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A Comparative Analysis of Transfer Pricing Favorability among Selected Economies

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Abstract: *Transfer pricing (TP) is an indistinguishable element of the International Financial Management. It has taken a very strong position in MNCs in a short span of ten years. In the present scenario, MNCs are emerging very rapidly and are inclining more towards the concept of transfer pricing. MNCs in different industries viz., manufacturing, ITeS, BPOs-KPOs, Services, etc. are using transfer pricing for their profit maximization by tax avoidance. The countries are earning tax by penalizing MNCs on the grounds of transfer pricing through the litigation process. Thus, it can be said that on one hand, transfer pricing is benefitting MNCs and on the other hand, contributing to the revenue from taxes for different countries.*

The present study provides an objective assessment towards the understanding of TP issues among various countries. It provides a systematic and logical outline towards understanding whether TP is favorable for MNCs or countries. The focus will be on the emerging economies where MNCs from the developed countries have made major investments.

There are six methods described in guidelines of OECD, which are used for the calculation of Arm's Length Price (ALP) under TP. ALP is the right price at which an international transaction is done. The methods for the calculation of ALP are Comparable Uncontrolled Price (CUP), Resale Price Method (RPM), Cost Plus Method (CPM), Profit Split Method (PSM), and Transactional Net Margin Method (TNMM). Apart from these, Other Method is used for the transactions where none of the above can be applied.

In this research work, the focus is to compare different economies based on the TP issues. The countries are selected on the basis of their significance in international trade. A sample of countries comprising of a diverse set both from the developed and emerging economies will be chosen and also on the basis of OECD membership and non-membership. The key variables for comparison among the countries are number of cases settled and amount adjusted in TP litigation and transfer pricing regulations (including income tax legislation). Other variables which are important from the TP view are overall company profit, restrictions imposed by foreign countries on repatriation of profits or dividends, the competitive position of the subsidiaries in other countries, and income tax rates differentials (Borkowski, 1996).

The research will be administered by an extensive review of literature and scanning of databases. Based on the review of the literature, key variables for this study will be extracted, and their level of importance in the context of transfer pricing will be discussed. The variables will also be segregated based on the focus on overall MNC profitability and tax evasion. The databases will be used to extract information that comes under the broad purview of the regulations by the countries on TP and their application. The information would include TP methods used by the economies and which method is given higher precedence. Other information would include, TP documentation process, TP penalties, and advance pricing arrangements. For the purpose of comparison period of five years is considered. In addition, the basis for comparison will include methods for transfer pricing and the legal structure of various economies under consideration.

The Review of Literature and information collected from the databases will be assimilated for comparing the economies under study. From the practical viewpoint, the results will provide the MNCs a fair idea about the level of challenges while trading between its subsidiaries located in certain economies. From the academic viewpoint, the study opens further scope for research on TP variables and their associated impact on countries and MNCs (Lohse, 2012).

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I. Introduction

Transfer Pricing (TP) is an integral element of International Financial Management. This has become one of the most important components of MNCs in a very short span of 10 years. Transfer Pricing is the price at which the transaction of goods and services takes place between two or more subsidiaries or the related party. In this research work, the focus is to compare different economies based on the Transfer Pricing issues. The countries are selected across the globe to make it more representative sample. Use of Arm's length price and methods used for transfer pricing is a major concern of this paper. There are six methods accepted by all the countries viz., Comparable Uncontrolled Price (CUP), Resale Price Method (RPM), Cost Plus Method (CPM), Profit Split Method (PSM), Transactional Net Margin Method (TNMM) and Other Method. None of the countries uses Best Method approach. These methods have a significant role in transfer pricing regime. The major outcome of this paper is to analyze transfer pricing regime in the developed and emerging economy based on different traits like the relationship threshold for TP rules to be applied between the parties, limitation on the adjustment,the statute of limitations on assessment of TP adjustments, Disclosure Overview,TP Study (OECD guidelines), Chapter II of OECD guidelines, and Advance Pricing Agreement (APA).

Arm's Length Price

To ensure that enterprises don't indulge in the malpractices of transfer pricing, Arm's Length Principle ('ALP') has been adopted to ensure that tax base in different jurisdictions remains intact. OECD has listed down the procedures for ALP computation and methods adopted to determine it.

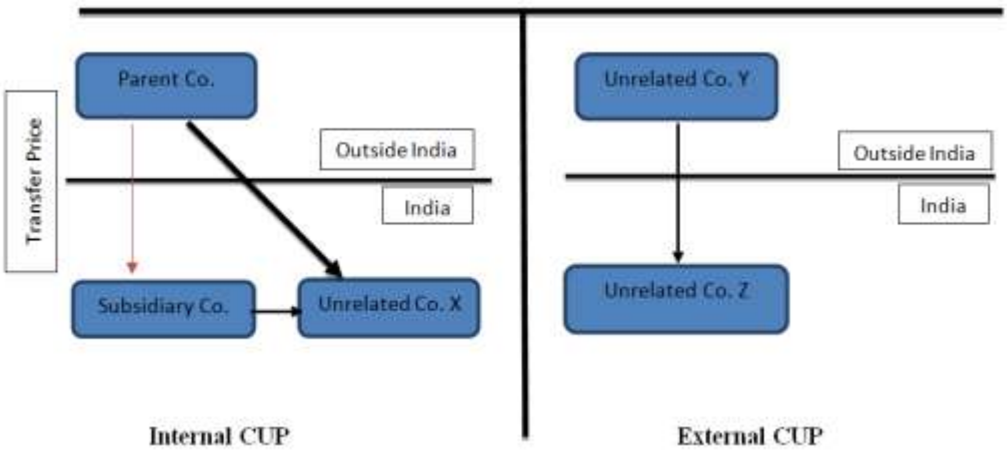
Methods used to determine Arm's Length Price

Comparable Uncontrolled Price (CUP)

This is the most direct method of testing Arm's Length price and the price for benchmarking. The CUP method require strict comparability in products (attributes, target population, use of the product etc.), contractual terms, economic terms etc. Calls for adjustments to be made for differences which could materially affect the price in open market. For example:

- Difference in volume/quality of product
- Difference in credit terms
- Risk assumed
- Geographic market

There are two types of CUP method – Internal CUP and External CUP.



Internal CUP **External CUP**

Resale Price Method (RPM)

- The method compares the resale gross margin earned by the associated enterprise with the resale gross margin earned by comparable independent distributors.
- This method is preferred for a distributor buying finished goods from a group company.

- The RPM is to be applied when a goods purchased or service obtained from the Associated Enterprise (AE) is resold to an unrelated enterprise.
- The main merit of this method is that it is less dependent on strict product comparability an addition emphasis is on similarity of functions performed and risk assumed.

Cost Plus Method (CPM)

- This method compares and identifies the mark up earned on direct and in direct costs incurred with that of comparable independent companies.
- This is a preferred method in the following cases:

✓ Semi-finished goods sold between relate parties
✓ Contract/toll manufacturing agreement
✓ Long term buy supply arrangement

- This method can be applied in cases involving manufacture, assembly or production of tangible products or services that are sold to Associated Enterprises (AE).
- The comparability analysis is not much dependent on close physical similarity between the products.
- This method is largely dependent on the functional comparability.

Transfer Net Margin Method (TNMM)

- This is the most often used method. This method examines net operating profit from transactions as a certain base (can be different bases i.e. costs, turnover etc.) in respect of similar parties.
- Ideally, operation margin should be compared to operating margin earned by same enterprise on uncontrolled transaction. This arrangement is known as internal TNMM.
- This is most frequently used method globally due to lack of availability of comparable uncontrolled prices and gross margin data required for application of the comparable uncontrolled price method/ cost plus method/ resale price method.
- The main merit of this method is that the broad level of product comparability and broad level of functional comparability is there.
- This method is applicable for any type of transaction and often used to supplement analysis under other methods.
- The application of the TNMM to a specific tested party breaks down when factors other than transfer prices have a material impact upon profits.
- Grouping of transaction- Relevant controlled transactions require to be aggregated to test whether the controlled transaction earn a reasonable margin as compared to uncontrolled transaction.
- The selection of tested party is the selection of least complex entity.
- Selection of Profit level indicator such as Operating Margin, Return on Value added expenses, Return on Assets- unaffected by transfer price.

Profit Split Method (PSM)

- This method is to be applied in cases involving transfer of unique intangibles or in multiple international transactions that cannot be evaluated separately.
- PSM calculates the combined operating profit resulting from an inter-company transactions based on the relative value of each AEs contribution to the operating profit.
- Evaluates contribution of combined profit/loss in controlled integrated transaction.
- The contribution made by each party is based upon a functional analysis and valued, if possible, using external comparable data.
- There are two methods discussed by OECD guidelines:

✓ Contribution PSM analysis
✓ Residual PSM analysis

Other Methods

- CBDT has notified the “other method” vide a Notification and Rule 10AB has now been inserted in the Income-tax Rules, 1962 (the Rules). Applicable from FY 2011-12.

- Rule 10AB describes the other method as "any method which takes into account the price which has been charged or paid, *or would have been charged or paid*, for the same or similar uncontrolled transaction, with or between non-associated enterprises, under similar circumstances, considering all the relevant facts."
- "Other method" refers to "price that would have been charged or paid". Effectively, this implies that under this "other method" "quotations" rather than prices "actually" charged or paid can also be used
- This method could be applied in case of revenue split / allocation in case of investment banking, logistics and
- Other similar complex uncontrolled transactions wherein it is difficult to use the other five prescribed methods.
- Other method could also cover new instances of ALP computation which would now arise due to the various amendments introduced in the Finance Act 2012 like expansion/clarification of the definition of "international transaction" and introduction of domestic transfer pricing. (e.g. intangibles, exit charge)
- Proper documentation specifying the rejection reasons for non-application of the other five prescribed methods and the appropriateness of the "other method" based on the facts and circumstances of the case would have to be maintained by the taxpayer.

II. Methodology

The present study attempt to compare various counties on the basis of transfer pricing methods they follow. The choice of the countries is the main basis which is sampled in a way to sufficiently represent the globe to a good extent.

TP is a financial phenomenon very important from the view point of trade and supply chain. In accounting a due weightage is given to mechanism followed in determining the TP during the supply chain flow. Talking parse from the organizational view point, several disclosures has to be given by any organization to the various authorities dealing with taxes, levies, and charges. To guide these disclosures and with a view to get a relevant pictures for determining the cost, price of product at different level of product and services in a supply chain. The Accounting Associations, Autonomous bodies, organizations and the department of governments of the nations had been laying down from time to time the methods, practices, records to be prepared and implemented so as to support these disclosures. We recognize these as the frameworks or the guided lines to determine, implement and execute the TP policy. While defining our methodology for this paper we selected countries with the view to have a picture as to what and how the companies follow a framework for determining TP on uniform basis throughout the nations and how they synchronize with the practices followed by other nations. The global trade scenario has been around the developed countries which is last two decades have shifted towards middle east, south, and south east Asian countries. Looking at the manufacturing, procurement and distribution chains of major companies, it is an established fact that they have boundary less existence throughout the globe with most of the activities of distribution and sourcing coming out of developed countries. Whereas, the procurement and manufacturing is based on the developing and emerging countries, therefore covering almost all countries across the globe. This phenomenon brings the need for following TP not at the organizational and national level but at the international and global lever throughout the globe. While deciding on the countries we considered countries which are the markets, also, countries which are developing industry as markets. We started with countries which have best established norms for TP like Britain, Germany, Australia, Russia and the countries like India, China, Brazil, Finland, and Portugal etc. to cover the globe. Howsoever, while defining the countries we would like to cover, we limit our self to those who have published their system practices and norms publically.

Analysis

The outcome of our paper is in the form of grid presented in the diagram. This grid or framework provides insight of various factors like the relationship threshold for TP rules to be applied between the parties, limitation on the adjustment, the statute of limitations on assessment of TP adjustments, Disclosure Overview, TP Study (OECD guidelines), Chapter II of OECD guidelines, and Advance Pricing Agreement (APA).

1. In case of most of the countries, developed and developing as well, the definition of relationship threshold is more or less same with the clause of wearing interest of the parties percentage. In case of Australia, Sweden, US arm's length rule is also followed.

2. In terms of Disclosure overview, In case of most of the companies, the disclosure is mandatory and is considered as a part of corporate tax regime. Most of the countries are taking TP and RPTs assessment as the

part of their annual returns for assessment under indirect taxes for which the statute laws have given a limitation on assessment with minimum of 4 years in case of Portugal, Germany, England with maximum of 7 years in case of Australia, In case of Russia and US this limit is kept as 3 years but this with respect to income tax assessment.
3. The methods of TP has been very broad when we look in the national statute laws of company but with the view of international synchronization and trade relation , the guidelines of Chapter II of OECD is considered as the umbrella for usage of any method to be used as per guidelines.
4. Requirement for preparation of transfer pricing study is one of the major factor of this study.
5. Benchmarking set of comparables is not required by countries at the time of preparation of TP study. It is basically asked by auditing authority at the time of litigation.Even at the time of litigation, comparables are required at all by Finland, Australia, Brazil, United States, Russia where as a set comparables is required by Sweden, Portugal, Germany, England, China and India. However, there is no defined rule for use of comparables in Turkey but comparables may be used at the time of audit.
6. Advance Pricing Agreement (APA) is a new concept in transferpricing where by following a defined set terms and conditions of contract between company and country, litigation or auditing of transfer pricing may be avoided. Finland use only Unilateral APA, where asSweden, Portugal, Turkey, Australia, United States, Russia, China and India follow all i.e. Unilateral, Bilateral and Multilateral APAs. There is no concept of APA in Brazil. Germany follow Bilateral and Multilateral APA where as England follow Unilateral and Bilateral APA.
The major finding of this grid as well as literature review done is that no country follows any specific method when it comes to industries at large. Chapter II of OECD is considered to be a broad guideline but the method to calculate TP, its accounting and the framework differs from company to company within the industry and across industry. Howsoever, the purpose, the outcome and the benefit remains uniform. In case of India we follow two different systems, one is under Chapter II of OECD as blanket of international trade and the other as per the companies ACT. In most of the cases, the method of calculating TP remains more or less the same. A general view point is, companies use no Best Method approach for the convenience of law.

III. Conclusions and Limitations

The present study describes the six methods of ALP. After studying various countries in detail it was found specific best method is not ascertained. However,countries use similar methods for calculation of arm's length price but its applicabilitydiffers country to country and company to company. The issue arises when company and country differ with each other for the selection of method which is to be used. The purpose of this paper is to analyze transfer pricing favorability among selected economies.

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Appendix

Country	OECD Member	Effective Date of TP	The relationship threshold for TP rules to apply between parties	The statute of limitations on assessment of TP adjustments	Disclosure Overview	Requirement for preparation of transfer pricing study	TP Study (OECD guidelines)	Transfer Pricing Methods	Benchmarking set of comparables	Advance Pricing Agreement (APA)
Sweden	Yes	1928	Direct or indirect management, supervision, ownership or control	6 years fro tax year end	NO	Yes, For all companies, anually. No specific document related penality. General tax rules apply.	Chapter V + Intera-group agreement +APAs + Ruling + Mutual Agreement Procedures (MAPs).	Chapter II of OECD guidelines	Yes, PAN European	Yes, Applicable since 2010 (Bilateral and multilateral)
Finland	Yes	ALP - 1965. TP documentaion requirement come into force in Jan 1, 2007	A company controls other company if it has - 1. Direct or Indirect ownership of more than 50% of share capital and voting power	5 years fro tax year end	Yes, to be submitted with the corporate tax return	Yes, For all Cross border transactions, only SMEs are exempted	Chapter V with instructions provided by Finnish tax authority	As per OECD guidelines	No	Only Unilateral
Portugal	Yes	1-Jan-02	As of 2014, any of the given conditions would define the relationship as related party	4 years fro tax year end	Yes, Selected TP methods on cross border transation, amounts of RPTs, any increase in taxable income related to TP adjustment	Yes, for certain tax payers	Yes, Chaper V	As per OECD guidelines (Most appropriate Method based on nature of transaction)	Tax authority may use comparables for benchmarking	Yes, all

Germany	Yes	Recently revised in 2013, Documentaion requirement was introduced in 2003 and Penalities in 2004	The taxpayers holds direct or indirect 25% or more ownership in related party; or has direct or collateral possibility to exert a dominating influence to related party; a third party holds a share of 25% or more in taxpayer and the related party or exerts indirectly or collaterally a dominating influence	4 years fro tax year end	NO	No, nothing official, hwever it's a general practice to avoid any penality in future.	Yes, Chaper V	As per OECD guidelines, (No 'Best Method')	Yes, occasionally, they have lesser evidence value in court	Bilateral and multilateral
Turkey	Yes	1-Jan-07	Based n shareholding that provides a direct or indirect controol over the related parties including a transation effected with a resident of low tax jurisdiction	5 year statring from the close of related fiscal period	Yes, all corporate tax payers are required to complete and submit transfer pricing form along with corporate tax return.	Yes, annual transfer pricing report	Chapter V (No official binding, used for reference purpose)	Chapter II of OECD guidelines	No official, may used at the time of audit	Yes, all
Australia	Yes	July 1, 2004 intoduced and revised on July 1, 2014	Parties not dealing with each other at arm's length, having regard to any connection between them, or any other	A 7 year amendment period	yes	No,	Yes, Chaper V	Chapter II of OECD guidelines	No	Yes, all

			relevant circumstances							
Brazil	No	Jan-07	Companies are deemed to be a related when they are under common control or one of them is located in a low-tax jurisdiction or privileged tax regime.	5 years as of the tax return filing date	Yes, Summary of RPT and TP calculations	No	N/A	No,	No	No
United States	Yes	Effective from Oct 6, 1994 and amendments in 1996, 2009, 2011	The parties must be under common control. Control is based on the facts and circumstances test, and not on specific ownership thresholds.	3 years from the tax return filing date.	Yes,	No	Yes, Chaper V (10 Principal documents)	Chapter II of OECD guidelines with some minor differences (pg 291)	No	Yes, All
Russia	No	1-Jan-12	More that 25% direct or indirect ownership of one company by another company including parties in which one company participates directly or indirectly and such participation exceeds 25% (sister companies)	Tax authorities can audit only 3 calendar year preceding the year in which the decision to conduct a transfer pricing audit was taken by the transfer pricing authority.	Yes	Yes, (Including cross border transation, and domestic transacions.)	Can be in any form no OECD guidelines are required	Chapter II of OECD guidelines	No	Yes {3 years + 2 years (extened)}

England		1-Jul-99	Ownership between 40-50% based on voting power, Share capital or management control	4 years from tax year end	NO	No	Yes	Chapter II of OECD guidelines	Yes, UK comparables	Unilateral and bilateral
China		1-Jan-08	25% be it direct or indirect	10 years from the year in which related party transaction occurs	Yes, RPT must be submitted to tax authority along with the annual income tax return	Yes, With specific condition	Yes, Chaper V	Chapter II of OECD guidelines	Yes	Yes, All
India	No	1-Apr-01	List on page 127		Form 3CEB, Report obtained from CA before Nov 30	Yes	No	No, But similar to OECD guidelines	Yes	Yes