A Primer on

# Transfer Pricing:

## Norms, Standards, Misuse for Tax Avoidance, and Impacts on Developing Countries

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# List of Abbreviations

| | |
|---|---|
| ALP | Arm's Length Price |
| APA | Advance Pricing Agreement |
| BEPS | Base Erosion and Profit Shifting |
| CBCR | Country-By-Country Reporting |
| CCCTB | Common Consolidated Corporate Tax Base |
| CIT | Corporate Income Tax |
| CUP | Comparable Uncontrolled Price |
| DEMPE | Development, Enhancement, Maintenance, Protection and Exploitation |
| DTAA | Double Tax Avoidance Agreement |
| EBITDA | Earnings Before Interest, Taxes, Depreciation and Amortization |
| EU | European Union |
| MNC | Multi National Corporation |
| OECD | Organisation for Economic Co-Operation and Development |
| PIT | Personal Income Tax |
| R&D | Research and Development |
| SA | Separate Accounting |
| SHR | Safe Harbour Rules |
| TDS | Tax Deducted at Source |
| TNMM | Transactional Net Margin Method |
| TP | Transfer Pricing |
| UN | United Nations |
| UNCTAD | United Nations Conference on Trade and Development |
| UT-FA | Unitary Taxation with Formula Apportionment |

# I. Introduction

Governments have a number of duties towards its citizens, including realizing and safeguarding human rights, making endeavours towards justice and equity, making public provisions for education, healthcare, drinking water and sanitation, infrastructure, etc. A government's ability to fulfil its obligations towards its citizens is directly dependent on the resources it can mobilise. Taxes being the single biggest contributor to a government's resources, it follows then that the amount of tax revenue mobilised by a government has direct bearings on its ability to carry out its duties.

The resources a government can raise through taxes, also known as the tax potential of the country, is decided broadly by following three aspects defined in the tax structure of the country:

1. Who is a tax payer: It defines entities who are legally obligated to pay taxes. It can be an individual, a household or a legal entity like corporation, partnership, trust, joint venture, etc.
2. What constitute the tax base: It identifies which sources the taxes will be levied on, generally comprised of incomes, assets, transactions, or other business activities.
3. What are the tax rates: It defines the tax rates for each particular tax base.

Governments fail in realising their full potential tax revenue when tax payers do not pay the appropriate amount of tax as required by the tax regulations. Tax payers can do so by violating one or more of the above three aspects of tax regulations. For example, a tax payer can circumvent regulation and identify itself as a non-tax payer in a jurisdiction, by using complex accounting technique a firm can show lesser taxable income, or a Multi-National Corporation (MNC) can create a complex corporate structure across multiple countries and thus manipulate the tax base declared in a particular country. The practice of tax payers not paying their fair share of taxes is known as tax dodging.

This primer focuses on a prominent feature of modern day business – the practice of 'Transfer Pricing'. From the perspective of tax revenue, the importance of transfer pricing (TP) lies in the fact that along with being an essential feature of modern business, it is also one of the biggest route which can be and is being grossly misused for the purposes of tax dodging by the multi-national corporations.

The modern business practices of MNCs are result of many different influencing factors, such as technological progress, economic and political developments, national and international regulations, etc. One such prominent factor to shape modern business is globalisation. The advancement of globalisation has two distinct impacts, among many others, on how businesses operate. First, in terms of the rise of multi-nationalcorporations, where one firm 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 or service are located in different locations, as opposed to the entire production process being carried out in a single location. There can be multiple motivations behind a company's decision to either disintegrate the production processor 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 across 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. All these factors together have contributed towards creating a complex system where multiple subsidiaries of a single parent company, often situated in different legal jurisdictions, engage in business transactions with each other.

Subsidiaries that belong to a single parent company, or firms with shared control are known as 'related entities' and transactions between them are known as 'intra-group transactions'. These intra-group transactions differ from the other market transactions carried out between unrelated entities in terms of the process of price setting. While, in case of transaction between unrelated entities, prices are set by the market forces of demand and supply; in case of intra-group transaction, prices are set by the overall strategy of the MNC determined centrally. This process of price setting for intra-group transactions is known as transfer pricing. From a taxation perspective, transfer pricing is important because the ultimate tax that a subsidiary has to pay can be changed through transfer pricing, as different levels of transfer prices result in different level of profit. Different countries have different tax bases, tax rates and criteria to define tax payable. By using different transfer price levels, MNCs can report larger profits for subsidiaries in low tax jurisdictions, and thus avoid paying their fair share of taxes in other jurisdictions where they actually create value.

Though, the revenue loss by governments, which consequently impacts the government's ability to fulfil its obligations towards citizen, is not the only negative outcome of abuse of transfer pricing process. There are at least two other major undesirable outcomes of abusive transfer pricing. First, it is against the idea of fair market practices as it provides undue advantage to firms engaging in this practice against their competitor firms which do not, thus creating an uneven playing field. Second, it can undermine other government policy objectives, such as using tax for wealth redistribution, or using tax policy to encourage or disincentives a certain industry. All these details highlight the fact that transfer pricing is not an obscure practice for only businesses to be concerned with, but it is something that has far reaching implications for the wider social, economic and political developments.

In such context, this primer aims to provide a brief introduction to Transfer Pricing to those who are unfamiliar with this subject. Broadly, the primer tries to answer following questions:

- What is transfer pricing?
- How is transfer pricing used for tax avoidance and 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 and methods?
- What are some of the developing countries specific issues in transfer pricing?
- What are some of the recent developments in the area of 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 can also be known as sister companies, associated companies, affiliated companies or controlled group of companies. The process of deciding transfer price for any particular transaction is known as 'Transfer Pricing'.

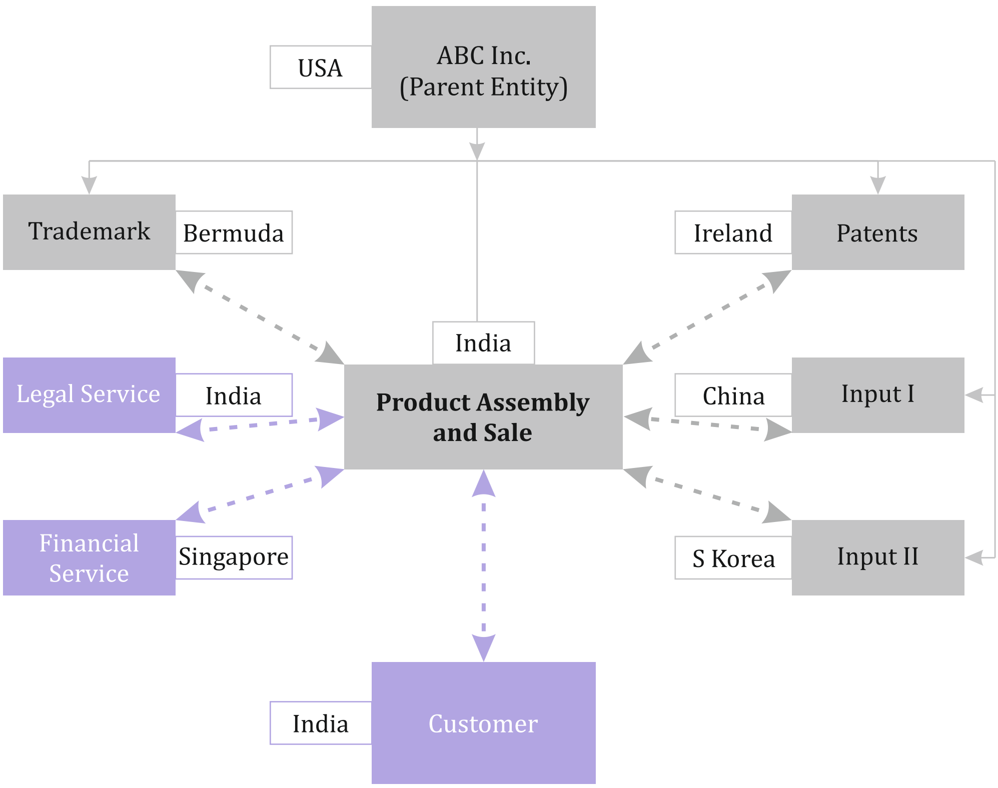
> "Transfer pricing is the setting of prices for transactions between associated enterprises involving the transfer of property or services."
>
> – United Nations (2017): *Practical Manual on Transfer Pricing for Developing Countries*

Based on the product or 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 commercial services such as banking, legal advice, consulting, financial service, education, medical treatment, 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 thin solid grey lines indicate ownership while thick dotted lines represent the transactions related to goods, services and intangibles. The blue box and the thick dotted 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 grey dotted lines, the accompanied payment is called 'transfer price'. For example, when the Indian entity uses the brand name 'ABC Inc.'; it makes 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 the buyer wants to minimise the price while the 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 or service in transaction. In contrast, MNCs operate as integrated firms, and generate profit from the synergy between their various activities. So when two related companies in such a corporate group engage in a transaction, they 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 a commensurate market price, but at a different level which might 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 jurisdiction.

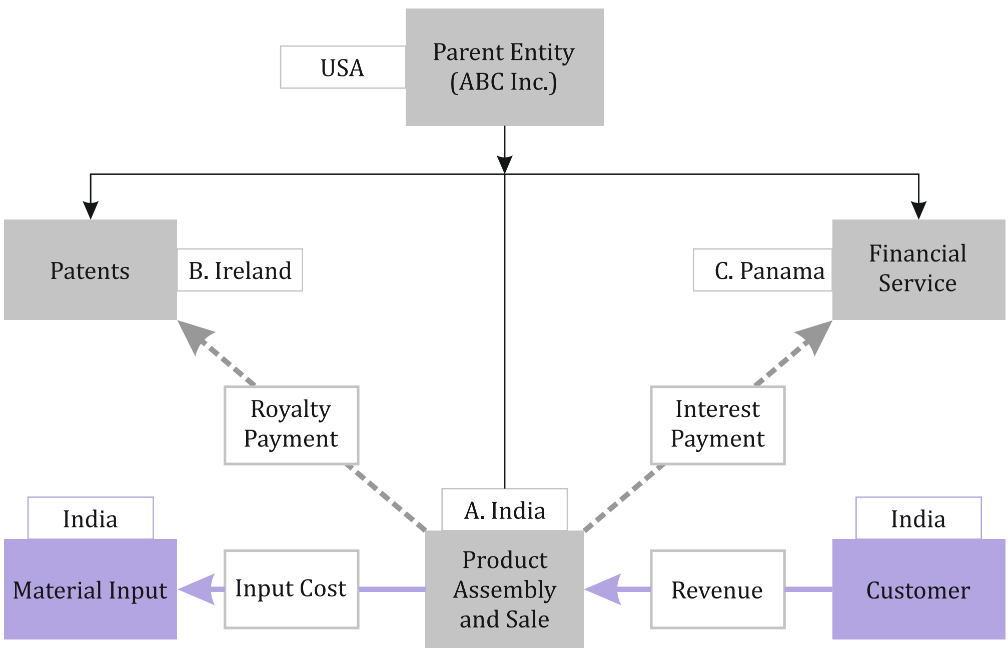
> The practice of setting transfer price at a level different from market price is known as 'abusive transfer pricing'. The practice of abusive transfer pricing is also known as transfer mis-pricing, unfair transfer pricing, incorrect pricing, unjustified pricing or non-arm's length pricing.

The opportunity for tax avoidance through abusive transfer pricing arises due to the regulatory and economic differences between the countries. To illustrate: the 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 methods, profits or cost can be shifted from one jurisdiction to another which will change the value of transaction, value of property and/or the level of income and thus the total tax payable by the corporation.

It is important to note that transfer pricing by itself, does not indicate tax avoidance. On the contrary, for deciding the valuation of intra-group transactions, it is the most prevalent methodology currently, and has been adopted by the governments all across the world. The problem arises when the transfer price deviates from the commensurate market price, i.e. - the practice of 'abusive transfer pricing'.

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

**Chart II: Tax Avoidance through Transfer Pricing**




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 us 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 case 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 example given above 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, aparent company based in USA can establish research and development(R&D) subsidiaries in other countries such as France, but the patents resulting from these R&D centres can be registered in a low tax jurisdiction 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 information and communication 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, legal, financial, consulting and marketing services derive their market value on the basis of 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 commensurate 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 on behalf of its owner. 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, they 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, and as holding company to act as owner of certain properties.

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 countries.
- 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 which offer 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, including abusive transfer pricing.

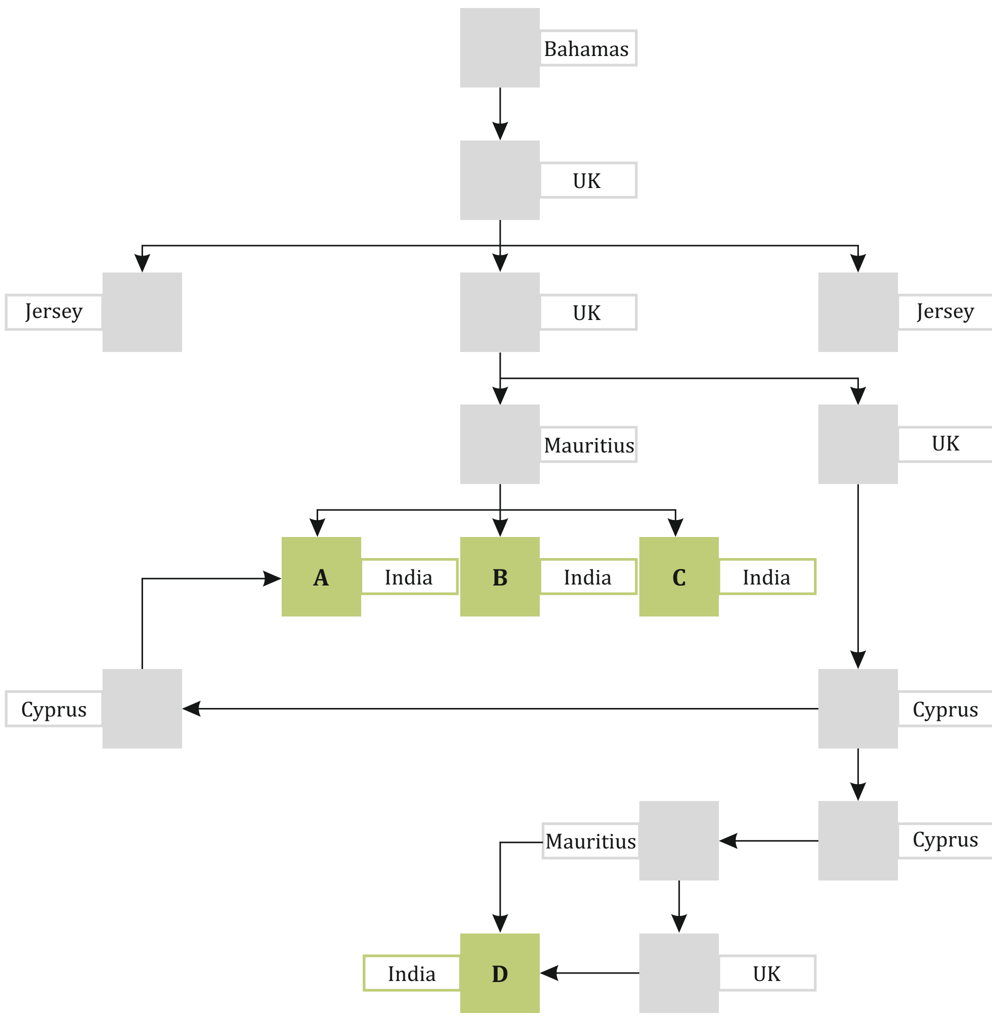
In 2008, British Virgin Islands has 3,389 companies per 100 residents and Cayman Islands have 182 companies per 100 people.

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

Shell companies and tax havens are particularly used for tax avoidance in case of intangibles, since the ownership of intangibles (patents, trademarks, and copyrights) 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 a suitable tax haven, where royalty payments are exempt from taxation, the corporation can lower its tax liability. Moreover, in case of use of shell companies for trade misinvoicing, governments can implement 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 III).

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 creator of such products; while copyrights are granted in case of creative works like books, movies, music.

## Chart III: A Sample of Corporate Structure




*Based on the corporate structure of a real Multi-National Corporation
**The green ones are the “Operating Companies”, which engage in real economic activity. While the grey ones are shell companies created merely for financial or taxation purposes

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.

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.

Apart from directly minimising the overall tax liabilities of the MNCs by shifting profits across jurisdictions, abusive transfer pricing can also be used for some other purposes, such as:

- 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.
- Bypassing government regulations: Transfer pricing can also be used to bypass some regulations on business operations. For example, many countries put cap on the maximum value for export or import of certain goods. Such a cap could have been avoided by under-invoicing.

# IV. Government Policies for Transfer Pricing

Governments have long been aware of the problem of allocation of income among the various affiliates of MNCs through transfer pricing. Many countries have brought legislation related to transfer pricing. These legislations provide standard guidelines for MNCs on how to decide the transfer pricing. They also give powers to the national tax authorities to adjust transfer price in particular transactions, when they are found to be not agreeing to the guidelines provided. The standard for deciding transfer price, which was agreed internationally, was to compare them with those of independent firms, and this approach was called arm's length principle or Separate Accounting (SA) principle. Based on this principle, the Organisation for Economic Co-operation and Development (OECD) published Transfer Pricing Guidelines in 1995 which approved five transfer pricing methods.  However, many independent commentators have long highlighted the shortcoming of arm's length principle and argued for a shift away towards approaches which would treat MNCs in accordance with the economic reality that they operate as unitary firms. This approach is known as Unitary Taxation with Formula Apportionment (UT-FA).

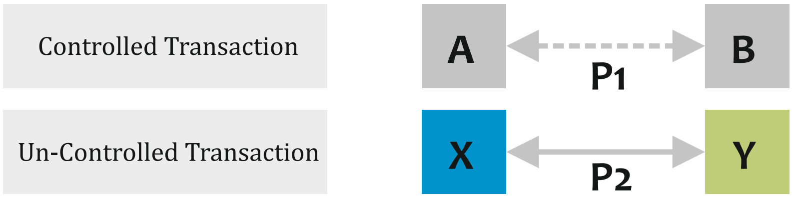
Both, the Arm's Length Principle and UT-FA are discussed below in detail.

## 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  an independent standalone entity, and hence all the transactions between related entities should be carried out as if it were carried out between unrelated entities. Essentially it means that transfer price for a particular transaction should conform to the commensurate market price between unrelated entities. At present, it is the most prevalent approach used by most countries.

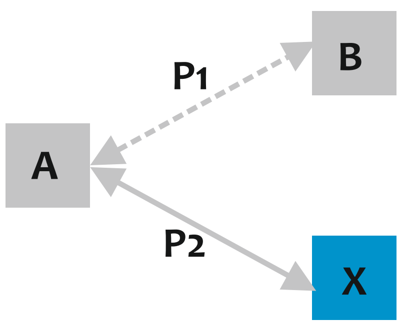
Organisation for Economic Co-operation and Development (OECD) and the United Nations (UN) have published model guidelines for formulating transfer pricing legislations on the basis of the Arm's Length Principle. To calculate transfer price in a particular cases, both manuals prescribe five methods. The basic objective behind these methods is to find a transaction between unrelated parties comparable to that intra-group transaction, and use this to arrive at an appropriate transfer price. All five methods are discussed below.

1. **Comparable Uncontrolled Price (CUP) 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.



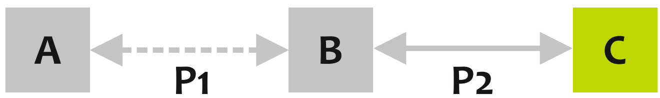

Consider the picture above, which depicts two transactions: between A and B, and between X and Y. A and B are related entities, and hence the transaction between A and B reflects case of transfer price P1. X and Y are unrelated entities, and the transaction between them reflects market price P2. If the XY transaction is comparable to AB transaction, then the P1 should be close to P2. In most cases, the comparison is done not on the point basis but on the range. Thus, P1 does not have to be exactly equal to P2, but it can be within a smaller range around P2. For example it can be allowed that P1 should be within 10 percent range of P2.

The above example is known as external comparable, where X and Y are not related to either A or B. A different case is known as 'internal comparable', where the market price considered is for a transaction between one of the parties involved in transfer price and a third party. The following picture shows an example of internal comparable:




In the above example, the comparable market price for transfer price between A and B is from the transaction between A and X. Since A and X operate under normal market principle, P2 reflect a fair uncontrolled market price, and hence can act as a comparable for transfer price P1.

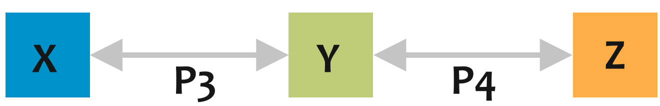
2. **Resale Price Method:** Under this method, the first transaction with the unrelated party is taken as the benchmark price, from which an appropriate margin is deducted to adjust for profit, risk, costs and other considerations. The remaining amount is considered arm's length price (ALP). This method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




Consider the picture above in which B buys something from related entity A, and resells it to an unrelated entity C. Here the transaction between A and B refers to the case of transfer pricing. The principle behind resale price method is that resale price (P2) is fair market price, and by deducting appropriate profit margin for B, the arm's length price for P1 can be determined, as follows -

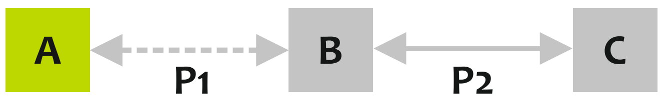
$$ALP = P2\ (1 - \text{Gross Profit Margin})$$

To find the appropriate profit margin, a comparable uncontrolled transaction needs to be found.




Consider the picture above, in which three unrelated entities, X, Y and Z carry out a transaction which is comparable to the one carried out among A, B and C. As such the gross profit margin derived by Y, can be taken to the profit margin that B should have. Inserting this value in the previous formula, ALP can be calculated for the AB transaction.

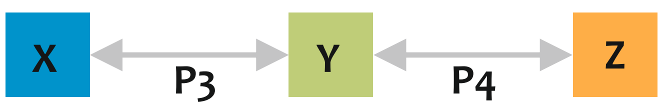
3. **Cost-Plus Method:** Under this method, the cost is calculated in producing the product or service which is being sold to a related entity, which includes cost of different inputs and processes. An appropriate mark-up, to adjust for profit and other considerations like risk, is then added to the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




Consider the picture above in which B buys something from an unrelated entity A, and sells it to a related entity C. Here the transaction between B and C refers to the case of transfer pricing. The principle behind cost plus method is that cost (P1) is fair market price, and by adding appropriate profit margin for B, the arm's length price for P2 can be determined, as follows -

$$ALP = P1\ (1 + \text{Cost Plus Mark-up})$$

To find the appropriate mark-up, a comparable uncontrolled transaction needs to be found.




Consider the picture above, in which three unrelated entities, X, Y and Z carry out a transaction which is comparable to the one carried out among A, B and C. As such the gross profit mark-up derived by Y, can be taken to the profit margin that B should have. Inserting this value in the previous formula, ALP for transaction BC can be calculated.

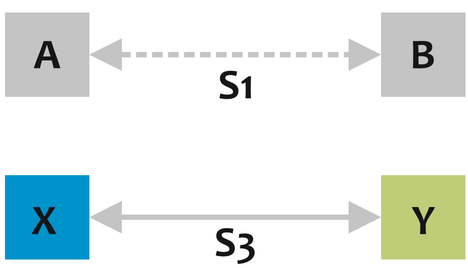
The above three methods are known as 'Traditional Transactional Methods', where the focus is on finding of price of product or service. The next two methods are known as 'Transactional Profit Methods', where the focus is on the profit or net margin to find out the ALP. These methods are likely to be used when using the first three methods is not feasible. The reasons for this can be that the products or services under transactions are relatively unique and hence finding a comparable transaction with same product or service is difficult. These methods are used primarily in case of complex products, services and intangibles.

**4. Profit-Comparison or Transactional Net Margin Method (TNMM):** Under this method, the level of profit arising out of transfer price 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.

The process to determine arm's length price through transactional net margin method (TNMM) is similar to cost plus or resale price method, in the sense that net profit margin in case of a controlled transaction is compared with the net profit margin in case of comparable uncontrolled transaction. The difference lies in the product or service under transaction. When the product or service has a direct comparable, cost plus or resale method is applied, while the direct comparable for the product or service is not available, and instead the comparable has to be found taking a wider range of factors, including product or service, the process; and the price of two transaction can vary more than allowed under cost plus or resale method.

While in metric used in case of cost plus method and resale methods are cost plus mark-up and gross profit margin, the same metric in TNMM is known as 'net profit indicator'.

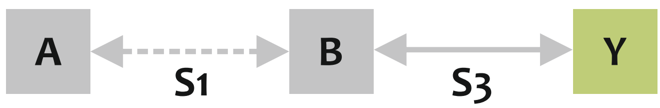
Consider the following picture, which depicts two transactions, between related entities A and B, and between unrelated entities X and Y. S1 and S2 refer to the net profit margin.




The net profit indicator is calculated as percentage to some other measure, like revenue, cost, assets, etc. Once, this value is known for uncontrolled transaction, the profit for controlled transaction can be determined given the revenue, cost or asset value for controlled transaction.

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.

Consider the following transaction, B buys from related party A, and sells it to C. In this process, A makes a profit of S1 while B makes a profit of S2.




If the products or services involved in both the transactions are highly interrelated and calculating individual prices or profits are not feasible, the profit split method can be applied.

Under this method, the combined profit (S1+S2) will be distributed among A and B based on their contribution towards profits. The contribution is measured by factors like functions performed, risks borne, assets used, cost incurred. All these factors are converted into a quantitative metric and then used to calculate the individual contribution of each entity.

A slightly different version of profit split method is used in some countries, where the contribution share is instead taken from a comparable uncontrolled transaction. In such cases, similar to CUP method, a comparable uncontrolled method is found and then the profit split ratio from this transaction is used in case of transaction under consideration.

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

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. To find a comparable transaction, a 'Comparability Analysis' is carried out, in which the following factors are 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 or 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.

Along with above five methods advocated by UN and OECD, there are some cases when countries adopt other methods to determine transfer price for a particular set of transactions. Given below are two of the more famous of such examples:

6. **The Sixth Method:** This method was first developed by Argentina in 2003, mainly in response to the transfer pricing of agricultural commodities and minerals. 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.

   In essence, this method can be categorised as a variant of 'Comparable Uncontrolled Price (CUP)' method prescribed by the UN and OECD manuals. The difference is while CUP method requires looking for a comparable transaction, the sixth method directly uses the price for that particular product from a publicly available source.

7. **The Fixed Margin Method:** This method is used mainly in Brazil, and can be categorised as a variation of OECD's resale price and cost plus method. The process to determine arm's length is same as cost plus or resale price method, the difference lies in calculating the profit margin. Unlike cost plus or resale price method where the margin is taken from a comparable uncontrolled transaction, under fixed margin method, there are fixed margin

applicable while calculating transfer price. These fixed margins differ according to whether it is export or import, and according to which sector the trade belongs to.

For example, to calculate transfer price for import of oil products or tobacco products, 40 percent profit margin from the resale price is to be deducted, while to calculate the transfer price in case of imports of chemical and glass products, 30 percent from the resale price needs to be deducted. In case of export, the weighted average price for that particular product in destination country is to be taken as the benchmark resale price and a fixed margin of 30 percent is to be deducted to calculate the arm's length price for transfer pricing.

## 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 in fact 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 percent 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 with Formula Apportionment (UT-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 UT-FA approach, tax authorities would apportion the MNC's global consolidated profit among the subsidiaries, based on factors which reflect its real economic presence, such as number of employees, payroll, physical assets and sales. Each subsidiary will then pay taxes according to domestic tax regulations.

A workable UT-FA 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 Unitary Taxation with Formula Apportionment Method

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

The principle behind UT-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. The formula can get further complicated in cases of entities involving 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, different countries also adopt individual or case specific measures. These methods are more focused on curtailing the abuse of transfer pricing than determining the fair level of transfer price. 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, and such payments are called royalty payments. Since, royalty payments, which are essentially fee for using intellectual properties, are hard to determine exactly; it provides a convenient route to those willing to engage in abusive transfer pricing practice. Subsidiaries based in country with higher tax rate can pay very high royalty payments to entity based in a low tax country, thereby escaping tax in the former country. In order to deal with such abusive transfer pricing, 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

A company can raise fresh capital either through debt or through equity. Since, interest payments on debts are generally deductible from tax, it provides incentive to an MNC to finance a subsidiary through intra corporate loan instead of equity. Generally, the subsidiary which provides loan is based in a low tax country. This way, through high level of debt and consequently high level of interest payment, profits can be shifted from a high tax jurisdiction to low tax jurisdiction. When a company uses disproportionately large debt compare to equity for financing itself, such companies are called 'Thinly Capitalised'.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, there can be absolute upper limit as nominal value for debt or interest payment. Or, 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. 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 level more than 15 percent of revenue.

### V. 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. Some Recent Developments Related to Transfer Pricing

In last few years, tax dodging by MNCs has received global attention by policy makers, media, civil society and general public. This has also led to some policy initiatives - both domestically and globally. The most significant such development is the Base Erosion and Profit Shifting (BEPS) project initiated by the OECD and backed by G20 countries. The overall stated objective of the project is to address tax avoidance by MNCs and to ensure that profits are taxed in countries where value creation takes place. The BEPS project has 15 action plans focusing on different aspects of profit shifting and tax misalignment. Out of 15 action plans, 4 are related to transfer pricing. Action plan 8, 9 and 10 address transactions of intangibles, contractual allocation of risks, and other high risk areas. Action plan 13 refers to the documentation requirement of transfer pricing.

The adaptation of arm's length principle for transfer pricing in BEPS action plan has not been without criticism. However, within the ambit of APL there are some significant changes proposed in the BEPS action plans related to transfer pricing. Broadly these changes can be classified in two categories:

1. Determining TP in case of transfer of intangibles, and
2. The documentation requirement for Country-by-Country Reporting (CBCR).

In developing an intangible and using it for commercial purposes, multiple subsidiaries of an MNC can be involved. Each of these subsidiaries can contribute towards the value of intangible in terms of functions performed, assets used and risk borne. The BEPS action plan introduces the concepts of Development, Enhancement, Maintenance, Protection and Exploitation of intangibles (DEMPE). Earlier, the revenue from intangible would go to the subsidiary that is legal owner of that intangible irrespective of how many other subsidiaries were involved in creating that intangible. The DEMPE approach tries to significantly change this. Briefly, it aims to achieve that:

- Legal ownership of an intangible by a subsidiary is not the only criteria to allocate the profit from said intangible to a particular subsidiary;
- All subsidiaries involved in the Development, Enhancement, Maintenance, Protection and Exploitation of intangibles should get appropriate return.

Assigning ownership of intangibles to subsidiaries in low tax jurisdictions has been one of the major routes of profit shifting. An effective DEMPE approach should be able to curb such profit shifting, but in large part it will depend on the actual legislation and the practice adopted by the countries.

Another strong incentive for abusive transfer pricing arise because of information asymmetry between the government and the businesses. Government authorities have to depend on tax payers to give them information regarding the transactions involving transfer pricing, and this asymmetrical access to information have been one of the biggest constraints for authorities to be able to control abusive TP. However, this information asymmetry will be tackled, at least partially, with the introduction of country by country reporting. According to the proposal, there is a three tier documentation requirement for the MNCs, as follows:

1. A master file: It contains the aggregate details of the MNC, such as overview of the MNC, its global business, overall transfer pricing policies
2. A local file: It has details about a particular subsidiary in a country, such as business description, transfer of intangible, the selection of TP method and other details related to intra-group transactions
3. A country by country report: It gives the jurisdiction wise details of MNC's operation. The details that need to be provided include jurisdiction wise allocation of income, taxes paid, revenue, number of employees, etc.

However, a major flaw in this action plan is the revenue threshold of 750 million euros, i.e. – only the MNCs with annual revenue above 750 million euros have to comply with the CBCR reporting requirements. Such a high threshold implies that close to 80-85 percent of all MNCs across the world will be outside the CBCR reporting requirements. It can be argued that since MNCs based and operating only in developing countries tend to be of smaller size compared to ones in developed countries, there is possibility that this high threshold will disproportionately exclude the MNCs operating in developing countries. Also, it is proposed that the ultimate parent entity should file the CBCR in its home country and the home country then shares it with other relevant countries based on the multilateral convention or any other bilateral agreement. One precondition for sharing of CBCR is the data confidentiality and security arrangements in receiving country, which leaves open the risk that some developing countries can be denied access to CBCR on the basis of lack of proper data confidentiality an security arrangements.

It is to be noted that notwithstanding these concerns, the information acquired through CBCR is expected to provide tax authorities with a clearer picture of MNCs' operations and the real allocation of profits across jurisdictions. While the current analysis of transfer pricing is focused on the transactions; after the implementation of CBCR, tax authorities will have access to wider macro level information and will be useful for analysis which were not possible earlier. This in turn can be expected to curb the practice of abusive transfer pricing.

# VI. Challenges Faced by Developing Countries

Abusive transfer pricing is a global concern, 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[1] 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 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 Riedel[2] (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 percent and 14 percent, which is significantly lower than the similar estimates for developed countries which are above 20 percent 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 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 regulatory framework is highly required in developing countries.

For government authorities, there are two broad areas of work related to transfer pricing: first, framing the appropriate regulations, and second, effective implementation. In framing the regulations, the specific features of individual country, in terms of nature of economy, prevalent

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[1] UNCTAD (2015).*World Investment Report 2015: Reforming International Investment Governance.* UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT, pp.176-187.

[2] Fuest, C., Maffini, G. and Riedel, N. (2012).*What Determines Corporate Tax Payments In Developing Countries? Evidence from Firm Panel Data.*

business practices, resources, domestic legal framework, international agreements, need to be kept in mind. While, 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

Both these aspects, framing the regulation as well as implementation of it, require human resources with proper skill set, time and other resources on part of tax authorities. In case of developing countries, the transfer pricing department faces many challenges, which broadly can be put into following three categories:

1. **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.

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. **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 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.

While these concerns are applicable for most developing countries, it is important to note that the term developing countries as a group encompasses a large number of countries and there are significant differences within this group. Even considering only the factors relevant for transfer pricing, one developing country can differ from another one in various ways, like composition of domestic economy, nature and extent of international trade, particular sectors important for transfer pricing, government regulations, regulatory power and effectiveness of authorities dealing with transfer pricing, country specific institutional issues, etc. The effective implementation of transfer pricing regulation requires taking into consideration all these factors. An effective implementation may also require co-operation with other branches of governments, such as department of commerce, department of international trade, department of law enforcement, etc. Thus the overall quality of public institutions of individual countries also has important bearings on the issues of transfer pricing.

# VII. Summary

Transfer pricing is currently an important feature in the international operations of multinational corporations. However, it has also 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 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 alternative, 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 innovative 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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