TRANSFER PRICING – DEFINITION AND METHODS

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Abstract: Transfer prices refer to the terms and conditions which so called "associated enterprises" agree for their "controlled transactions." Examples of such transactions are the provision of management services, the supply of goods and the provision of loans. According to this widely used OECD definition, enterprises are associated if*:* (a) an enterprise participates directly or indirectly in the management, control or capital of another enterprise or (b) the same persons participate directly or indirectly in the management, control or capital of two enterprises. Transfer prices are very important, because of the following: there are large differences in tax rates between countries. If left unchecked, the practice could lead to the shifting of profits from high-tax countries to lower tax countries. Even though less likely, it can also be the case that the pricing policy leads to multinationals reporting too much taxes in high tax countries and too little in low tax countries. The main goal of transfer pricing regulation is to prevent both situations and ensure that profits are taxed at the place where value is actually created. Transfer pricing rules provide that the terms and conditions of controlled transactions may not differ from those which would be made for uncontrolled transactions. The main goal of these rules is to prevent profit shifting from high-tax countries to low-tax countries (and the other way around, although less likely).

The aim of this paper is to investigate the importance of transfer pricing, and to examine what are the methods of transfer pricing available.

Most countries have transfer pricing rules in their domestic tax legislation. In a nutshell, these rules provide that the terms and conditions of controlled transactions may not differ from those which would be made for uncontrolled transaction (transactions between independent enterprises). This is referred to as the arm's length principle.

There are several methods that multinational enterprises and tax administrations can use to determine accurate arm's length transfer pricing for transactions between associated enterprises. The Organization for Economic Cooperation and Development (OECD) outlines five main transfer pricing methods that these enterprises and tax administrations can use. We explore the five methods, giving examples for each, to help organizations decide which is most appropriate for their needs: 1. Comparable uncontrolled price (CUP) method; 2. Resale price method; 3. Cost plus method; 4. Transactional net margin method (TNMM); 5. Transactional profit split method. These are the five transfer pricing methods, and the ones favored by the OECD. The option that an organization chooses to use depends on the particular situation. It should take into account the amount of relevant comparables data that is available, the level of comparability of the uncontrolled and controlled transactions in question, and whether a method is appropriate for the nature of a particular transaction (determined through a functional analysis). The OECD states that it is not necessary to use more than one transfer pricing method when determining the arm's length price for a particular transaction.

Keywords: transfer, pricing, associated entities, controlled transactions, methods

1. INTRODUCTION

The globalization of world economy has hauled the structure of business transactions. The business entities engaged in multinational businesses are always looking for opportunities to enhance their business and particularly they try to find ways to save their tax liabilities. For that purpose, they use number of schemes. One of such kind of element is transfer pricing, which is used by all the business entities to transfer their profits and reduces the tax liabilities.

Transfer pricing, in general, is the value attached to the sale of goods or services between related parties. To make it simpler, transfer pricing is the process where the multinational entities transact with those entities that have common controlling power or the related parties and the profit earned by such proceeds is transferred to the country which has least tax slabs. The prices at which such transactions are conducted are generally low as compared to those prices at which they sell to the non-related party/company. The price at which the goods are sold to the non-related party is known as Arm's length price. No doubt, the scheme has given ample opportunities to large multinational business entities. But like a double-edged sword, it has been also abused by many. The scheme is not illegal in itself but it has been misused to manipulate the prices. That is the reason, it became import to regulate the pricing scheme and keep a check to maintain the smooth running of the economy.

2. TRANSFER PRICES MEANING

Transfer prices refer to the terms and conditions which so-called "associated enterprises" agree for their "controlled transactions." Examples of such transactions are the provision of management services, the supply of goods and the provision of loans. According to this widely used OECD definition, enterprises are associated if:[90]

(a) an enterprise participates directly or indirectly in the management, control or capital of another enterprise or (b) the same persons participate directly or indirectly in the management, control or capital of two enterprise

For example, if a subsidiary company sells goods to a parent company, the cost of those goods paid by the parent to the subsidiary is the transfer price. Legal entities considered under the control of a single corporation include branches and companies that are wholly or majority owned ultimately by the parent corporation. Certain jurisdictions consider entities to be under common control if they share family members on their boards of directors. Transfer pricing can be used as a profit allocation method to attribute a multinational corporation's net profit (or loss) before tax to countries where it does business. Transfer pricing results in the setting of prices among divisions within an enterprise.

Transfer pricing multi-nationally has tax advantages**,** but regulatory authorities frown upon using transfer pricing for tax avoidance. When transfer pricing occurs, companies can book profits of goods and services in a different country that may have a lower tax rate**.** In some cases, the transfer of goods and services from one country to another within an interrelated company transaction can allow a company to avoid tariffs on goods and services exchanged internationally. The international tax laws are regulated by the Organization for Economic Cooperation and Development (OECD)**,** and auditing firms within each international location audit financial statements accordingly.

Article 9 of the OECD Model Tax Convention is dedicated to the Arms Length Principle (ALP). It says that the transfer prices set between the corporate entities should be in such a way as if they were two independent entities. A framework has been provided by the OCED in the Transfer Pricing Guidelines issued by it which provides details regarding the arm's length price.

ALP is based on real markets and provides the MNE's and the governments a single international standard for the contracts that allows various different government entities to collect their share of tax at the same time creating enough room for the MNE's to avoid the double taxation.[91]

Example:

USAco, a local company, makes small engines available to be purchased both in the United States and abroad. Outside deals are made through BITco, a wholly owned foreign company. USAco's engines cost $1200 to make and $200 to market, and offer for $2,000 abroad. Notwithstanding the transfer prize utilized for deals by USAco to BITco, the consolidated income from a remote deal is $600 per engine [$2,000 final sales price -$1200 manufacturing cost -$200 selling expense]. Be that as it may, transfer prices do influence the designation of that joined profit amongst USAco and BITco.

At one end, a transfer price of $600 would designate the consolidated profit of $600 totally to BITco, as takes after:

Transaction	Effect on USAco.	Effect of BITco.
Manufacture engine	Production cost = 1200 $	
Controlled sale	Sales revenue = 1200 $	Cost of sale = 1200$
Foreign selling activities		Selling expenses = 200$
Sale to foreign customer		Sales revenue = 2000 $
	Net profit = 0 $	Net profit = 600$

[90] https://transferpricingasia.com/what-is-tp/

[91] Ruud De Mooij and Li Liu, "At a Cost: The Real Effects of Transfer Pricing Regulations", IMF Working Paper, 2018

At the other extreme, a transfer price of $1800 would designate the combined benefit of $600 totally to USAco, as follows.

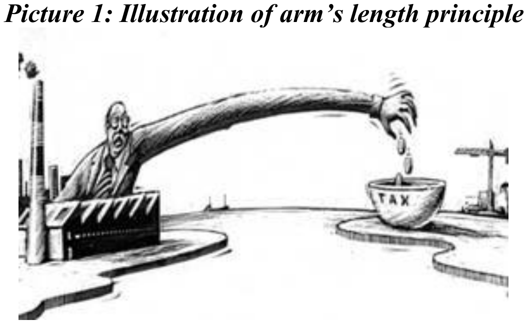
Transaction	Effect on USAco.	Effect of BITco.
Manufacture engine	Production cost = 1200 $	
Controlled sale	Sales revenue = 1800 $	Cost of sale = 1800 $
Foreign selling activities		Selling expenses = 200 $
Sale to foreign customer		Sales revenue = 2000 $
	Net profit = 600 $	Net profit = 0 $

3. ARM'S-LENGTH PRINCIPLE

When we look at countries around the world, we can see huge differences in tax rates. If left unchecked, Multinational Enterprises (MNEs) could shift profits from high-tax countries to low-tax countries. How? Well, MNEs always have internal transactions. A regional head-quarter invoicing management and service fees. A holding company providing financing to an operational company. A manufacturing branch supplying finisheds product to a distributing branch. MNEs are able to control the terms and conditions of these transactions. They can *set the price*. This way, they can influence taxable profit and the amount of tax due. To prevent this from happening, tax administrations (organized in the OECD) have invented the arm's length principle**.** This principle requires that controlled transactions are done at market rates.

The "arm's-length principle" of transfer pricing states that the amount charged by one related party to another for a given product must be the same as if the parties were not related (Picture 1). An arm's-length price for a transaction is therefore what the price of that transaction would be on the open market. For commodities, determining the arm's-length price can sometimes be as simple a matter as looking up comparable pricing from non-related party transactions, but when dealing with proprietary goods and services or intangibles, arriving at an arm's length price can be a much more complicated matter. US transfer pricing law requires that the best method rule be used to determine which transfer pricing methodology is most appropriate for determining the arm's-length price of a given transaction.[92]

Picture 1: Illustration of arm's length principle



In a bid to avoid such problems, current OECD international guidelines are based on the arm's length principle – that a transfer price should be the same as if the two companies involved were indeed two independents, not part of the same corporate structure. The arm's length principle (ALP), despite its informal sounding name, is found in Article 9 of the OECD Model Tax Convention and is the framework for bilateral treaties between OECD countries, and many non-OECD governments, too.

The OECD Transfer Pricing Guidelines provide a framework for settling such matters by providing considerable detail as to how to apply the arm's length principle. In the hypothetical French-Dutch bicycle case, the French MNE could ask the two tax authorities to try to reach agreement on what the arm's length transfer price of the bicycles is and avoid double taxation. It is likely that the original transfer price set by the MNE was wrong because it left all the profit with the manufacturer, while the Dutch proposal erred on the other side by wanting to transfer all the profit to the distributor. But all of this assumes the best possible world, where tax authorities and MNEs work together in good faith. Yet transfer pricing has gained wider attention among governments and NGOs because of another risk: that it could be used to shift profits into low tax jurisdictions even if the MNE carries out little business activity in that jurisdiction. This leads to trade distortions, as well as tax distortions.

[92] Neighbour, John."Transfer pricing: Keeping it at arm's length", OECD Centre for Tax Policy and Administration,http://oecdobserver.org/news/archivestory.php/aid/670/Transfer_pricing:_Keeping_it_at_arms_length.html

No country – poor, emerging or wealthy – wants its tax base to suffer because of transfer pricing. That is why the OECD has spent so much effort on developing its Transfer Pricing Guidelines. While they help corporations to avoid double taxation, they also help tax administrations to receive a fair share of the tax base of multinational enterprises. But abuse of transfer pricing may be a particular problem for developing countries, as companies might take advantage of it to get round exchange controls and to repatriate profits in a tax free form. The OECD provides technical assistance to developing countries to help them implement and administer transfer pricing rules in a broadly standard way, while reflecting their particular situation.[93]

Applying transfer pricing rules based on the arm's length principle is not easy, even with the help of the OECD's guidelines. It is not always possible – and certainly takes valuable time – to find comparable market transactions to set an acceptable transfer price. A computer chip subsidiary in a developing country might be the only one of its kind locally. But replacement systems suggested so far would be extremely complex to administer.

The most frequently advocated alternative is some kind of formulary apportionment that would split the entire profits of an MNE among all its subsidiaries, regardless of their location. But proponents of such alternatives not only have to show that their proposals are theoretically "better" but that they are capable of winning international agreement. Not easy, since the very act of building a formula makes it clear what the outcome is intended to be and who the winners and losers will be for a given set of factors. Tax authorities would naturally want the inputs to reflect their assessment of profit. Questions like how to apportion intellectual capital and R&D between jurisdictions would become contentious.

4. TRANSFER PRICING METHODS

When discussing the transfer pricing principles and practices it is important to emphasize that they are quite similar all around the world. The OECD Transfer Pricing Guidelines (OECD Guidelines) provide 5 common transfer pricing methods that are accepted by nearly all tax authorities.

The five transfer pricing methods are divided in "traditional transaction methods" and "transactional profit methods." Traditional transaction methods measure terms and conditions of actual transactions between independent enterprises and compares these with those of a controlled transaction. This comparison can be made on the basis of direct measures such as the price of a transaction but also on the basis of indirect measures such as gross margins realized on a particular transactions.

The transactional profit methods don't measure the terms and conditions of actual transactions. In fact, these methods measure the net operating profits realized from controlled transactions and compare that profit level to the profit level realized by independent enterprises that are engaged in comparable transactions. The transactional profit methods are less precise than the traditional transaction methods, but much more often applied. The reason is that application of the traditional transaction methods, which is preferred, requires detailed information and in practice this information is not easy to find.

Traditional transaction methods are:

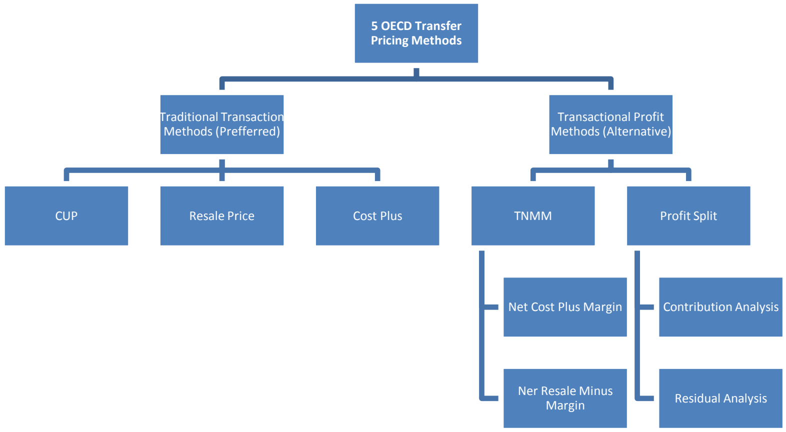
1. CUP (Comparable Uncontrolled Price) method
2. Resale price method
3. Cost plus method

Transactional profit methods are:

4. Transactional net margin method (TNMM)
5. Transactional profit split method.

Diagram 1: OECD Transfer pricing methods

[93] Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, *OECD, 2001.*



4.1. Comparable Uncontrolled Price

The Comparable 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. The CUP Method may also sometimes be used to determine the arm's length royalty for the use of an intangible asset. CUPs may be based on either "internal" comparable transactions or on "external" comparable transactions. [94]

When applying the CUP Method, an uncontrolled transaction is considered comparable to a controlled transaction if:[95]

- There are no differences in the transactions being compared that would materially affect the price; or
- Reasonably accurate adjustments can be performed to account for material differences between the controlled and the uncontrolled transaction.

In cases where comparable uncontrolled transactions can be found, the CUP Method is typically a very reliable method to use in determining whether the terms of commercial and financial transactions between associated enterprises are at arm's length.

4.2. Resale price method

The Resale Price Method (RPM) is one of the traditional transaction methods that can be used to determine whether a transaction reflects the arm's length principle. The Resale Price Method focuses on the related sales company which performs marketing and selling functions as the tested party in the transfer pricing analysis.

The Resale Price Method analyses the price of a product that a related sales company charges to an unrelated customer (i.e. the resale price) to determine an arm's length gross margin, which the sales company retains to cover its sales, general and administrative (SG&A) expenses, and still make an appropriate profit. The appropriate profit level is based on the functions it performs and the risks it incurs. The product sold in the controlled and uncontrolled transactions is the same and all other circumstances surrounding the controlled and uncontrolled transactions are substantially the same other than the geographic differences. However, the Comparable Uncontrolled Price Method may still provide the most reliable measure of an arm's length result. in controlled sales. MCO does not however make these modifications in uncontrolled sales. Only if the minor physical differences in the product have a material effect on prices should adjustments be made to the results of the uncontrolled transactions to account for these differences. These adjusted results may then be used as a measure of the arm's length result.

4.3. Cost plus method

In a controlled transaction involving tangible property, the Cost Plus Method focuses on the related manufacturing company as the tested party in the transfer pricing analysis. The Cost Plus Method may also be used in the case of services rendered. The Cost Plus Method begins with the costs incurred by the supplier of property (or services) in a controlled transaction for property transferred or services provided to a related purchaser. An appropriate cost plus

[94] United Nations,"Practical Manual on Transfer Pricing for Developing Countries", 2017

[95] Shantanu J.Pendse," International Transfer Pricing: A Review of Non-Tax Outlook", Procedia, Social and Behavioral Sciences, 2012

mark-up is then added to this cost, to make an appropriate gross profit in light of the functions performed, risks assumed, assets used and market conditions.[96]

The Cost Plus Method is used to analyse transfer pricing issues involving tangible property or services. It is typically most applied to manufacturing or assembling activities and relatively simple service providers. The Cost Plus Method focuses on the related party manufacturer or service provider as the tested party in the transfer pricing analysis. The method evaluates the arm's-length nature of an inter-company charge by reference to the gross profit mark-up on costs incurred by suppliers of property (or services) for tangible property transferred (or services provided). It compares the gross profit mark-up earned by the tested party for manufacturing the product or for providing the service to the gross profit mark-ups earned by comparable companies.

4.4. Transactional net margin method

The TNMM is defined in the Glossary of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines), as a method that examines the net profit margin relative to an appropriate base (e.g. costs, sales or assets) that a taxpayer realizes from a controlled transaction.

The OECD Guidelines indicate that the TNMM should be applied in a manner similar to the application of the Resale Price Method (RPM) or the Cost Plus Method (CP). Specifically, this implies that the indicator of the net benefit which the taxpayer obtains from the relatedtransactions, should ideally be established by reference to the net profit indicator that the sametaxpayer earns in comparable uncontrolled transactions carried out in the free market. In other words, using "internal comparables" as reference. Where this is not possible, the net margin that would have been earned by an independent enterprise in a comparable transaction. That is, an "external comparable." However, it must be mentioned that in spite of that stated in the guidelines, for practical purposes, in the presence of internal comparables one usually applies the RPM or CPM, practically limiting the application of the TNMM to external comparables. It is possible to identify these external comparables, thanks to international financial markets which allow for obtaining financial information of enterprises that is made available for use by investors, by those enterprises that place securities in these markets. Some of the most common quantitative criteria are: average or recurrent losses (to avoid selecting companies with particular situations that affect their performance), research and development or advertising expenditures above specific sales levels (to avoid selecting enterprises that develop non-routine intangibles), sufficient financial information. On the other hand, some of the most common qualitative criteria are: controlled enterprise, bankrupt, being restructured or winding up, in the start-up stage, carrying out different functions.

4.5. Transactional profit split method

The objective of the transactional profit split method is to identify relevant profits or losses and split them between group companies on an economically valid basis that approximates a division that would have been agreed at arm's length between independent parties from the same or similar transactions.[97]

Two commonly-used approaches to splitting profits are:

- Contribution analysis: Relevant profits are divided between relevant group companies based upon a reasonable approximation of the profits that independent parties would have expected to realize. Data from comparable transactions should be used where available.
- Residual analysis: Relevant profits are separated into two categories: (a) each relevant company is allocated an arm's length return for routine contributions that can be directly valued by one-sided methods (typically, where there is reliable third party comparable data); and (b) any residual profit (or loss) is allocated among the relevant group companies based on the relative value of contributions, similar to the contribution analysis outlined above.

5. CONCLUSION

Transfer pricing is an accounting practice that represents the price that one division in a company charges another division for goods and services provided. Transfer pricing allows for the establishment of prices for the goods and services exchanged between a subsidiary, an affiliate, or commonly controlled companies that are part of the same larger enterprise. Transfer pricing can lead to tax savings for corporations, though tax authorities may contest their claims.

Multinational companies (MNC) are legally allowed to use the transfer pricing method for allocating earnings among their various subsidiary and affiliate companies that are part of the parent organization. However, companies

[96] Sven-Eric Baersch, Jost H. Heckemeyer and Marcel Olbert. (2018) Transfer Pricing and the Decision-Making Authority of the Tax Function in Multinational Companies. *SSRN Electronic Journal*. Online publication date: 1 Jan 2018

[97] https://www.taxathand.com/article/9874/Denmark/2018/BEPS-actions-8-10-Revised-guidance-on-profit-splits

at times can also use (or misuse) this practice by altering their taxable income, thus reducing their overall taxes. The transfer pricing mechanism is a way that companies can shift tax liabilities to low-cost tax jurisdictions.

The selection of a transfer pricing method should take into account the strengths and weaknesses of each method, the appropriateness in view of the nature of the accurately delineated controlled transaction, the availability of reliable information and the degree of comparability between related party and third party transactions.

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