an incentive to shift profits to its subsidiary to reduce its tax rate on these amounts from 30% to 20%. This may be achieved by the parent being over charged for the acquisition of property and services from its subsidiary.

1.2.6 While the most obvious motivation may be to reduce an international enterprise's worldwide taxation, other factors may influence transfer pricing decisions, such as imputation of tax benefits in the parent company's country of residence.

1.2.7 A further motivation for an international enterprise to engage in such À 0

1.3. Evolution of Transfer Pricing

1.3.1 This section aims to trace the history and the reasons for transfer pricing taxation regimes. First and foremost, an important aspect of transfer pricing to be kept in mind is that it involves the application of economic principles to a fluid marketplace. Thus new approaches and techniques to arrive at the appropriate transfer price from the perspective of one or more actors in the system are constantly being evolved.

1.3.2 The OECD Guidelines as amended and updated, published in 1995 following previous OECD reports on transfer pricing in 1979 and 1984, represent a consensus among OECD Member countries, mostly developed countries, and have largely been followed in domestic transfer pricing regulations of these countries. Another transfer pricing framework of note which has evolved over time is the USA Transfer Pricing Regulations (26 USC 482).

1.3.4 Special attention must be focused on the meaning and scope of the term "associated enterprises", which is a topic of importance but one not defined or discussed adequately so

countriesto keep their tax basesintact. Other developingcountriesarebases

1.3.13 The United Nations (UN) is again taking a leadership role, through this Transfer Pricing Manual, in trying to arrive at updated global transfer pricing guidance which can be used by countries all over the world in developing (or calibrating) their transfer pricing regulations.

1.4. Concepts in Transfer Pricing

1.4.1 The UN Model Tax Convention Article 9(1) states the following *"Where*

(a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or

i. the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which

international enterprise operates. In the absence of consistent rules and administration, international enterprises may be provided with an incentive to avoid taxation through transfer pricing manipulation.

1.4.7 While it is relatively easy to describe the arm's length principle, establishing guidelines on the practical application of the principle is a complex task as its practical application requires identification and application of reliable comparable transactions.

1.4.8 A practical example follows of a situation where the arm’s length principle needs to be applied:

r Assume a corporation P (parent) manufactures

1.4.13 An alternative to the arm's length principle might be a global formulary apportionment method which would allocate the global profits of an MNE group amongst the associated enterprises on the basis of a multi factor weighted formula (using factors such as property, payroll and sales for example, or such other factors as may be defined while adopting such formulae). A formulary apportionment approach is currently used by some states of the USA, cantons of Switzerland and provinces of Canada. Also, the Brazilian transfer pricing rules set out a maximum ceiling on the expenses that may be deducted for tax purposes in respect of imports and lay down a minimum level for the gross income in relation to exports, effectively using a set formula to allocate income to Brazil. The EU is also considering a formulary approach, at the option of taxpayers, to harmonise its corporate taxes under the Common Consolidated Corporate Tax Base (CCCTB) initiative.

Applying the arm's length principle:

1.4.14 The process to arrive at the appropriate arm's length price typically involves the following processes or steps:

a) Comparability analysis;

b) Evaluation of transactions;

c) Evaluation of separate and combined transactions;

d) Use of an arm's length range or central point in the range;

e) Use of multiple year data;

f) Losses;

g) Location savings and location rents;

h) Intentional set offs; and

i) Use of customs valuation.

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1.4.15 The above processes are discussed in detail in the chapter of this Manual dealing with comparability.

1.4.16 Use of transfer pricing methods: The transfer pricing methods are set forth TD [illegible]

1.5.1 The key question is how to apply the arm's length principle in practice to determine the arm's length price of a transaction. Several acceptable transfer pricing methods exist, providing a conceptual framework for the determination of the arm's length price. No single method is considered suitable in every situation and the taxpayer must select the method that provides the best estimate of an arm's length price for the transaction in question.

1.5.2 All these transfer pricing methods rely directly or indirectly on the comparable profit, price or margin information of similar transactions. This information may be an "internal comparable" based on similar uncontrolled transactions between the entity and a third party or an "external comparable" involving independent enterprises in the same market or industry.

1.5.3 The five major transfer pricing methods (all discussed at Chapter 6 of this Manual) are:

Transaction based methods:

1.5.4 Comparable Uncontrolled Price (CUP) The CUP method compares the price charged for a property or service transferred in a controlled transaction to the price charged for a comparable property or service transferred in a comparable uncontrolled transaction in comparable circumstances.

1.5.5 Resale Price Method (RPM) The resale price method is used to determine the price to be paid by a reseller for a product purchased from an associated enterprise and resold to an independent enterprise. The purchase price is set so that the margin earned by the reseller is sufficient to allow it to cover its selling and operating expenses and make an appropriate profit.

1.5.6 Cost Plus (C+, CP) The cost plus method is used to determine the appropriate price to be charged by a supplier of property or services to a related purchaser. The price is determined by adding to costs incurred by the supplier an appropriate gross margin so that the supplier will make an appropriate profit in the light of market conditions and functions performed.

Profit based methods

1.5.7 Two classes of transactional profit methods are recognised by the USA Section 482 IRS regulations and the OECD Guidelines. These may be categorised as *profit comparison meth*[illegible] 1.2514 0 TD 0 Tc <0s(Tra

provide for the use of additional methods applicable to global dealing operations like the Comparable Uncontrolled Transaction (CUT) method. This method is similar to the CUP in that it determines an arm's length royalty rate for an intangible by comparison to uncontrolled transfers of comparable intangible property in comparable circumstances.

1.5.11 Other unspecified methods by which an arm's length price can be established: Other unspecified methods may be used to evaluate whether the amount charged in a controlled transaction is at arm's length. Any such method should be applied in accordance with the reliability considerations used to apply the specified methods described above. An unspecified method should take into account the general principle that uncontrolled taxpayers evaluate the terms of a transaction by considering the realistic alternatives to that transaction, and only enter into a particular transaction if none of the alternatives is preferable to it. In establishing whether a controlled transaction achieves an arm's length result, an unspecified method should provide information on the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled transaction. These methods are discussed in detail at Chapter 6 of this Manual.

1.6. Special Issues Related to Transfer Pricing

Documentation requirements

1.6.1 Generally, a transfer pricing exercise involves various steps such as:

- Gathering background information;
- Industry analysis;
- Comparability analysis (which includes functional analysis);
- Selection of the method for determining arm's length pricing; and
- Determination of the arm's length price.

1.6.2 At every stage of the transfer pricing process, varying degrees of documentation are necessary such as information on contemporaneous transactions. One pressing concern regarding transfer pricing documentation is the risk of overburdening the taxpayer with disproportionately high costs in obtaining relevant documentation or in an exhaustive search for comparables that may not exist. Ideally, the taxpayer should not be expected to provide more documentation than is objectively required for a reasonable determination by the tax authorities of whether or not the taxpayer has complied with the arm's length principle. Cumbersome documentation demands may affect how a country is viewed as an investment destination and may have particularly discouraging effects on small and

1.6.4 The domestic legislation of some countries may also require "contemporaneous documentation". Such countries may consider defining the term "contemporaneous" in their domestic legislation. The term "contemporaneous" means "existing or occurring in the same

1.6.10 If a direct chargemethod is difficult to apply, the MNE may apply the chargeindirectly via cost sharing, by

1.7.1 Article 9

shareholding in low tax jurisdictions and "parking" income there. CFC rules treat this income as though it has been repatriated and is therefore taxable prior to repatriation. Where there are CFC rules in addition to transfer pricing rules, an important question arises as to which rules have priority in adjusting the taxpayer's returns. Due to the fact that the transfer pricing rules assume all transactions are originally conducted under the arm's length principle, it is widely considered that transfer pricing should have priority in application over CFC rules. After the application of transfer pricing rules, countries can apply the CFC rules on the retained profits of foreign subsidiaries.

Thin Capitalisation

1.7.8 When the capital of a company is made up of a much greater contribution of debt than of equity, it is said to be *thinly capitalized*. This is because it may be sometimes more advantageous from a taxation viewpoint to finance a company by way of debts (i.e., leveraging) rather than by way of equity contributions as typically the payment of interest on the debts may be deducted

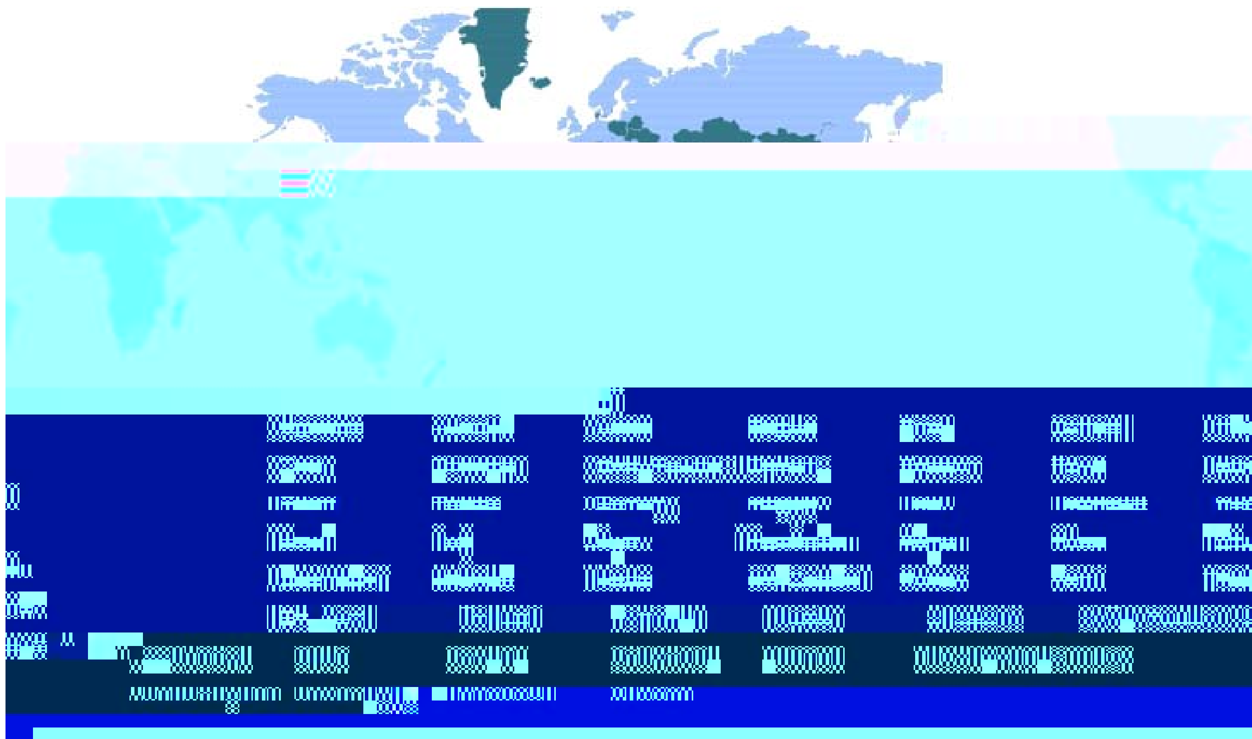
APAs for developing country administrations and taxpayers, including some implementation issues, are addressed in Chapter 9.

Time

should be focused on the following areas in which many developing countries are encountering difficulties with administering the arm's length principle.

1.8.11 Developing countries often have substantial problems with the availability of comparable transactions. This issue is considered more fully in a subsequent section and it suffices to note that due to a typically small domestic market in many developing countries, third party transactions comparable to the MNE's intra group transactions are rarely discovered in the home market.

1.8.12 Documentation requirements should as far as possible be far



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1.10. Transfer Pricing as a Current and Future Issue

General issues with transfer pricing

1.10.1 Several issues arise

Complexity

1.10.9 Rules based on the arm's length principle are becoming increasingly difficult and complex to administer. Transfer pricing compliance may involve expensive databases and the associated expertise to handle the data. Transfer pricing audits need to be performed on a case by case basis and are often complex and costly tasks for all parties concerned.

1.10.10 In developing countries resources, monetary and otherwise, may be limited for the taxpayer (especially an SME) who has to prepare detailed and complex transfer pricing reports and comply with the transfer pricing regulations, and these resources may have to be "bought in". Similarly the tax authorities of many developing countries do not have sufficient resources to examine the facts and circumstances of each and every case so as to determine the acceptable transfer price, especially in cases where there is a lack of comparables. Transfer pricing audits also tend to be a long, time consuming process which may be contentious and may ultimately result in "estimates" fraught with conflicting interpretations.

1.10.11 In case of

greater detail later in this Manual. An overview of location savings is provided at Chapter 5, at Para 5.3.2.4.5 and specific country practices on the use of location savings are provided at Chapter 10.

1.11 Summary and Conclusions

1.11.1 Transfer pricing is generally considered to be the major international taxation issue faced by MNEs today. It is an enormously important issue for many countries, developing and developed. Even though responses to it will in some respects vary, transfer pricing is a complex and constantly evolving area and no government or MNE can afford to ignore it.

1.11.2 For both governments and taxpayers, transfer pricing is difficult to grapple with; it tends to involve significant resources, often including some of the most skilled human resources, and costs of compliance. It is often especially difficult to find comparables, even those where some adjustment is needed to apply the transfer pricing methods.

1.11.3 For