A Primer on

Transfer Pricing

Norms, Standards, Misuse for Tax Avoidance,
And Impacts on Developing Countries

2017

Draft Version for Comments

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I. Introduction

The advancement of globalisation has two distinct impacts, among many others, on how businesses operate: first, in terms of the rise of multi-national corporations (MNCs), where one company establishes subsidiary entities in other country to undertake business operations; and second, through the dis-integration of production processes, where different steps of producing a single good/service are scattered across different locations, as opposed to all production processes being carried out in a single location. There can be multiple motivations behind a company's decision to either disintegrate the production/business process or to establish a new subsidiary. For example, a company can establish a subsidiary in another country to cater to the local market, to own some resources like coal or minerals, to carry out research and development activities, etc. Similarly, the disintegration of production process in multiple locations can be due to factors like relatively low costs of land, labour or material inputs in a particular location, availability of ancillary or supporting industries in the region, preferable tax and regulatory regime, etc. These factors together have contributed towards creating a system where multiple subsidiaries of a single parent company, often situated in different legal jurisdictions, engage in business transactions with each other (See Chart I). Such transactions are known as 'intra-group transactions'. A 2013 report by The United Nations Conference on Trade and Development (UNCTAD) estimates that by 2012, intra-group transactions comprise close to 80 per cent of all trade taking place across countries. One negative consequence of such complex and interlinked system is the opportunity it provides for MNCs to engage in tax avoidance through a practice known as abusive transfer pricing, which has detrimental impacts on resources being raised by governments across the world.

Tax avoidance is a practice where tax payers reduce their tax payable by exploiting tax loopholes. Though technically legal in the strictest sense, tax avoidance is unpalatable as it violates the spirit of law and has negative impacts on resource mobilisation by governments.

In such context, this primer aims to provide an introduction of Transfer Pricing to those who are unfamiliar with this subject. Briefly the primer tries to answer following questions –

- What is Transfer Pricing
- How is transfer pricing used for tax avoidance/evasion
- What are the governments' policies on transfer pricing
- Are there any weaknesses in the current policies on transfer pricing? If yes, what are they
- What are the possible corrections or alternatives of current policies
- What are some of the developing countries specific issues in transfer pricing

II. What is Transfer Pricing?

The price of a good, service or intangible in a transaction is called transfer price, if the transaction is carried out between two related companies (See chart I). The related companies are those which are owned and/or controlled by same entity or are part of same group of companies. These companies are known as *Sister Companies* or *Associated Companies* or *Affiliated Companies* or *Controlled Group of Companies.* The process of deciding transfer price for any particular transaction is known as 'Transfer Pricing'.

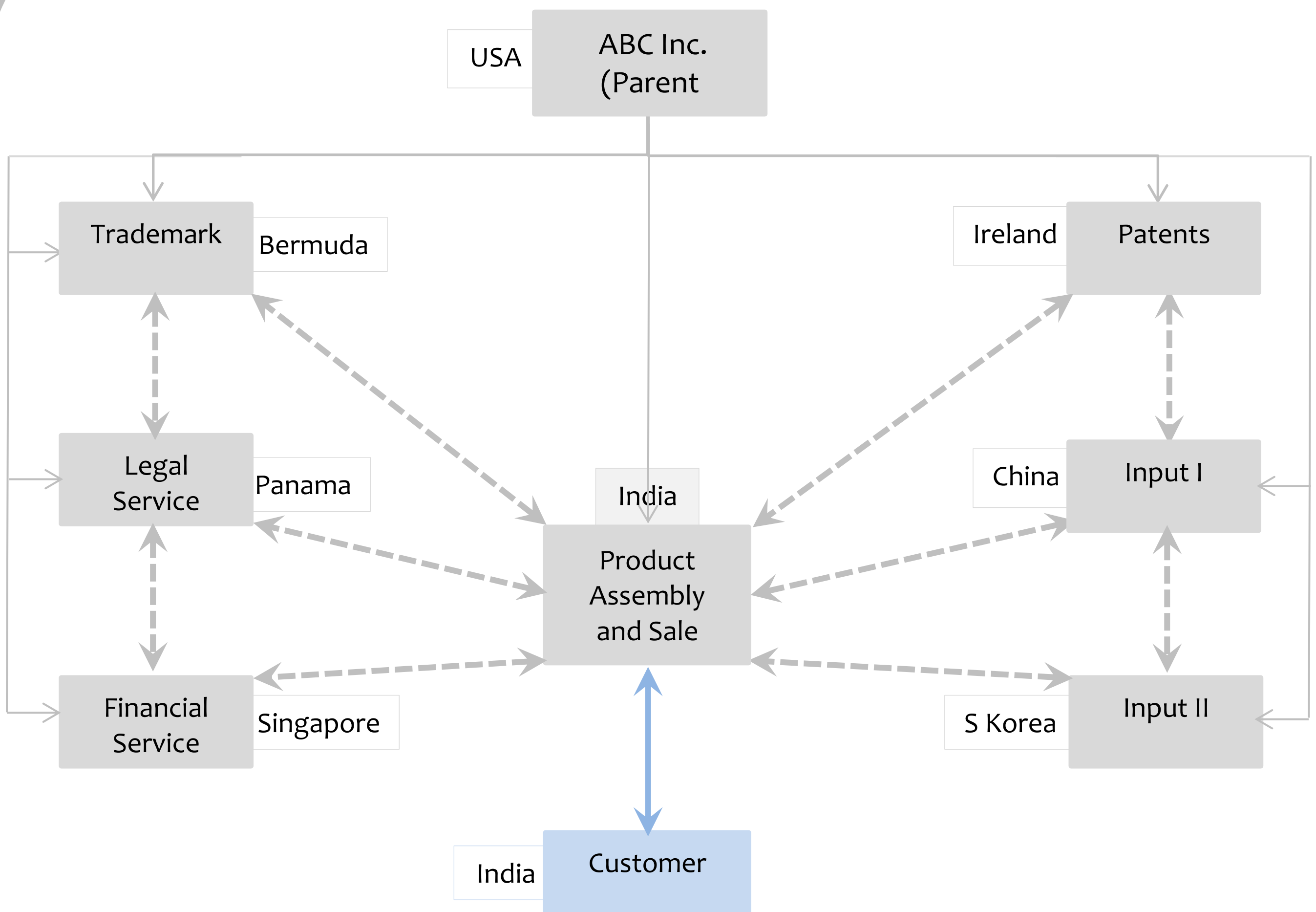
> "Transfer pricing is the setting of prices for transactions between associated enterprises involving the transfer of property or services."
>
> – United Nations (2017): Practical Manual on Transfer Pricing for Developing Countries"

Based on the product/service under transaction, all transfer pricing cases can be divided into four broad categories, as follows:

1. Goods: This category refers to physical products, and can include finished goods, intermediary goods and raw material
2. Services: This category includes intangible products such as banking, education, medical treatment, legal advice, consulting, financial service, information technology, etc.
3. Intellectual Property: it refers to creations and innovations of the mind, which enables people to benefit from something they create. Intellectual property includes products like patents, trademarks and copyrights
4. Intra-Corporate Lending: This category refers to loans made from one business unit of a company to another

While transfer pricing is generally referred to transactions between entities situated in different countries, it also applies when both the related entities are located in the same country.

Chart I: Transfer Pricing



There is an MNC named ABC Inc. based in USA which has subsidiaries in various countries. From the picture, the boxes in grey colour represent a business entity owned by ABC Inc., while the country name in the side shows where it is based. The texts inside the box show the function that subsidiary performs. The solid grey lines indicate ownership while thick dotted lines represent the transactions related to goods, services and intangibles. The blue box and the thick blue line represent an unrelated entity and transaction with an unrelated entity. All these entities which share either ownership or control, depicted by grey boxes, are also known as 'related companies' or 'sister companies'.

For the transactions depicted by thick dotted lines, the accompanied payment is called 'transfer price'. For example, when the Indian entity uses the brand name 'ABC Inc.'; it has to make a royalty payment to the Bermuda entity, which holds the copyright of brand name. Similarly, when it buys input from the Chinese or Korean entity, there will a payment made to these entities. All such payments made to related companies are known as 'transfer prices'.

III. How is Transfer Pricing Used for Tax Avoidance?

In a transaction between two unrelated parties, both the buyer and the seller act in their self-interest, such that buyer wants to minimise the price while seller wants to maximise it. The price level set through this process is known as the 'market price'. The market prices are generally regarded as the fair value of the good/service in transaction. In contrast, when two related companies engage in a transaction, both the buyer and the seller are not trying to increase their individual profit levels but the aggregate profit of their parent or controlling company. This provides the possibilities that transfer price is set not according to the fair value of that property or service, as expressed by commensurate market price, but at a different level which might provide some benefit to that group of companies. The most common reason, for setting transfer price at a level different from market price, is to avoid paying taxes in a particular country, by shifting profits to a low tax country.

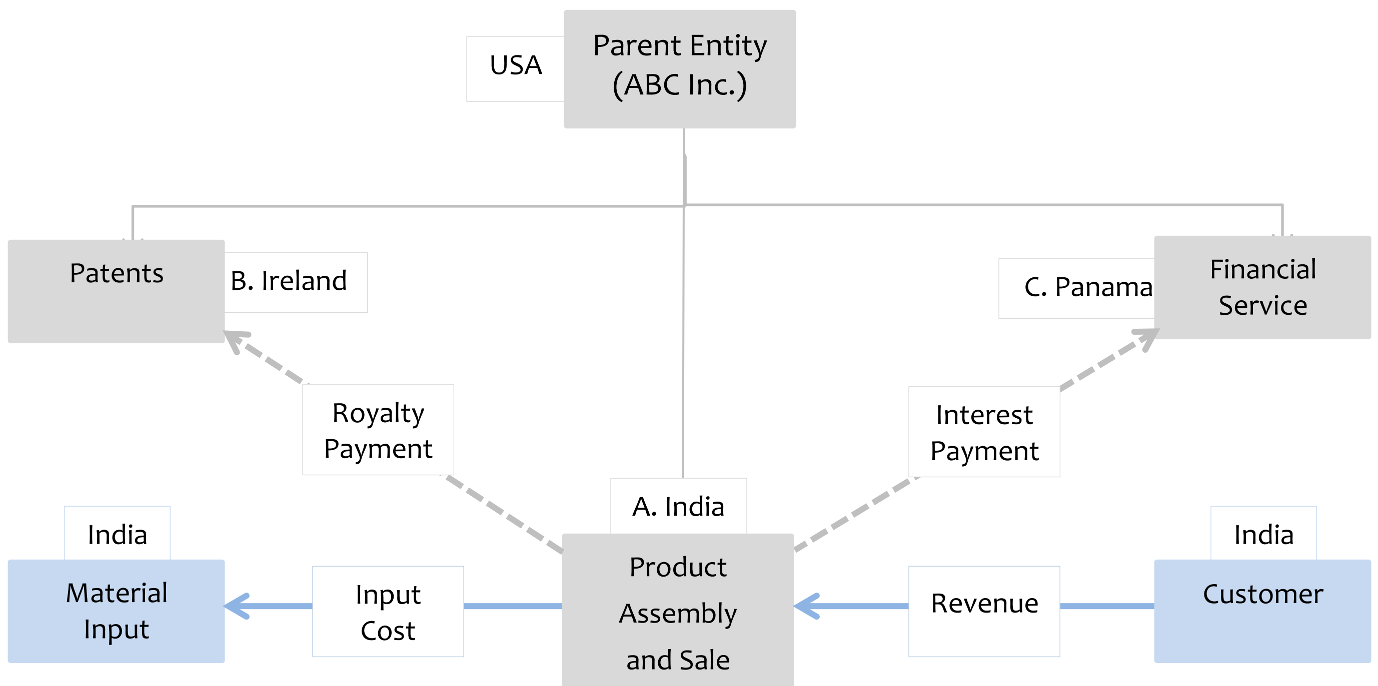
The practice of setting transfer price at a level different from market price is known as 'abusive transfer pricing'. The practice of abusive transfer pricing is also known as transfer mis-pricing, unfair transfer pricing, incorrect pricing, unjustified pricing or non-arm's length pricing.

The opportunity for tax avoidance through abusive transfer pricing arises due to the regulatory and economic differences between the countries. To illustrate - tax liability of a company is determined on the basis of the value of transactions, the value of properties and/or the level of income; all three of which can be changed using different levels of transfer prices. Additionally, if the two transacting subsidiaries are situated in different countries such that their tax regulations differ in terms of tax base, tax rates, accounting standards or disclosure requirements; then by using abusive transfer pricing, profits or cost can be shifted from one jurisdiction to another which will change the value of transaction, value of property and/or level of income and thus the total tax payable by the corporation.

Tax base is defined on two aspects: first, which categories of income/property are taxed; and second, at what threshold. For example, in case of income tax in India, salary income is taxable but not the income earned from agriculture. Therefore, agriculture income does not form part of the tax base. Secondly, within salary income, those earning below INR 250,000 annually are exempted from paying income tax. So here again, only a salary above INR 250,000 annually forms the tax base while salaries falling below that limit do not.

It is important to note that transfer pricing by itself, does not indicate tax avoidance. On the contrary, it is a globally accepted and essential part of business, without which MNCs cannot function. The problem arises when the transfer price deviates from the market price or the practice of 'abusive transfer pricing'.

The following picture illustrates the abuse of Transfer Pricing for tax avoidance.



Consider a hypothetical situation similar to the previous example, where a Company ABC Inc. has subsidiaries in India, Ireland and Panama, as described in the picture. The total cost of A is made of material input cost from a third party, royalty payments to the sister company B in Ireland and interest payments to the sister company C in Panama; while it earns revenue from selling the product to the customer. Let's also assume that B and C have total cost amounting to $50 each and their total revenue consist of payments from the Indian subsidiary. The following table illustrates the impact of setting two different transfer prices on the total tax incidence for the MNC:

	Case I			**Case II**		
	A	**B**	**C**	**A**	**B**	**C**
1. Material Input Cost	100			100		
2. Royalty Payment	100			150		
3. Interest Payment	100			150		
4. Total Cost (1+ 2+ 3)	300	50	50	400	50	50
5. Total Revenue	500	100	100	500	150	150
6. Profit (5 - 4)	200	50	50	100	100	100
7. Tax Rate	30%	10%	10%	30%	10%	10%
8. Tax	60	5	5	30	10	10
9. Total Tax by MNC (A+B+C)		70			50	

*Highlighted cells in Scenario II represent the changed entries using transfer pricing

In the first case, the price for patents is assigned at $100 and for interest payment at $100. In this case, profits shown by A, B and C come to $200, $50 and $50 respectively. However, if the transfer prices are set at $150 instead of $100, then the incomes become $100 each. The global tax paid by the MNC in first case is $70; while with different transfer prices it falls to $50 in the second case. From the perspective of policy makers, however, this means a revenue loss of $30 for India, while a gain of $5 for each Ireland and Panama.

This way, by assigning different transfer prices to the intra-group transactions, MNCs can reduce their total tax liability.

While the above example uses only three countries and three intra-corporate transactions, the real-world business operations of multi-national corporations are far more complex and involve much larger number of subsidiaries in different countries. For example, a parent company based in USA can establish R&D subsidiaries in other countries such as India, but the patents resulting from these R&D centre can be registered in a tax haven which has favourable tax regulation for patents. With reference to Chart I, patents and trademarks registered in Ireland and Bermuda may have been generated in subsidiaries located in some other jurisdiction; however, they would be registered in these countries to take advantage of the beneficial taxation rules. With the evolution of communication and information technology, many services can be provided in one geographical location without the need of service provider being physically present there. This advancement can be used to establish the subsidiaries which provide such information technology enabled services, in a jurisdiction which have beneficial taxation and regulatory regime. From Chart I, financial and legal services could be set up in a low tax jurisdiction like Panama and Singapore, even though they provide services to an entity based in India. Also, services like legal, financial, consulting and marketing derive their market value on the basis of personal/institutional traits of the service provider, like subject matter expertise, experience, technical knowhow, and the skills employed. Since, these characteristics can vary widely from one service provider to others, the prices of same service, provided by different service providers, can differ significantly. Such wide range of value of a product/service increases the possibility where transfer prices can be set at a level significantly different from the actual market price.

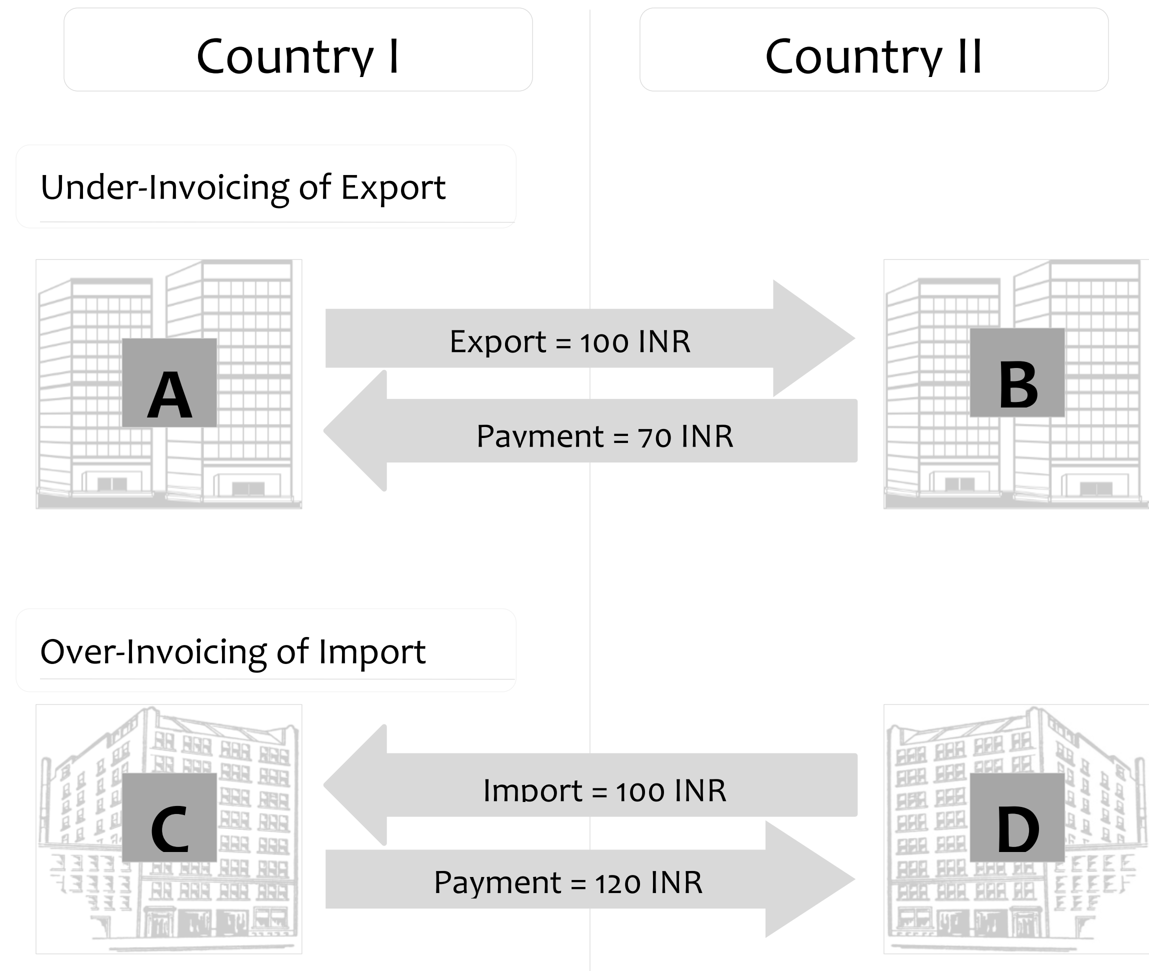
The situation becomes most acute when two additional factors are involved in a transfer pricing case – a shell company or a tax haven, or both.

A shell company is a company which by itself does not engage in any real economic or business activities, and does not own significant physical assets; but is merely used as an instrument for carrying out financial transactions or owning intellectual property rights.

Shell companies, by design, have very few employees, little assets, low or negligible cost of daily operations, and symbolic office premises primarily to meet the legal obligations. Due to these factors, shell companies can be established with relative ease and negligible monetary cost. These entities are mainly used for two purposes – either to carry out the transactions on behalf of its parent entity or to act as an intermediary in a series of transactions. For example, let's assume there is a company in Russia who drills oil and the cost of producing oil is $20/barrel. This company can set a shell company in a low tax jurisdiction, and then sell oil from Russia to this subsidiary at $25/barrel. Then this shell entity can sell the oil in the foreign market at a market price of $50/barrel. This way, out of the total profit $30/barrel made by the oil company, only profit of $5/barrel is reported and booked in Russia while remaining $25/barrel is booked in the jurisdiction where tax rates are lower than in Russia. This way, the

corporation is able to reduce its total tax payable, but it also results in Russia losing commensurate tax revenue. Such practice of exporting/importing at a price different from market price is known as 'trade misinvoicing', which is a major way in which abusive transfer pricing is used for tax avoidance purposes.

Chart III: Trade Mis-Invoicing



In Under-Invoicing of export, an exporter receives less than then market price; while in case of Over-invoicing of import, an importer pays more than the market price. Both of these practices are collectively known as 'Trade Mis-Invoicing'. Trade mis-invoicing in case of transactions between associated entities is one of the major components of abusive transfer pricing.

Another factor, which complicates the transfer pricing cases, is a tax haven.

A tax haven is a country characterised by following criteria –

- Low or no taxes: Tax rates (both personal and corporate) in tax havens are extremely low when compared to other countries. Tax havens also often have a territorial tax system, by way of which they tax their own citizens but not foreign nationals and foreign entities.
- Lack of transparency: Along with an escape from tax, tax havens also offer an escape from financial regulations by sidestepping due diligence processes; and transparency standards with regard to corporate ownership, financial accounts, assets and transactions.
- Lack of effective exchange of information: They systematically try not to engage in exchange of information with other country
- No requirement of substantial value creation activity: Foreign nationals and businesses can carry out financial transactions from tax havens even when no real businesses or economic activities are taking place there, and the transaction actually involves a business which is situated in a different country.

Earlier examples have shown that transfer pricing is used to avoid taxes by shifting income or profits to a lower tax jurisdiction. The presence of large number of tax havens along with relative ease of establishing shell companies has resulted in a situation where a disproportionately large number of shell companies are established in tax havens. These companies are primary aimed at tax avoidance methods, including abusive transfer pricing.

In 2008, British Virgin Islands has 3,389 companies per 100 residents and Cayman Islands have 182 companies per 100 people.

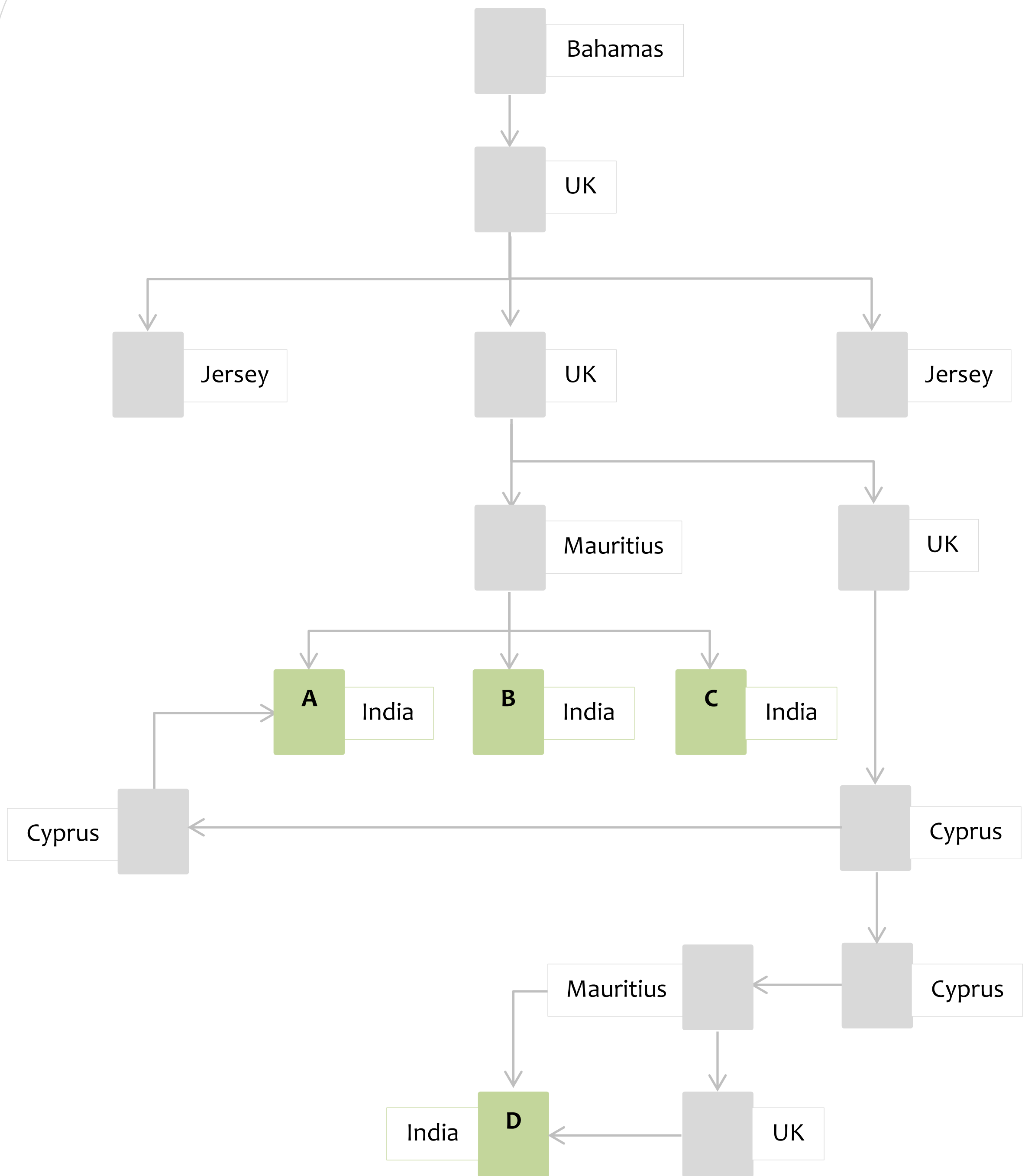
- Tax Justice Network (2009): *Secrecy Jurisdictions: Number of Companies*

Patents, Trademark and Copyright are the exclusive legal rights for use of a product granted to the creator. For example, Patents are generally granted regarding a new scientific invention or process to the inventor; trademarks are granted in case of product name, design or logo to the designer/creator of such products; while copyrights are granted in case of creative works like books, movies, music.

Shell companies and tax havens are particularly used for tax avoidance in case of intangibles, since the ownership of intangibles (patents, trademark, and copyright) are very easy to assign to a particular entity. For example, creating new intangibles requires appropriate research and development, know how, skill set, or the individual contribution, each of which is associated with monetary and other costs, like risk, developing certain work culture, time required, etc. However, once these intangibles have been created within a subsidiary, they can be registered by the subsidiaries situated in tax havens as their intellectual property with respective legal authorities. This way, when the parent company or any other subsidiary uses such intangibles, they need to make a royalty payment to the owner. In absence of the shell entity and tax havens, such payment would have gone either to the parent company or subsidiary which created them. However, by assigning ownership to an entity based in suitable tax haven, where royalty payments are exempt from taxation, the corporation can lower its total tax payable. Moreover, in case of use of shell companies for trade misinvoicing, governments can bring anti-abuse regulation. However, making such regulations for intangibles is difficult due to the complexity of processes associated with creating such intangibles. This has resulted in a growing trend of ownership of intellectual property being assigned to subsidiaries situated in tax havens, where they pay zero or close to no tax. In fact, setting up the entire corporate structure across different jurisdictions, including shell companies in tax havens, with the primary aim to avoid paying fair share of taxes has become a standard practice for Multi-National Corporations (See Chart IV).

There are ways in which government can limit the abuse of regulation, such as by specifying the criteria in the law which defines what an abuse is, and such cases can be dealt with separately. Shell companies can be identified with a threshold limit to certain economic indicators, and trading with such shell company could invite certain costs, like further disclosure requirements, withholding tax, penalty, etc. For example, the 2016 amended India-Mauritius Double Tax Avoidance Agreement (DTAA) has provisions called 'limitation of benefits', which puts the minimum limit for operational expenditure in Mauritius as INR 27,00,000 or Mauritian Rupees 15,00,000. A company spending below it, and also investing in India, will be ineligible for Double Tax Avoidance Agreements benefits.

Along with low tax rates, tax havens are also preferred for establishing shell companies because of the lack of transparency and strict confidentiality regulations offered by these jurisdictions. These regulations prevent tax authorities from other jurisdiction to access information regarding such corporations. This lack of information makes the implementation of anti-abuse regulation by authorities in non-tax haven jurisdiction much more difficult.



*Based on the corporate structure of real world Multi-national Corporation

**The green ones are the "Operating Companies", which engage in real economic activity. While the grey ones are shell companies which are created merely for finance/taxation purposes

Apart from directly minimising the overall tax liabilities of the MNCs by shifting profits across jurisdictions, abusive Transfer Pricing can also be used for following purposes:

- Moving money or capital from one country to another: A parent entity may find it preferable to keep its profits in its own country of residence than where the subsidiary is based, and can use abusive transfer pricing for this purpose.
- Using tax benefits on losses: Many countries provide relief to companies who incur losses, by proving some tax benefits. For example, the amount of loss incurred in one year can be deducted from tax payable for next few years when company starts making profits. This way, by assigning loss to entities residing in such jurisdiction through abusive transfer pricing can be beneficial.
- Managing cash flow: MNCs' operations involve numerous financial transactions, such that it receives capital in some cases and pays in other cases. This can create a situation, where the cash payment requirement is more than the cash stock. In such cases, cash from surplus entity can be moved to deficit entity using transfer pricing.
- Bypass government regulations: transfer pricing can also be used to bypass some regulations on business operations. For example, before economic liberalisation reforms in 1991 in India, there were caps on exports and imports. Such a cap could have been avoided by under-invoicing.

IV. Government Policies for Transfer Pricing

Due to various negative impacts of abusive transfer pricing, national governments create legal frameworks to regulate transfer pricing. The government policies on transfer pricing can be framed on the basis of two different approaches – Arm's Length Principle or Separate Accounting (SA), and Unitary Taxation or Formula Apportionment (FA).

A. Separate Accounting (SA) or Arm's Length Principle

The guiding principle behind this approach is that each subsidiary, though owned and controlled by a common parent, is regarded as an independent standalone entity, and hence all the transfer prices should resemble the corresponding market prices. Since, under this principle, each subsidiary treats its related companies as if they are unrelated entities, this has come to be known as the 'Arm's Length Principle'. At present, it is the most prevalent approach accepted by most countries. Organisation for Economic Co-operation and Development (OECD) and the United Nations (UN) have published model guidelines for formulating transfer pricing legislations on the basis of the Arm's Length Principle.

Based on this principle, there are different methods to assign arm's length price (ALP) to a particular transaction. The following five methods are the ones prescribed in the UN and OECD manuals on transfer pricing. The first three methods are known as 'Traditional Transactional Methods', where the focus is on the product, service, production and sale processes.

1. **Comparable Uncontrolled Price Method:** Under this method, the transfer price is compared with price in a transaction between unrelated enterprises. This method is useful when the good or service under transfer pricing is identical or very similar to the good or service under transaction between unrelated parties.

2. **Resale Price Method:** Under this method, the first transaction with the unrelated party is taken as the benchmark price, from which an appropriate margin is deducted to adjust for profit, risk, costs and other considerations. The remaining amount is considered ALP. This method is preferred when the product/service is not exactly identical but the function and other considerations associated in terms of production, risk, sale and assets are similar.

3. **Cost-Plus Method:** Under this method, the cost is calculated in producing the product/service which is being sold to a related entity, which includes cost of different inputs and processes. An appropriate margin, to adjust for profit and other considerations like risk, is then added to the cost to calculate the ALP. This method is useful when the reliable details of costs are available to make the comparison.

The next two methods are known as 'Transactional Profit Methods', where the focus is on the profit or gross margin to find out the ALP. These methods are used when the product or service and the associated functions are relatively unique; however there are similarity certain aspects such as industry, competition, management, experience. These methods are more likely to be used in case of complex products, services and intangibles.

4. **Profit-Comparison or Transactional Net Margin Method:** Under this method, the level of profit arising out of transfer prices is compared with the level of profit arising in the comparable uncontrolled transactions. In case the level of profit is found to be inappropriate, it is adjusted accordingly to find the ALP.

5. **Profit-Split Method:** This method is generally applied when the product or service under transaction provides some unique benefits to the transacting parties, meaning the same product or service will be less valuable to a third entity. Under this method, the combined profit of two or more related entities, arising from series of transactions related to one product or service, is divided among the entities based on the level of profit of comparable transactions or entities.

The principle behind these methods is to find comparables and not identical transactions. Meaning, it allows for the possibility that comparable transactions may have some differences, although such differences shouldn't have any significant impact on the arm's length price (ALP) and if they do, it should be possible to make an appropriate adjustment.

There is another relatively new method, discussed below, which has been adopted by many countries recently.

6. **The Sixth Method:** – This method was first developed by Argentina in 2003, mainly in response to the transfer pricing of minerals or commodities. Under this method, the pricing of the commodity should be based on the publicly available data from commodities exchange on the day of shipment. Some other countries, mainly in Latin America, have also started using this method. It is useful mainly in case of minerals and commodities that are publicly traded and the reliable data for the same is available in a timely and transparent manner.

For selecting the best method among all listed above to determine transfer price in any particular case, there are three key criteria – comparability, data quality, and reliability of assumptions. For a 'Comparability Analysis', the following factors should be taken into consideration:

- Product or service under transaction
- Functions undertaken, including risks and assets
- Contractual terms

- Economic environment and government policies
- Business strategies
- Any other factor which may have significant impact on the value of transaction/profit

Comparables can be of two types:

1. Internal: The transaction between a third party and one of the parties in consideration;
2. External: The transaction is between two independent entities such that none of them are related to the parties in consideration.

Apart from comparability, availability of data and assumptions also play important roles. For example, cost plus method requires detailed and accurate accounting of all the costs, while profits methods require assumptions about the comparability when the product or service and the process may be very different.

Shortcomings of Separate Accounting Method

Though arm's length principle has been adopted in large number of countries, there are some significant drawbacks in this method:

1. **The comparables for the product:** MNCs, even from the same sector, differ from each other in many ways, like – production processes, level of vertical integration, scale of economy, operational efficiency, corporate structure, management, technologies, skill set, cost structure, etc. The integrated MNCs have better synergies compare to standalone entities and hence are likely to be more efficient or profitable. Any of these factors can have a resultant impact on the prices of the products charged by them. Under such circumstances, the assumption that there exists a comparable transaction which can provide corresponding market prices can be wrong in many cases. In fact, the choice of suitable comparable transactions is considered the biggest cause of transfer pricing disputes.

   There are two problems with comparables – the first is theoretical, where finding the comparable can pose challenges; and the second is practical in terms of actually deciding the arm's length price which involves time, skilled human, data and other resources.

2. **Arm's Length price of Intangibles:** Intellectual property, like patents, trademarks and copyrights derive their value on the basis of their uniqueness, and the very idea of intellectual property is to bar others from having a duplicate product or process. Intangibles also differ from goods and services in terms of costs and risks associated. Due to these factors, finding the arm's length price of intangibles becomes extremely difficult.

Other than the two aforementioned challenges, some other difficulties include lack of cooperation between government authorities as the adjustment may be beneficial to one

entity but not to the other, identifying related parties when there is only partial common ownership or in the case of multi-layered ownership which involves a number of intermediary companies, where it first has to be established that all these entities are infact associated entities, etc.

There are some methods to identify the related parties in case of partial common ownership, such as looking at the minimum ownership threshold, use of same brand name, etc. For example, Indian transfer pricing regulations provide a wide definition of associated enterprises or those who fall under transfer pricing legislations. Such as minimum threshold of 26% common ownership, high number of common board directors, any past joint venture, sharing of know-how and intellectual properties, high degree of co-dependency between firms, etc.

B. Unitary Taxation (UT) or Formula Apportionment (FA)

The guiding principle for this approach is that an MNC functions as one single entity with the aim of combined profit maximisation, and not the profit maximisation of an individual subsidiary. Since an MNC creates a subsidiary with the ultimate aim of profit maximisation, treating each entity as an independent entity is regarded as illogical under this method. Moreover, a MNC derives better efficiency due to coordination among its subsidiaries which puts it at a more advantageous position compared to standalone entities, especially in terms of knowledge sharing, bargaining power, risk appetite, financing options, etc.

Under the FA approach, an MNC will distribute its aggregate global profit among the subsidiaries, based on that subsidiary's contribution towards revenue, value creation, payroll, cost contribution, profits, number of employees, capital base, etc. Each subsidiary will then pay taxes according to domestic tax regulations.

A workable UT system requires three components – combined and disaggregated reporting, profit apportionment and a resolution procedure. The reporting requires a combined, aggregated report as well as a country-by-country report to be submitted to each tax authority, which includes information on entities of corporate group and their relationship, intra-corporate transactions, assets, sales, costs, employees, etc. The profit apportionment formula can be based on some quantitative metrics of value creation, like assets, number of employees, payroll, sales, etc. Thirdly, in case of a disagreement either between the tax payer and the government authorities, or between the government authorities, there should be a detailed guideline on how to resolve such conflicts.

The proponents of this approach argue that, under this arrangement, there will not be any tax-motivated abuse of transfer pricing, since total profit accrued by the MNC globally will

form the tax base. It will also remove the burdensome and costly process to determine the arm's length price.

Till now, UT or FA has only been implemented at the national level, like in USA and Canada, but not at international level. However, in 2016, the European Commission re-proposed the introduction of a 'Common Consolidated Corporate Tax Base' (CCCTB), which was originally proposed in 2011. CCCTB refers to single set of rules to calculate the taxable profits of MNCs operating in the European Union (EU), even though they may be operating in more than one country. This consolidated profit will then be shared among the EU member states using an apportionment formula, and states would tax their share according to their national tax rate.

Shortcomings of Formula Apportionment Method

There are two slightly different but related difficulties with the FA approach. First pertains to devising an appropriate formula/methodology to distribute profits and income across different subsidiaries; and second, getting all the involved governments to agree on this formula/methodology.

The principle behind FA approach is that profits should be distributed among the subsidiaries based on their individual contribution towards value creation, however creating a quantitative indicator or metric corresponding to the value creation is rather difficult. Generally the suggested approach is that it should be a combination of assets, employee, payroll and sales. However, given since different businesses have different models and requirement, finding a suitable formula is difficult. For example – a company engaged in manufacturing will have substantial physical assets while a legal firm will have hardly any physical assets. Even when considering employee and payroll, quality of work and process may differ and hence contribution towards values creation, in such cases an appropriate formula will be difficult to devise. Another difficulty pertains to the cases of joint venture or partial ownership.

The second challenge refers to the requirement of agreement among all the countries involved, which implies a global or near global consensus on accounting standards and the formula to distribute aggregate profits. Countries have their specific traits in terms of factors of production, for example some specialise in labour, some in certain specific sectors, some have natural resource while some countries specialise in knowledge economy. In such cases, each country will support a formula which increases the share of its dominant factor and mode of production. For example country with cheap labour will support the formula which accords a higher share to labour while countries with high share of capital intensive industry will oppose it, and vice versa. Since moving to the formula apportionment method from current separate accounting method will be beneficial to some countries while harmful to others, it is bound to face resistance. Also, different countries adopt a particular accounting practice keeping in mind their individual requirements and preferences; and in this case, a global agreement could prove to be extremely laborious and difficult process.

C. Other Methods

Due to the limitations of the two approaches mentioned above, countries can also adopt individual or case specific measures. Some of the frequently used methods are as follows:

I. Cap on Royalty Payments

If an entity uses the intellectual property owned by another entity, then the former has to make a mutually agreed payment to the latter, such payments are called royalty payments. In order to deal with abusive transfer pricing related to the transactions of intellectual property, an upper limit can be put on associated royalty payments. This limit can either be absolute or relative. For example, in absolute terms the cap can be a nominal amount per year; while in relative terms it can be expressed as proportion of annual revenue, exports or profits.

II. Thin Capitalisation Rules

When a company uses disproportionately large debt compare to equity for financing itself, such companies are regarded as 'Thinly Capitalised'. Though, debt financing though intra-corporate loans can also be used for profit shifting, as interest payments on debts are generally deductible from tax. To avoid profit shifting in the way of interest payment to a related entity, there can be legislation regarding either the debt level or interest payment or both. The upper limit on both the debt and interest payments can either be absolute or relative to some indicator. For example, while the absolute limit can be a nominal value, the relative limit for debt can be defined in terms of debt-equity ratio; while for interest payment, it can be expressed as proportion of revenue, Earnings before interest, taxes, depreciation and amortization (EBITDA), etc.

III. Withholding Tax

Withholding tax, also known as Tax deducted at Source (TDS) or retention tax, are those where the payer collects the tax on behalf of the government while making specified payments, for example – an employer can deduct a specified amount from the salary payment to an employee as an alternate way of collecting income tax. A withholding tax can be levied on different kind of payments and fees made to an associate enterprise, such as royalty payments, interest payments, technical service fee, legal service fee, etc. This way, if an MNC tries to make undue payments to shift income from one jurisdiction to other, an appropriate level of withholding tax can make it unattractive to engage in such activity.

IV. Advance Pricing Agreement (APA)

An advanced pricing agreement is struck between concerned national tax authorities and the tax payer beforehand on the method to decide the transfer pricing. The agreement can be of different type in terms of the participants, like bilateral agreement between a government authority and the tax payer, bilateral agreement between two government

authorities, and multilateral agreement involving two government authorities and a tax payer. This is not necessarily a different method for transfer pricing, as the agreements can choose one of the separate accounting methods mentioned above. APAs are instead a mechanism to avoid any future disputes between the authorities and the tax payer, by the way of an agreement beforehand.

V. Safe Harbour Rules (SHR)

Safe Harbour Rules refer to a set of rules that provides conditions fulfilling which, transfer prices used in a particular transaction will be accepted by the authorities and will be exempted from transfer pricing audits. These conditions may refer to level of profits relative to revenue or operating costs, level of payments to the associated enterprises as a threshold proportion of revenue or operating costs, etc. For example, it can be ruled that companies operating in XYZ industry will be exempted from transfer pricing audits if they report a profit above a threshold level prescribed in the regulations.

V. Challenges Faced by Developing Countries

Abusive transfer pricing is a global issue, however it is of particular importance to developing countries, primarily because of two reasons – the significance of corporate tax in total revenue collection in developing countries, and them being more vulnerable to transfer pricing abuse by MNCs due to institutional factors. Both of these are discussed below in greater detail.

Governments raise revenue though different sources, like taxes, social contribution, revenue from natural resources, ownership of public sector enterprises, etc. Out of all these sources, taxes are by far the largest source of revenue for governments and more so in the case of developing countries. Taxes are of various types, like personal income tax (PIT), corporate income tax (CIT), goods and services tax, property tax, custom duties, etc. A 2015 report by The United Nations Conference on Trade and Development (UNCTAD) estimates that while in case of developed countries, corporate income tax contributes only 11 percent of the total tax collection; in case of developing countries this goes upto to 21 percent, highlighting the importance of corporate income tax for developing countries. However abusive transfer pricing can result in reducing the total corporate tax income payment along with the indirect taxes on the specified transactions.

Secondly, developing countries are more vulnerable to tax avoidance by MNCs. For example, Fuest, Maffini and Riedelz (2012) found that despite similar statutory tax provisions in developing and developed economies, the effective marginal tax burden on corporate profits in developing countries is between 6% and 14%, which is significantly lower than the similar estimates for developed countries which are above 20% in most cases. Apart from the aggregate revenue loss at global level, abusive transfer pricing can also result in situation where one government (particularly in a developed country or in a tax havens) receives higher tax revenue than its fair share while there is a corresponding or even bigger loss of revenue for the other government (in developing countries). Other negative impacts of abusive transfer pricing can be aiding to corruption, increased national debt and poverty, businesses' loss of trust by public and government, and broader implication for societal well-being. Due to these reasons, an effective transfer pricing framework is highly required in developing countries.

For government authorities, there are two broad areas of work related to transfer pricing: first, framing the regulations, and second, effective implementation. In framing the regulations, developing countries can, if needed, take help from the manuals published by multilateral organisations like UN or OECD. Although, the specific features of individual country, in terms of nature of economy, resources, domestic legal framework, need to be kept in mind, and model regulations need to be tailored accordingly. Countries can also take example and/or help from other similar countries that might have prior experience with transfer pricing regulations.

For implementation of transfer pricing rules, there are a number of steps involved, like:

- Gathering background information and data
- Industry analysis
- Comparability analysis
- Selection of method for determining arm's length price
- Determination of ALP
- Completion of case involving adjustment, documentation, etc
- Dispute resolution mechanism

All these steps require human resources with proper skillset, time and other resources on part of tax authorities. In case of developing countries, the transfer pricing unit/department faces many challenges, such as:

1. **Information or Data Gap:** Developing countries face difficulties in accessing relevant information, especially from the non-resident members of the MNEs. Even the quality of data (financial or otherwise) may be unsuitable for the purpose of comparability. Finding comparables can also be difficult in case of companies who are first movers, or the companies who enjoy monopoly positions. In case the information/data for comparables are taken from another (developed) country, there are many differences between both the countries which need to be considered to make adjustment to decide ALP.
2. **Skill Gap:** To be able to formulate and implement appropriate and effective transfer pricing rules, concerned officials need to have an understanding of the business entity in consideration, associated sector, accounting practices, legal analysis, comparability analysis; and each of these subjects require specialised skill sets. Developing countries face qualitative and quantitative challenges in terms of skill gap. In terms of quality, the officials may not have the required skill set, while in terms of quantity, the number of officials with such skill sets may be inadequate to properly deal with all the cases of transfer pricing.
3. **Resource Gap:** For proper formulation and implementation of transfer pricing, the resources required include various databases for comparability, adequate human resources skilled in subjects mentioned above, institutional infrastructure, mechanism for dispute resolution, and proper legal framework for transfer pricing and enforcement of the same. Developing countries often lack such resources which make effective implementation of transfer pricing standards difficult.

VI. Summary

Transfer pricing is a vital component of international operation of multinational corporations. However, it has emerged as one of the most contentious issues in the area of international taxation. While there can be some genuine difficulties for MNCs in assigning a monetary value to certain kind of transactions due to inherent interlinkages between the subsidiaries, especially in case of intangibles, transfer pricing can also be abused by MNCs to avoid taxation by taking advantage of tax rate differential among jurisdictions. Abusive transfer pricing can have significant negative impacts on domestic resources being raised by the governments, particularly in developing countries. Although developed countries have paid attention to the issue of transfer pricing for some time now, developing countries are only beginning to focus on this issue around the turn of century, when many countries like China, India, Brazil and Argentina developed transfer pricing regulations. Since then a number of countries in Asia, Africa and Latin America have also developed transfer pricing regulations. Multilateral organisations like OECD and UN have played a significant role by producing transfer pricing guidelines. However, there remain a number of challenges. At the theoretical and implementation level, there are major weaknesses in the arm's length principle, which currently forms the basis of almost all transfer pricing regulations. The other alternate, Formulation Apportionment or Unitary Taxation also has some technical problems in designing, and faces significant political challenges to become a viable option. Against the weakness of globally accepted framework, some developing countries have adopted many innovating approaches, like Argentina introduced the 'Sixth Method', while Indian regulations provide for 'Any Other Method' in addition to the five methods mentioned in the OECD transfer pricing manual. Developing countries face greater challenges in implementation and enforcement of the transfer pricing regulations, especially with regard to financial and human resources, and capacity constraints. These challenges emanates from the complexity associated with transfer pricing regulations, but also from some of the developing countries specific issues, such as skill gap and resource gap as well as information gap. OECD, backed by the G20, has initiated the Base Erosion and Profit Shifting (BEPS) project in 2013, which currently has close to 70 member countries. Of the 15 BEPS Action Plans, four are focused directly on transfer pricing. Some provisions of BEPS project, like country-by-country reporting requirement for MNCs, can divulge significant information about the inner workings of MNCs which should be helpful in better framing and application of transfer pricing regulations.

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