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Chapter -1

An Introduction to Transfer Pricing

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SYNOPSIS

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What is Transfer Pricing?

- The structure of transactions within an MNE group determined by
  - a combination of the market forces and
  - Group driven forces (i.e. common interests of the entities of a group) which can differ from the open market conditions operating between independent entities.
- In such a situation, it becomes important to establish the appropriate price, called the "transfer price", for intra-group, cross-border transfers of goods, intangibles and services.
- Transfer pricing is the general term for the pricing of cross-border, intra-firm transactions between related parties.

Basic issues underlying Transfer Pricing

- Cross border tax situations involve issues related to
  - Jurisdiction
    - Which government should tax the income of the group entities ?
    - What happens if both governments claim the right to the same income ?
  - Allocation of income and valuation
  - Tax base arises in more than one country, any one of the governments give tax relief to prevent double taxation of the relevant entities' income, and if so, which one?

Evolution of Transfer Pricing

- US
  - First country to adopt a comprehensive transfer pricing legislation in 1968.

- OECD
  - reports on transfer pricing in 1979 and 1984
  - issued the TP Guidelines in 1995 as amended by 2010 version

- United Nations (UN)
  - Report on "International Income Taxation and Developing Countries" in 1988.
  - The UN Conference on Trade and Development (UNCTAD) also issued a major report on Transfer Pricing in 1999.
  - The United Nations (UN) is again taking a leadership role, through its 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.

- European Commission (EC)
  - Proposals on income allocation to EC members of MNEs

Concepts in Transfer Pricing

- Transactions with related parties must be based on the "**arm's length principle" (ALP**)

- **Arm's length principle" (ALP**)
  - Origins in Contract law
    - to arrange an equitable agreement that will stand up to legal scrutiny, even though the parties involved may have shared interests.

  - Not specifically used in Article 9 of both OECD MTC and UN MTC. However it is well accepted by countries as encapsulating the approach taken in Article 9 with some differing interpretations.

Concepts in Transfer Pricing (contd)...

- Using the arm's length principle
  - Argument in favour
    - Geographically neutral, as it treats profits from investments in a similar manner
  - An alternative to the arm's length principle
    - Global Formulary Apportionment method
      - Currently used by
        - USA,
        - Cantons of Switzerland and
        - Provinces of Canada.
      - EU is also considering a formulary approach [Common Consolidated Corporate Tax Base(CCCTB) and home state taxation]

Transfer Pricing Methods

The five major transfer pricing methods are:

A] Transaction based methods:

1. Comparable Uncontrolled Price (CUP)
2. Resale Price Method (RPM)
3. Cost Plus (C+, CP)

B] Profit-based methods

4. Profit comparison methods (TNMM/CPM)
5. Profit-split methods (PSM)

Special Issues Related to Transfer Pricing

1. *Documentation requirements:*
   - 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.

2. *Intangibles*
   - Trade intangibles
     - such as know-how relate to (production of goods and the provision of services)
   - Marketing intangibles (aid in the commercial exploitation of a product or service)
     - Trade names,
     - Trademarks and
     - Client lists

Special Issues Related to Transfer Pricing

3. Intra-group services

   - Managerial,
   - legal,
   - accounting and finance,
   - credit and collection,
   - training and personnel management services.

4. Cost – Contribution Agreements

   • Jointly develop, produce or obtain rights, assets or services.

5. Use of “secret comparables”

Transfer Pricing in Domestic Law

- Transfer Pricing rules and regulation
- Safe harbours
- Controlled Foreign Corporation (CFC) provisions
- Thin Capitalisation
- Documentation
- Advance Pricing Agreements
- Statute of limitations - Time allowed in domestic law to do the transfer pricing audit and make assessments

Transfer Pricing in Treaties

- Meaning of related parties i.e. associated enterprises
  - Ambiguity
    - in UN and OECD Model Tax Conventions and
    - in respective domestic transfer pricing regimes.

  - Model Tax Conventions use the associated enterprises concept
    - to cover relationships between enterprises which are sufficiently close to require the application of transfer pricing rules.

  - Extended under the domestic law in many countries.

- The concept of arm's length principle
  - is (not specifically) used in following Articles of MTCs

    - OECD – Article 9 i.e. Associated Enterprise
      Article 7(2) and 7(4) - revised by 2010 Model Tax Convention.

    - UN – Article 9 i.e. Associated Enterprise
      Article 7(2) and 7(4)

Transfer Pricing in Treaties

- Corresponding adjustments - to avoid economic double taxation

- Transfer pricing dispute resolution mechanism
    - Mutual Agreement Procedure (MAP) – in Article 25**.**

- Arbitration to resolve transfer pricing disputes.
    - The EU Arbitration Convention

Specific challenges – Developing Countries face in dealing effectively with Transfer Pricing Issues

- Lack of comparables
- Lack of knowledge and requisite skill-sets
- Complexity to administer
- Growth of the “E-commerce economy”
- Location savings

Conclusion

- **Major international taxation issue**

- For both governments and taxpayers,
  - Transfer pricing is difficult to grapple with;
  - Tends to involve significant resources, skilled human resources, and costs of compliance.
  - Difficult to find comparables

- For developing countries governments,
  - Often do not have easy access to resources to effectively administer their transfer pricing regulations.
  - Transfer pricing manipulation would lead to potential loss of revenue may run into billions of dollars.

- This chapter serves to introduce the fundamentals of the concepts involved in transfer pricing such as the arm's length principle and issues related to it.

THANK YOU