

Transfer Pricing: Principles and Practice¹

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1. Introduction

The current globalised international economy, in which intra-group transactions are predominant, provides international enterprises² with significant tax planning opportunities. International enterprises have the capacity and incentive to shift profits between jurisdictions to take advantage of differences between national company tax rates. The economic incentive for international enterprises to avoid taxation is to maximise their after-tax profits, and they are usually indifferent as to the countries in which tax is paid. In response, governments in developed and developing countries are pursuing tax revenue from international trade to protect their domestic tax bases. International enterprises have to deal with demands from the various jurisdictions in which they operate as national tax agencies implement measures to protect their revenue from international trade between associated entities. International enterprises often incur significant costs in complying with domestic tax rules and at times are subject to double taxation in situations in which relief is unavailable.

Transfer pricing manipulation is one of the tax planning techniques that may be used by international enterprises to minimise their overall level of worldwide taxation. The transfer pricing policies of international enterprises have an effect on the taxable profits or losses that these enterprises report in the countries in which they carry on business. The *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*³ (*Transfer Pricing Guidelines*) provide measures to counter transfer pricing manipulation to ensure that each jurisdiction in which an international enterprise carries on business receives an appropriate amount of revenue from cross-border intra-group trade. The *Transfer Pricing Guidelines* are premised on the arm's length principle that controlled transfer prices should reflect prices

¹ The views expressed in this paper are the views of the author and do not necessarily reflect the views or policies of the Asian Development Bank (ADB) or its Board of Directors or the governments they represent. ADB makes no representation concerning and does not guarantee the source originality, accuracy, completeness, or reliability of any statement, information, data, finding, advice, opinion, or views presented.

² The term 'international enterprise' is used in this paper to refer to a company operating around the world through locally incorporated subsidiary entities.

³ (Paris; OECD, 2001).

used in uncontrolled transactions between unrelated entities. These rules have been enacted in the domestic law and tax treaties of many jurisdictions resulting in transfer pricing being a key tax concern for international enterprises. Transfer pricing is an area in which there are risks for both tax agencies and international enterprises as there is no single rule for determining the right transfer price; transfer pricing is an art not a science. The risk transfer pricing poses for tax agencies is tax avoidance, and the OECD has recently stated that ‘transfer pricing is where the big bucks lie.’⁴ Transfer pricing enforcement by tax agencies creates uncertainty for taxpayers with the risk of adjustments, penalties and the potential for unrelieved double-taxation. Consequently, managers of international enterprises rate transfer pricing as their key international tax concern.

This paper provides an introduction to the transfer pricing principles and practice. The central theme of this paper is that developing countries need to both develop transfer pricing rules and enforce them to ensure that their tax bases are protected when controlled transactions are undertaken by associated enterprises operating within their borders. Transfer pricing manipulation provides international enterprises with tax planning techniques to reduce their overall tax liabilities by shifting profits from high tax jurisdictions to low tax jurisdictions. Transfer pricing enforcement by some jurisdictions may encourage international enterprises to use transfer prices in favour of those jurisdictions to minimise risk of adjustments. This paper outlines the motivations for associated international enterprises to engage in international profit shifting through transfer pricing manipulation. The *Transfer Pricing Guidelines* provide internationally accepted measures to counter transfer pricing manipulation. The paper analyses the arm’s length principle for allocating profits of international enterprises between the jurisdictions in which they carry on business. Although the arm’s length principle is internationally accepted there are problems in its practical application. Transfer pricing rules should ideally be implemented to operate at both the domestic law level and at the tax treaty level.

⁴ J. Weiner, TNI interview: Jeffrey Owens, (28 May 2007) *Tax Notes International* 913.

2. What is transfer pricing?

Transfer pricing is the price at which intra-group transactions take place and is a normal business activity.⁵ According to the OECD: ‘Transfer prices are the prices at which an enterprise transfers physical goods and intangible property or provides services to associated enterprises.’⁶ Transfer pricing is the price charged for the transfer of property or services between associated entities, or intra-group trade, also referred to as controlled transactions. The economic reason for associated entities charging transfer prices for intra-group trade is to be able to measure the performance of the individual entities in a company group. The individual entities within a company group are separate profit centres and transfer prices are required to determine the profitability of the entities. The charging of transfer prices provides managers and accountants with a method of determining whether it is in a profit centre’s best interests to engage in intra-group trade instead of transacting with independent entities. In other words, an entity will only acquire products or services from an associated entity if the purchase price is equal to, or cheaper than, prices being charged by unrelated suppliers. This principle applies in reverse for an entity providing a product or service.

An important reason for setting transfer prices for intra-group cross border transactions is that jurisdictions require taxpayers to declare their profits from intra-group cross-border transactions. Most jurisdictions tax resident companies on their worldwide income and they tax non-residents on the source income derived from the host country. In the case of permanent establishments - non-resident companies with a fixed place of business in the source country - the permanent establishments are taxed on profits attributable to them. Resident companies must use transfer prices to determine their profits for tax purposes in their country of residence. Similarly, permanent establishments of an international enterprise must use transfer pricing for their notional intra-entity cross border transactions to calculate their taxable profits in their host country.

⁵ L. Eden, *Taxing Multinationals: Transfer Pricing and Corporate Income Taxation in North America* (Toronto; University of Toronto Press, 1998), p. 20.

⁶ *Transfer Pricing Guidelines*, para. 11.

3. Transfer pricing manipulation

Transfer pricing has attracted the connotation of tax avoidance, but transfer pricing at large needs to be distinguished from transfer pricing manipulation.⁷ Transfer pricing manipulation is the intentional setting of a transfer price for a transaction by one entity with an associated entity in another jurisdiction, for the purpose of reducing the aggregate tax burden of the group.⁸ Transfer pricing manipulation is a significant avoidance technique available to international enterprises and is consequently one of the major international tax issues.⁹ The motivation to reduce taxation is one of the motives influencing an international enterprise in the setting of transfer prices for intra-group transactions, but it is not the only factor influencing the transfer pricing policies and practices of the international enterprise.

The aim of transfer pricing manipulation is to reduce a company group's worldwide taxation by shifting profits to low tax countries through either under-charging or over-charging an associated entity for intra-group trade. The net result of transfer pricing manipulation is to maximise an international enterprise's after tax profits. For example, if an international enterprise has a tax rate in the residence country of the parent company of 30% and it has a subsidiary entity resident in another country with a tax rate of 20%, the parent has an incentive to shift profits to its subsidiary to reduce its tax rate on these amounts from 30% to 20%. If the parent company shifts \$1 million of taxable profits through transfer pricing manipulation it will make a tax saving of \$100,000. This could be achieved through transfer pricing manipulation by the parent being over-charged for the acquisition of property and services from its subsidiary.

While the most obvious motivation for transfer pricing manipulation is reducing an international enterprise's worldwide taxation, other factors may create an inducement for transfer pricing manipulation, such as imputation tax benefits in the residence country. Some countries, including Australia and New Zealand, provide tax credits to shareholders for corporate tax paid by a company. But tax credits are only provided for corporate tax paid by the international enterprise in Australia. Tax credits are not provided to shareholders for

⁷ L. Eden, *supra* note 3, p. 20.

⁸ *Ibid*, pp. 20-21.

⁹ V. Tanzi, 'The Nature and Effects of Globalization on International Tax Policy, Technological Developments, and the Work of Fiscal Termites' (2001) 26 *Brooklyn Journal of International Law* 1261, p. 1269; R. S. Avi-Yonah, 'The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation' (1995) 15 *Virginia Tax Review* 89, p. 90.

foreign taxes paid by an international enterprise. For example, if an Australian resident international enterprise has a tax rate in Australia of 30% and its subsidiary company in Country A has the same tax rate in that country, the tax benefit of being able to provide its Australian shareholders with a tax credit for Australian company tax paid by the enterprise provides it with the incentive to shift profits to Australia. As Australia provides relief from double taxation by, either exempting the foreign income or providing foreign tax credits for any foreign income subject to double taxation, it may be assumed that there is no incentive for Australian international enterprises to engage in transfer pricing manipulation. As the tax rate in both countries is the same the international enterprise should be indifferent, from an economic perspective, as to where it pays tax as its foreign income is either exempt or it can claim a credit for foreign taxes. While the overall tax paid by the international enterprise is the same whether it is paid in Australia or in Country A, the tax credit cannot be passed on to resident shareholders for foreign taxes. Consequently, there is an incentive for Australian international enterprises to pay tax in Australia and avoid foreign taxes in order to be able to provide resident shareholders with tax credits. This notion runs counter to the normal economic inference that an international enterprise will have an incentive to shift profits to lower tax jurisdictions.

Developed countries have domestic transfer pricing rules and tax treaties, which also provide the capacity to make transfer pricing adjustments. For transfer pricing measures to be effective a tax jurisdiction must enforce them and ensure that taxpayers comply with the rules. If developed jurisdictions, such as the United States, United Kingdom, Japan, or Australia, have detailed transfer pricing rules which are enforced, international enterprises have an incentive to make sure that adequate profits are reported in these jurisdictions from intra-group trade. If other jurisdictions either do not have transfer pricing measures or do not enforce their transfer pricing measures, there is an incentive to ensure that intra-group transfer prices favour jurisdictions that enforce their rules. In this situation an international enterprise minimises the risk of transfer pricing adjustments and penalties in countries such as the United States, Japan and Australia by using transfer prices that favour these jurisdictions to the detriment of the other jurisdictions in which they carry on business. This may be described as taking the line of least resistance, but it does provide an incentive for developing jurisdictions to develop and enforce transfer pricing rules to protect their revenue base.

The notion that international enterprises would use transfer prices to shift profits to countries which enforce their transfer pricing rules, in order to avoid transfer pricing scrutiny, is a paradox. It is normally expected that an international enterprise would shift profits to jurisdictions in which tax law, such as transfer pricing rules, is not enforced. Transfer pricing is a 'zero sum game' - a situation in which the gain by one jurisdiction must be matched by a loss by the other jurisdiction. An over-allocation of an international enterprise's profits to one jurisdiction will result in profits being under-allocated to another jurisdiction. Consequently, some international enterprises may set their transfer prices to favour a jurisdiction expected to enforce its transfer pricing rules, in order to minimise the risk of transfer pricing adjustments and penalties. As stated above, transfer pricing is an international enterprise's most significant tax concern. Transfer pricing adjustments and penalties imposed on international enterprises may be significant. Moreover, transfer pricing disputes are often time consuming. For example, in 2006 the GlaxoSmithKline Group (GSK) settled the largest US transfer pricing dispute with the US IRS. The tax dispute involved transfer prices used between GSK and its foreign associated entities for the income years 1989-2000. The cost to GSK of the settlement was approximately \$3.4b US.¹⁰ GSK was involved in transfer pricing negotiations with the IRS for 14 years. Publicity generated by incidents such as the GSK case would be expected to have a significant deterrent effect.

On the issue of enforcing transfer pricing rules, tax agencies often have the support of the large accounting firms. The international accounting firms advise international enterprises on their transfer pricing risks in the countries in which they operate. The international accounting firms have expertise in providing advice on acceptable transfer prices, but the fees charged by the firms are costly. If an international enterprise forms the view that certain jurisdictions are not enforcing their transfer pricing rules, there is no point in paying fees to an international accounting firm for transfer pricing advice in these jurisdictions. Consequently, international accounting firms are not consulted by international enterprises on transfer pricing if there is a limited chance that the international enterprises' transfer prices will be scrutinised.

¹⁰ 'IRS Accepts Settlement Offer in Largest Transfer Pricing Dispute', Internal Revenue Service press release No. IR-2006-142, 11 September 2006.

4. Measures to counter transfer pricing manipulation

The scope for transfer pricing manipulation is significant because of the rapid increase in trade between associated enterprises; trade between associated international corporations was 25% of world trade in the 1980s¹¹ and in 2002 it was estimated to have reached 70%.¹²

Measures to counter transfer pricing manipulation are domestic transfer pricing rules and the transfer pricing rules in tax treaties. Transfer pricing rules are simply a method of countering a specific type of tax avoidance.¹³ Transfer pricing rules prescribe that a price for a transaction between associated entities, or a notional transaction between a head office and a branch of an international enterprise, must be comparable to prices for similar transactions between independent entities, in accordance with the arm's length principle. If this requirement is not satisfied, a tax agency may make a transfer pricing adjustment. Under the arm's length principle, the norm of the market place is imposed on intra-enterprise or intra-group transactions.¹⁴ But, the determination of arm's length transfer prices is not an exact method and a tax agency must use judgement in settling on an arm's length price from within a range of prices.¹⁵ Because of the growth in intra-firm trade, the arm's length principle is estimated to apply to 70% of cross-border trade.¹⁶

Tax treaties based on the OECD and UN models are premised on the arm's length principle because Articles 7 (the business profits article) and 9 (the associated enterprises article) of these models treat each of the head office and branches of an international enterprise, and its associated entities, as separate entities operating at arm's length. Under the arm's length principle the transfer prices for notional transactions between the head office and a branch of an international enterprise, and transactions between associated entities, must reflect the prices that independent entities would have used for similar transactions. The OECD has

¹¹ United States General Accounting Office, *International Taxation: Problems Persist in Determining Tax Effects of Intercompany Prices*, Report No. GAO/GGD-92-89 (1992), pp. 62-63.

¹² H. Hamaekers, 'Arm's Length - How Long?' in P. Kirchhof, M. Lehner, A. Raupach and M. Rodi (eds.), *International and Comparative Taxation* (The Hague; Kluwer Law, 2002) 29-52, p. 29. It should be noted that this estimate did not include supporting data or sources.

¹³ S. Cnossen, *Tax Policy in the European Union, A Review of Issues and Options* (Rotterdam; Erasmus University, 2001), p. 8.

¹⁴ S. S. Surrey, 'Reflections on the Allocation of Income and Expenses Among National Tax Jurisdictions' (1978) 10 *Law and Policy in International Business* 409, p. 414.

¹⁵ *Ibid.*, pp. 429-430.

¹⁶ H. Hamaekers, *supra* note 11, p. 51.

given significant attention to transfer pricing, centred on the arm's length principle, and in 1995 it issued the *Transfer Pricing Guidelines*.

4.1. The arm's length principle

Under the arm's length principle the entities in a company group are treated as separate entities dealing at arm's length with each other. Similarly, under the arm's length principle, an international entity operating through branches is treated as a group of separate entities dealing at arm's length with one another. Several rationales have been advanced as the basis for the use of the arm's length principle for transfer pricing. In an open market, companies considering a potential transaction are assumed to act rationally, and to evaluate alternative transactions to determine which is the most profitable type of transaction.¹⁷ Under the arm's length principle, intra-entity or intra-group transactions are compared to transactions between unrelated entities to determine acceptable transfer prices. Thus, the marketplace comprising independent entities, is accepted as the mechanism for verifying whether transfer prices for intra-entity or intra-group transactions are acceptable for tax purposes.¹⁸

The rationale for the arm's length principle itself, is that because the market governs most of the transactions in an economy it is appropriate to treat intra-entity or intra-group transactions as equivalent to those between independent entities. Under the arm's length principle the allocation of profit and expenses in relation to intra-entity and intra-group transactions is tested and adjusted, if the transfer prices for the transactions deviate from the transfer prices for comparable arm's length transactions.¹⁹ The arm's length principle is argued to be acceptable to taxpayers and tax agencies because it uses the marketplace as the norm, rather than allocating profits on the basis of a formula.²⁰ The US first incorporated the arm's length principle into its domestic tax law in 1936,²¹ and clearly promotes it as the accepted international norm. However this view is not universal, for while some describe the arm's

¹⁷ J. M. Weiner, *Using the Experience in the U.S. States to Evaluate Issues in Implementing Formula Apportionment at the International Level*, Report No. OTA Paper 83 (1999), pp. 2-3.

¹⁸ S. S. Surrey, *supra* note 13, p. 414.

¹⁹ *Ibid.*, pp. 414-415.

²⁰ United States General Accounting Office, *supra* note 10, p. 59.

²¹ *Ibid.*

length principle as having the status of customary law,²² others claim that it is not an international norm.²³

A further argument in favour of using the arm's length principle, is that it is geographically neutral. It is considered to be geographically neutral because it treats profits from investments both in a residence jurisdiction and a source jurisdiction in the same manner.²⁴ But this claim of neutrality is conditional on consistent rules and administration of the arm's length principle throughout the jurisdictions in which an 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.

The final argument in support of the arm's length principle is that if it is used by most jurisdictions, the risk of double taxation will be minimal.²⁵ Double taxation may still occur despite the use of the arm's length principle if one tax agency adjusts an international enterprise's transfer prices and the two countries do not resolve any resulting dispute.²⁶ It is relatively easy to describe the arm's length principle, but establishing guidelines on the practical application of the principle is a challenging task given the lack of comparables.²⁷

5. Problems with applying the arm's length principle to international enterprises

Several problems arise when applying the arm's length principle used in the *Transfer Pricing Guidelines* to the domestic laws of jurisdictions. The high level of integration of international enterprises, the intra-entity intangibles and services, and the use of sophisticated financing arrangements have eroded the normative basis for the arm's length principle and made it more difficult to apply.²⁸ Thus it is argued that the arm's length principle is obsolete, and inadequate as a basis for allocating the profits of international enterprises.

²² C. Thomas, 'Customary International Law and State Taxation of Corporate Income: The Case for the Separate Accounting Method' (1996) 14 *Berkeley Journal of International Law* 99.

²³ S. I. Langbein, 'The Unitary Method and the Myth of Arm's Length' (1986) 30 *Tax Notes* 625.

²⁴ Ibid.

²⁵ United States General Accounting Office, *supra* note 10, p. 60.

²⁶ Ibid.

²⁷ See S. S. Surrey, *supra* note 13, p. 419.

²⁸ R. J. Vann, 'International Aspects of Income Tax' in V. Thuronyi (ed.) *Tax Law Design and Drafting* (Washington D.C.; The International Monetary Fund, 1998) 718-810, p. 783.

Prior to the globalisation of the past 55 years, the arm's length principle may have been a more appropriate method for allocating profits and expenses within an international enterprise.²⁹ International trade was based on transactions involving the sale of primary tangible items. Due to geographic and economic isolation, subsidiaries and branches of an international enterprise were autonomous, and consequently it may have been appropriate to treat subsidiaries and branches as separate entities. Moreover, there were generally comparable transactions between independent enterprises from which to derive comparative prices.

But with increasing globalisation, sophisticated communication systems and information technology allow an international enterprise to control the operations of its foreign branches and subsidiaries from one or two locations worldwide. Trade between associated enterprises is often in intangible items. For example, in 1998 in the US, more than half of capital expenditure was for information technology other than software,³⁰ and structural change has seen significant growth in the service sectors of developed countries, the economies of which have a high demand for services and declining demand for products.³¹ The nature of the world on which the international tax system's principles are based, has changed significantly.³² This raises the issue of whether we should continue to apply the arm's length concept to globalised and integrated international business operations. One of the foundations of the arm's length principle, comparative pricing, is rarely available, thus weakening the continued validity of the application of the principle.³³ It is questionable whether significant resources should continue to be devoted to the administration of transfer pricing rules in this form.³⁴ Therefore, the arm's length principle does present challenges in allocating the income of highly integrated international enterprises.

5.1. Administrative burden

Transfer pricing audits must be done on a case-by-case basis and are often complex and costly tasks for both the tax agency and the taxpayer, especially given the large volume of

²⁹ R. J. Vann, 'A Model Tax Treaty for the Asian-Pacific Region? (Part I)' (1991) 45 *Bulletin for International Fiscal Documentation* 99, p. 105.

³⁰ Ibid.

³¹ V. Tanzi, 'Forces That Shape Tax Policy' in H. Stein (ed.) *Tax Policy in the Twenty-First Century* (New York; Wiley, 1988) 266-277, p. 276.

³² C. I. Kingston, 'The David Tillinghast Lecture: Taxing the Future' (1998) 51 *Tax Law Review* 641, p. 642.

³³ H. Hamaekers, *supra* note 11, p. 51.

³⁴ Ibid.

transactions that may potentially be examined.³⁵ The lack of comparable prices results in complexity because of the need for a tax agency to examine the facts and circumstances of each case to determine what it considers to be acceptable transfer prices.³⁶ Consequently, it is beyond the capacity of tax agencies to examine more than a limited number of transactions. Furthermore, it is likely to be impossible to find comparable transfer prices for highly integrated enterprises because of economies of scale and shared expenses.³⁷ Even if comparable transfer prices exist, the administrative burden on tax agencies in monitoring transfer prices to ensure compliance with transfer pricing rules is costly.³⁸

5.2. Intangible assets

Intangible assets can be divided into commercial intangibles, such as patents, licenses, and technical data, and marketing intangibles such as trademarks and branch names.³⁹ Enterprises owning unique intangible assets will have a competitive advantage that allows them to make monopoly profits.⁴⁰ Determining the income from intangible assets is a major obstacle under the arm's length principle, as intangible assets usually involve unique property, and consequently, comparable prices will usually be unavailable.⁴¹

6. International transfer pricing practice

Ernst & Young carries out international transfer pricing surveys of international enterprises. In its 2005 survey of the financial services industry the firm found that transfer pricing is a major concern for international enterprises.⁴² The survey disclosed that tax agencies around the worldwide are increasing their efforts to enforce their transfer pricing rules as this enforcement provides them with the ability to increase their tax revenues without increasing their tax rates. Other survey findings were:

³⁵ United States General Accounting Office, *supra* note 10, p. 60.

³⁶ *Ibid.*

³⁷ C. E. McLure and J. M. Weiner, 'Deciding whether the European Union should adopt formula apportionment of company income' in S. Cnossen (ed.) *Taxing Capital Income in the European Union* (Oxford; Oxford University Press, 2000) 243-292, p. 248.

³⁸ *Ibid.*, pp. 248-249.

³⁹ *Transfer Pricing Guidelines*, para. 6.3.

⁴⁰ United States General Accounting Office, *IRS Could Better Protect U.S. Tax Interests in Determining the Income of Multinational Corporations*, Report No. GGD-81-81 (1981), p. 33.

⁴¹ United States General Accounting Office, *supra* note 10, p. 64.

⁴² Ernst & Young: http://www.ey.com/global/content.nsf/International/Financial_Services_-_Transfer_Pricing_Survey_2005.

- More than 80% of respondents intended to increase their efforts in managing their transfer pricing issues in 2006.
- Fewer than 60% of respondents dedicate between one to three people to managing their international enterprise's transfer pricing activity. Around 30% allocate one person to transfer pricing work.
- Areas of particular concern were managing head office services (70% of respondents), information technology (61%) and inter-group debt and guarantees (45%).
- The UK, US and Japan undertake the most transfer pricing audits, followed by Germany, France and Australia. A broad range of issues has been subject to transfer pricing examination with respondents identifying 20 different business lines/transfer pricing issues being challenged.
- In 2005 the survey indicated that the UK is expected to be the most active tax agency with 68% of the survey respondents expecting transfer pricing challenges in the UK in 2006 and 2007. Significant transfer pricing scrutiny was expected in the US, Japan, France, Germany, South Korea, India, Canada and Australia. The survey concluded that in the financial services sector the traditional global financial centres and other countries are likely to challenge international enterprises on their transfer pricing policies.

7. Transfer pricing methods

Article 9(1) of the OECD *Model Tax Convention on Income and Capital*⁴³ provides that where 'conditions are made or imposed between two enterprises in their commercial or financial relations which differ from those that would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to any one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.' This provision provides a tax agency with capacity to adjust transfer prices to reflect the 'true taxable profits arising in that State.'⁴⁴ The term 'true

⁴³ (Paris; OECD, 2005)

⁴⁴ OECD Commentary on Article 9(1).

taxable profits' is defined in the Commentary as 'those that would have been achieved in the absence of conditions that are not arm's length.' The underlying principle of Article 9 of the OECD Model Treaty is that transfer prices for transactions between associated entities must reflect arm's length prices.

The *Transfer Pricing Guidelines* set out five transfer pricing methods to determine whether a transfer price for a controlled transaction is an arm's length price. There are three traditional methods and two profit methods. The traditional methods compare controlled transfer prices to prices in uncontrolled transactions to determine if controlled transfer prices are at arm's length. If appropriate comparative transactions are unavailable the non-traditional methods, which focus on net profits from controlled transactions, may be used. In practice, because of the lack of comparative transactions the profit methods are most commonly used.

7.1. Comparative uncontrolled price method

The best method of determining if a price charged for property or services is arm's length is to compare controlled transactions to uncontrolled transactions. The comparative uncontrolled price (CUP) method 'compares the price charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances.'⁴⁵ If comparable uncontrolled transactions can be identified, a CUP may be extracted from which to test transfer prices used by associated entities in controlled transactions to ensure that the transfer prices comply with the arm's length principle. If there is a significant difference between transfer prices used by associated entities and the potential CUPs that have been identified, the CUPs may need to replace the transfer prices that were used by the associated entities. The CUP method is the most direct way of determining arm's length prices.

For a CUP to be reliable, property or services provided and the circumstances of their provision must be identical to the property or services and circumstances in transactions between associated entities. A CUP will be reliable if differences between the controlled and uncontrolled transactions would materially affect the CUP. If there are any differences, adjustments will be required to make the CUP a reliable comparator. If numerous adjustments are required to a CUP this method may not be reliable as an indicator of arm's length prices. The factors that need to be considered to ensure the reliability of a CUP are differences:

- between the products or services,
- in the quality of products or services,
- in the volume of sales,
- to the terms of transactions,
- in markets, such as region or level of operation, and
- in the type of intangible property including marketing intangibles, such as trademarks.

Example: The Chinese tax agency may be testing the transfer prices charged by a resident company for the export of tea to an associated entity in Singapore. Assume that the transfer price for the controlled transaction is \$100 per kilo and that the tea is unbranded. The Chinese entity may sell identical tea in similar quantities to unrelated buyers in Japan for the same price. If the contractual terms and geographic markets are the same, the prices paid by the Japanese buyers would represent a CUP for the transfer prices paid by the Singaporean entity. Adjustments to the CUP may be required if there are differences between the quality of the tea, quantity of tea, contractual terms or the geographic markets involved. If minor adjustments are made the CUP may still be reliable, but if significant adjustments are required the CUP will become unreliable.

The CUP works best for commodities for which there is a world market price, such as coal, oil and wheat. But even in relation to commodities it may be difficult at times to find a reliable CUP. In practice it is very difficult to find a CUP for products that are not commodities.

7.2. Resale price method

The resale price method (RPM) is used if an entity (the reseller) purchases products from associated entities in controlled transactions and then resells the products to independent buyers. In this situation the RPM determines a transfer price for a product by starting with the price paid by an independent buyer for the product and then deducting an appropriate gross profit margin for the functions performed by the reseller. The resulting price is the appropriate transfer price for the product. The gross profit margin used in the RPM is the margin an independent reseller would seek in order to cover its operating expenses and provide an

⁴⁵ *Transfer Pricing Guidelines*, para. 2.6.

appropriate return for the functions performed, assets used, and risks assumed by the reseller. If a reseller acquires property under both controlled and uncontrolled transactions, the gross profit margin for the controlled transactions may be calculated by reference to the reseller's gross profit margin derived from the uncontrolled transactions. In this situation an internal comparator is used to determine the appropriate gross profit margin. For associated entities that only acquire products through controlled transactions, the gross profit margins derived by independent entities selling similar products in uncontrolled transactions may be used to determine comparable gross profit margins. As with the CUP method, adjustments are required for any differences between controlled and uncontrolled transactions. The advantage of this method over the CUP method is that fewer adjustments are required to reflect product differences as minor differences in products are less likely to materially affect the reseller's gross profit margins.

Example: A Chinese company sells microwave ovens to an associated entity in Indonesia. A reliable CUP was not found because of the features of the microwave. The microwave ovens are sold by the associated entity for \$100 US per item to independent buyers and a two year warranty is provided by the associated entity. Distributors of similar products, such as kitchen appliance distributors, may be used for comparison purposes. Assume that appliance distributors make a gross margin of 30%, but the independent distributors do not provide warranties for their products. In this situation an adjustment is required for the warranty provided by the reseller in the controlled transaction. Assume that the product is very reliable and that only 2% of products sold are returned. In this situation an appropriate gross profit margin for the Indonesian entity may be 32% and the transfer price paid for products in the controlled transactions should be \$68 per item. The RPM commences with an arm's length price and then subtracts an appropriate gross margin for the reseller to determine the arm's length price for the controlled transaction.

7.3. Cost plus method

The cost plus method (CPM) determines an arm's length price by adding an appropriate gross profit margin to an associated entity's costs of producing products or services. The gross profit margin should reflect the functions performed by an entity and should include a return for capital used and risks accepted by the entity. The gross profit margin for a controlled transaction is calculated by reference to the gross profit margins made in comparative uncontrolled transactions. Ideally the comparative transactions should be the same or very

similar to the controlled transactions. If an associated entity engages in both controlled and uncontrolled transactions for the supply of the same products or services, the uncontrolled transactions may provide a comparative gross profit margin.

The comparison under the CPM should reflect the functions performed, risks involved, and contractual terms. While the products being compared under the CPM need not be similar, there are limitations to the product differences. If there is a significant difference between the products being produced by controlled and uncontrolled transactions, the product differences may reflect different functions being performed by the suppliers and would make these transactions unreliable comparators. When applying the CPM comparable accounting methods should be used. If there are differences between the accounting methods used for the controlled and uncontrolled transactions, the data will need to be adjusted to ensure the same costs and the same methods of measuring the costs are being used. The gross profit margins for controlled and uncontrolled transactions have to be measured consistently to ensure that the uncontrolled comparator being used is a reliable indicator of arm's length prices.

The factors that may be used to determine if comparative gross profit margins are reliable are:

- complexity of manufacturing or assembly,
- engineering of production and process,
- procurement, purchasing and inventory control,
- testing,
- selling, general and administrative expenses,
- foreign currency risk, and
- contractual terms, such as warranties, volume of sales, trade credit and transportation costs.⁴⁶

The OECD suggests that CPM is most appropriate where: semi-finished products are sold between related parties; long-term buy-and-supply arrangements, or where the controlled transaction is the provision of services.⁴⁷

7.3.1. Contract manufacturing and toll manufacturing

⁴⁶ UN Ad Hoc Group of Experts on International Cooperation in Tax Matters, *Transfer Pricing* (Geneva; UN, 2001)

⁴⁷ *Transfer Pricing Guidelines*, para. 2.32.

The CPM is also used for contract manufacturing and toll manufacturing. In manufacturing there are principal manufacturers, contract manufacturers and toll manufacturers. A principal manufacturer carries on a business of manufacturing goods and will sub-contract some of its manufacturing work to contract and toll manufacturers. The principal manufacturer will own its products lines and will usually hold some intangible property which may include valuable trademarks and patents. Contract manufacturers provide manufacturing services to principal manufacturers and own the raw materials that are used in manufacturing and the finished products before sale to a principal manufacturer. The contract manufacturer does not develop product lines and performs manufacturing functions for principal manufacturers. Contract manufacturers do not have to bear market risk because they have an assured return for the work they are performing. Contract manufacturers may hold some know-how on the manufacturing process and procedures in acquiring raw materials for the manufacturing process. Toll manufacturers perform a manufacturing service for principal manufacturers. Toll manufacturers are provided the raw materials to be used in the manufacturing and they do not own the products produced prior to delivery to a principal manufacturer. Toll manufacturers, like contract manufacturers do not have market risk. Toll manufacturers receive a lower return than contract manufacturers as they are only service providers. Contract and toll manufacturers are usually rewarded on a per unit of production basis or a fee basis.

The CPM can only rarely be used for principal manufacturers as their profit margin will vary depending on the goods they produce. The gross profit margins will vary for each good produced and if there is a well recognized trademark, the gross profit margins may be significant. In practice it is usually difficult to find comparable product lines for principal manufacturers where significant trademarks exist, thereby preventing the CPM from being applied.

The CPM does have some problems in application, including the calculation of the costs of a supplier. While a business must at a very minimum be able to derive profits that cover its costs, the costs may not be determinative of appropriate gross profit margins for certain entities. Moreover, the OECD notes that in certain cases there may be no link between a business's costs and the market price for the products or services it produces.⁴⁸ Adjustments

⁴⁸ *Transfer Pricing Guidelines*, para. 2.36.

under the CPM need to be made to ensure that comparable costs are being compared. For example, if a supplier in a controlled transaction is operating from leased premises, the costs cannot be compared with a supplier in uncontrolled transactions operating from premises which it owns.

It is important that under the CPM comparable costs are being used in relation to the functions performed and risks being assumed by the parties. Expenses may be classified as operating expenses and non-operating expenses including financing expenses. The OECD suggests that the following factors be considered:

- If a supplier's expenses reflect a functional difference which has not been taken into account in applying this method, an adjustment to the cost mark plus mark up may be required.
- If a supplier's expenses reflect additional functions that are distinct from the activities tested by the method, additional compensation for these functions may be required.
- If differences in the costs of the parties being compared reflect significant efficiency or significant inefficiency, then adjustments to the gross profit margins being compared are not required.⁴⁹

Example: Company A is a principal manufacturer of laptop computers in Taipei, China and has several product lines and engages in research and development to maintain its market position. It uses a subsidiary, Company B, which is resident in Viet Nam, as a toll manufacturer for computer components. Company B is supplied with the raw materials by Company A to ensure that the quality of the component is maintained. Company B does not have to bear market and product risks. Company B has a 5 year contract under which it is remunerated at the rate of cost plus 35%. Taipei, China tax agency wants to ensure that the contract rate of cost plus 35% is not excessive. Company B also does contract manufacturing work for an unrelated Japanese company and is paid the rate of cost plus 40% but the contract periods are only one year. In this situation, assuming that the manufacturing services provided by Company B in the controlled and uncontrolled transactions are comparable, Company A would be able to defend its transfer prices.

⁴⁹ Ibid., para. 2.38.

7.4. The profit methods

The OECD states that the CUP method, RPM and CPM are the most direct means of determining transfer prices, but in reality it is unusual to find reliable comparable transactions. The OECD argues the profit-split method and the transactional net margin method are the only profit methods that satisfy the arm's length principle requirement. The OECD states that international enterprises may use the profit methods in exceptional circumstances where there is no comparable data available or it is unreliable. In practice, the transactional net margin method is the most commonly applied transfer pricing method. The key feature of the profit methods is that the profits from controlled transactions are allocated to an associated entity instead of checking the actual transfer prices used in each controlled transaction between associated entities.

7.5. The profit split method

If transactions between associated parties are highly integrated it may be impossible to evaluate each transaction separately for transfer pricing purposes. The OECD asserts that in this situation independent entities would set up a partnership and agree on a profit split for the business operation. The profit split method (PSM) identifies the profits from controlled transactions between associated entities that are to be allocated between the associated entities. This profit is then split between the associated entities on an economic basis. The profit allocated under this method is in theory required to reflect the profit allocation that unrelated entities would have used for performing similar functions. There are several approaches that may be used for estimating the allocation of profits based on either actual profits or expected profits. The *Transfer Pricing Guidelines* set out two methods that may be used, the contribution analysis or the residual analysis.⁵⁰ Under a contribution analysis, the OECD suggests that the profits from controlled transactions should be allocated on the basis of the relative value of the functions performed by each associated entity.⁵¹ The contribution analysis should be supplemented with external market data to indicate how independent entities would have allocated the profits in similar circumstances.

Under the residual analysis the profits from controlled transactions are allocated in two steps. This analysis may be used if an international enterprise has profits flowing from high value

⁵⁰ Ibid., para. 3.15.

⁵¹ Ibid., para. 3.16.

intangible property, such as internationally recognized trademarks, which cannot be readily allocated to one of the associated entities. Under the first step each associated entity is allocated 'sufficient profit to provide it with a basic return appropriate for the type of transactions in which it is engaged.' The associated entities are rewarded for the functions they perform, the tangible assets used and the risks accepted by each of the associated entities. The basic profit allocation would be determined by reference to the profits derived by independent entities from similar transactions. External market data is used to make the allocation under the first step. The OECD suggests that the external market criteria may include profit split percentages used by unrelated entities or the profits derived by independent entities performing the same function.⁵² Under the second step any residual profit or loss is allocated between the associated entities 'on an analysis of the facts and circumstances that might indicate how this residual would have been divided between independent enterprises.'⁵³ Factors considered in the application of this step are the relative contributions of the parties to the creation of the intangible property and their relative bargaining positions. It should be emphasized that the allocation of profits flowing from valuable intangible property under a residual analysis between associated entities is in most cases very difficult.

The main strength of the PSM is that its application does not depend on finding comparable uncontrolled transactions. This enables the method to be used in situations where there are no comparable uncontrolled transactions readily available. The profit allocation under the PSM reflects the functions performed by the associated entities. The OECD argues that under the PSM external commercial data may be used to provide valuations of the contributions of the associated entities, but not on the allocation of profits.⁵⁴ Consequently one of the benefits of the profits split method is the flexibility it provides and it is asserted by the OECD to conform to the arm's length principle as it reflects the profit allocations that unrelated entities would have used.

Another major advantage of the PSM is that the profits allocated between the associated entities will be balanced as the relative contributions of both entities are being evaluated. This method is particularly useful in analyzing the relative contributions of intangible property

⁵² Ibid., para. 3.5.

⁵³ Ibid., para. 3.19.

used in the controlled transactions. A risk with the other transfer pricing methods is that they are one-sided and the profits allocated under them may be excessive as the relative contribution of the other associated entity is not being considered. Another advantage of this method is that it can be used to allocate profits that arise from economies of scale or the efficiencies that associated entities may be able to exploit in controlled transactions.

The PSM has several shortcomings. The external data required for valuing the functions performed by the associated entities will not be as closely connected to those functions as with the traditional methods. This results in the allocation of profits under the functional analysis being arbitrary. But this is a difficulty that arises from trying to allocate profits from highly integrated business operations being carried by the associated entities. Another shortcoming of the PSM is that an associated entity may not have access to the amount of profits derived from controlled transactions by its associated entity in another jurisdiction. Even if the information of both associated entities is available, common accounting approaches in both jurisdictions would have to be used to ensure that the profits from the controlled transactions are being measured on a consistent basis.

Example: Company A, a US company, and Company B, a Malaysian company, are associated enterprises engaged in the manufacture and sale of a unique sports soft drink. The product has significant marketing intangibles such as a highly recognized international trademark. The sports drink syrup is made by Company A and sold to Company B. Company B mixes the drink, bottles and then sells it to retailers in Malaysia. Due to the significant marketing intangibles no uncontrolled comparable transactions are available. Company B also promotes the drink in Malaysia through television advertising and its average annual expenditure on advertising is \$6m US. The net profit from the controlled transactions is \$100m US. After undertaking a functional analysis it is determined that Company A owns the secret syrup recipe, manufactures the syrup and owns most of the trademark. Company B performs mixing, bottling, distribution and promotional functions. In this situation it is decided that a residual analysis is most appropriate given the facts and circumstances. Under the first step using comparable data for mixing, bottling and distribution functions it is determined that Company B should receive a basic return of \$40m US and that Company A should receive \$15m US for manufacturing the syrup. This leaves a residual

⁵⁴ Ibid, para 3.6.

profit of \$45m US to be allocated. As Company A owns the secret syrup recipe and has developed most of the trademark it is decided that 80% of the residual profit should be allocated to Company A: \$36m US. Company B has contributed to the value of the trademark and it should receive 20% of the residual profit: \$9m US.

7.6. Transactional net margin method

The most commonly used transfer pricing method is the transactional net margin method (TNMM). The TNMM tests the net profits from controlled transactions relative to an appropriate base, such as sales, assets or costs. The TNMM has similarities with the CPM or the RPM except that it measures net profits rather than gross profits. One problem with the CPM and RPM is that they rely on gross profit margins, but gross profit figures are often not available to taxpayers or tax agencies. On the other hand, net profit margins for comparison purposes are more commonly available. The TNMM must be applied in a similar manner to the CPM or RPM for it to be reliable. If an associated entity engages in both controlled and uncontrolled transactions, provided these transactions are comparable, the net margin it derives from the controlled transaction should reflect the net margins derived from the uncontrolled transactions. In most situations associated enterprises will only engage in controlled transactions and therefore a net margin derived by an unrelated entity from comparable transactions will have to be used for comparison purposes. As with the other transfer pricing methods, the TNMM requires a functional analysis to be undertaken. The functional analysis is required to determine whether the uncontrolled transactions are sufficiently comparable for them to be used as guide. It is also important to only use profit comparisons derived from uncontrolled international transactions.

There are several measurements that may be used in applying the TNMM. The appropriate ratio depends on the circumstances of the controlled transactions that are being examined. The aim of the TNMM is to determine an associated entity's net profit from its core business activities. The following ratios may be of use under the TNMM:

- The ratio of net profit before tax to sales. This ratio provides an indication of an enterprise's profitability. The net profit is net operating profit with non-operating income and costs excluded.
- The ratio of net profit before interest and tax to sales (NBIT). This profit measure is called earnings before interest and tax. A feature of NBIT is that the funding of the

enterprises (whether by debt or equity) is excluded from the comparison of operating profit from core business.

- The Berry ratio of gross profit to operating expenses provides a test of net profitability. A ratio of 1:1 is a break even point under this ratio.
- The ratio of net profit before tax to shareholders' funds. This ratio provides a measure of the return to shareholders on capital and retained earnings.
- The ratio of earnings before interest and tax to assets provides a return on assets.
- The ratio of net profit before tax to the number of employees, or the ratio of sales to the number of employees, may be used to test the relative efficiency of a business.⁵⁵

The above profit ratios may be distorted by factors such as business financing, business strategies, and business efficiency.

There are several advantages in using the TNMM. The main advantage of the method is that net profit margins are less likely to be affected by transactional functional differences than the traditional methods. Differences between functions performed in controlled and uncontrolled transactions should be reflected in operating expenses. Another advantage of the TNMM is that data is not required from an associated entity in a foreign jurisdiction. Furthermore, under the TNMM it is usually not necessary for the accounting records of the participants in a particular business operation to be stated on a common basis nor is it necessary to allocate costs for all participants.⁵⁶

The main disadvantage of the TNMM is that an associated entity's net profit margin from controlled transactions may be affected by factors that do not have an effect on price or gross margins. In this situation a reliable determination of arm's length net margins is problematic.

Example: Assume that a parent company has a wholly owned subsidiary company in India which distributes medicine within India for its parent. The Indian subsidiary imports the medicine from its Japanese parent and it distributes the medicine to pharmacies in India. It also engages in some minor advertising of the product with the medical profession in India. Assume that the sales revenue of the Indian subsidiary is \$100m US for an income year and that the profits of the Japanese parent company from the controlled transactions are not

⁵⁵ Australian Taxation Office, Taxation Ruling TR 97/20 'Income tax: arm's length transfer pricing methodologies for international dealings', para. 3.81.

⁵⁶ *Transfer Pricing Guidelines*, para 3.28.

obtainable by the Indian subsidiary. Assume that the CUP method could not be applied because there were no comparable medical products and that the gross profit margin of independent entities carrying on similar activities is not available. But we are able to find that entities performing comparable distribution and marketing functions for certain medical products receive a net profit margin to sales of 10%. The arm's length principle prescribes that the Indian company should receive an arm's length profit for the distribution and marketing functions it performs in India. In this situation we are able to determine that the Indian subsidiary company should be making a taxable profit of \$1,000,000 from the controlled transactions.

8. Conclusion

Transfer pricing is an important issue for international enterprises and the tax agencies of the jurisdictions in which they operate. International enterprises rate transfer pricing as the most important tax issue they face. Developing countries should implement and enforce transfer pricing rules to protect their revenue from cross-border controlled transactions. There are numerous motivations for an international enterprise to engage in profit-shifting through transfer pricing manipulation. The main incentive is to reduce the worldwide tax liability of an international enterprise and thereby increase its after-tax returns to shareholders. Another incentive may be to use transfer prices that favour jurisdictions which have a reputation for enforcing their transfer pricing measures to minimize the risk of adjustments and accompanying penalties in those jurisdictions. The *Transfer Pricing Guidelines* set out internationally accepted measures to counter transfer pricing manipulation and to ensure that an international enterprise allocates an appropriate amount of its profits from controlled transactions to the jurisdictions in which it carries on business operations. The transfer pricing rules are based on the arm's length principle which requires that transfer prices should reflect prices used in identical or similar uncontrolled transactions. There are however, difficulties in applying the arm's length principle in practice. The *Transfer Pricing Guidelines* set out the internationally accepted transfer pricing methods that may be used and state that the most appropriate method must be adopted. In most cases comparable uncontrolled transactions will be unavailable and the transactional net margin method will be the best method. As transfer pricing is not an exact science, transfer pricing cases often present some uncertainty and attendant challenges for tax agencies and international enterprises alike.