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RESEARCH ARTICLE

TRANSFER PRICING: CONCEPTS, EVOLUTION, METHODS, EXISTING GUIDELINES AND ITS EFFECTS IN DEVELOPING COUNTRIES.

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Abstract

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Transfer pricing is high on the agenda because globalization has lifted the level of cross-border trade between related entities to new heights. It is estimated that, worldwide, about 2/3 of all business transactions take place within a group. In the absence of Transfer Pricing legislation, both tax administrations and MNEs have only limited guidance they can refer to when determining transfer pricing in related-party transactions. However, we find that developing countries encounter particular problems when dealing with transfer pricing. Local tax administrations are often inexperienced with regard to transfer pricing and lack basic understanding in the field. The paper indicates that, despite strong affinity to the OECD standards, the scope of existing transfer pricing legislation or draft transfer pricing legislation is in part significantly broader as regards the definition of related parties than is outlined in the OECD Guidelines. From a transfer pricing policy perspective

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Introduction:-

Transfer pricing is a main issue for multinational corporations (Chan and Chow, 1997) and it has been known as the number one challenge facing the world’s leading companies (2010 Global Transfer Pricing Survey, Ernst and Young). Transfer pricing has also been as a major issue facing countries around the world, as they strive to retain the tax revenue from multinational corporations conducting business in their countries and step up their efforts in the enforcement of transfer policy legislation and regulations. Furthermore, the choice of transfer pricing methods and transfer pricing practices are very important considerations in the development of corporate strategy and in assessing the long-term sustainability of a multinational corporation (Gresik, 2001). Transfer pricing is a current, contentious issue for multinational corporations.

In principle a transfer price should match either what the seller would charge an independent, arm's length customer, or what the buyer would pay an independent, arm's length supplier(Smith, A. Chambers, I. Nichols, J And Ying, Q. 2003). While unrealistic transfer prices do Although the OECD Model Tax Convention and the OECD Transfer Pricing guidelines recommend the use of the 3 ‘arm’s length principle’, strict application of the principle is often problematic in practice (Bartelsman & Beetsma, 2003). Transfer pricing is the major tool for corporate tax avoidance.

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Existing Guidance and Initiatives On Transfer Pricing Documentation: -

Existing transfer pricing documentation rules can be divided into two groups. The first of these are the rules of individual countries. Such rules are adopted through local legislation or regulation and are enforced by local country tax administrations (Cernic, 2008). In some, but not all, countries, compliance with transfer pricing documentation rules is encouraged by adoption of a complementary penalty regime.

Some countries have a single set of transfer pricing documentation rules that are intended to comprehensively elicit the relevant transfer pricing information. Other countries segregate transfer pricing documentation rules from other information reporting requirements that may be relevant for transfer pricing purposes.

The aim of this documentation package ("the Package") is to allow taxpayers in PATA member countries (Australia, Canada, Japan and the United States) to create one set of transfer pricing documentation for multinational enterprise (MNE) that will satisfy the documentary requirements of each respective jurisdiction thus avoiding the imposition of penalties on the taxpayer for having insufficient transfer pricing documentation (Anderson and others. 2003).

Evolution of Transfer Pricing: -

This section aims to trace the history and the reasons for transfer pricing taxation regimes. It is important to note that transfer pricing essentially involves the application of economic principles to a fluid marketplace. Thus new approaches and techniques that help arrive at the appropriate transfer price from the perspective of one or more factors in the system continue to be developed.

The OECD Transfer Pricing Guidelines (OECD Guidelines) as amended and up dated, were first published in 1995; this followed previous OECD reports on transfer pricing in 1979 and 1984. The OECD Guidelines are recommendations addressed to enterprises operating in OECD countries (Cernic 2008). And have largely been followed in domestic transfer pricing regulations of these countries. Another transfer pricing framework of note which has evolved over time is represented by the USA Transfer Pricing Regulations (26 USC 482).

Parent companies of large MNE groups usually have intermediary or sub-holdings in several countries around the world (Buus and Brada, 2010) From a management perspective, the decision-making in MNE groups may range from highly centralized structures to highly decentralized structures with profit responsibility allocated to individual group members. Such group structures typically include

- Research and development (R&D) and services that may be concentrated in centres operating for the whole group or specific parts of the group;
- Intangibles, developed by entities of the MNE group; these may be concentrated around certain group members;
- Finance and "captive insurance companies which may operate as insurers or internal finance companies; and
- Production units, where the production or assembly of final products may take place in many countries around the world.

The Methods of Transfer Pricing: -

Advised to be used in OECD countries are (among others):

1. comparable uncontrolled price method.
2. comparable resale price method.
3. cost plus method.
4. profit split method.

Which in all cases directly or indirectly use a premise that the fair transfer price is on the level of price achieved at the market transaction, which are at marginal cost only in extraordinary cases (perfectly competitive market of the intermediate product).

The problem of transfer prices and their effect on the possibility of active fiscal policy is compelling, as (Bartelsman and Beetsma. 2003) show Nevertheless the number and size of possible tax evasions is greater at commodities, which are not standardized (not quoted), whereas at the commodities traded at the commodity exchanges the variance of transfer price and difference between transfer price and arms-length price is substantially smaller (Bernard, Jensen and Schott, 2006), Even the measurement becomes a problem in this globalized world, because the size and number of transactions inside MNE is so large that it influences the benchmarks used for derivation of arms-length price (Eden and Rodrigues, 2004).

The OECD Guidelines: -

The OECD has made considerable efforts in offering an international standard for levelling the playing field in the area of TP. The members of the OECD, which are mainly developed countries but also include some developing countries, have agreed common methods and practices in the area of TP, which are outlined in the OECD Guidelines. In particular, the OECD Guidelines outline five methods to determine the arm‟s length nature of transfer prices:

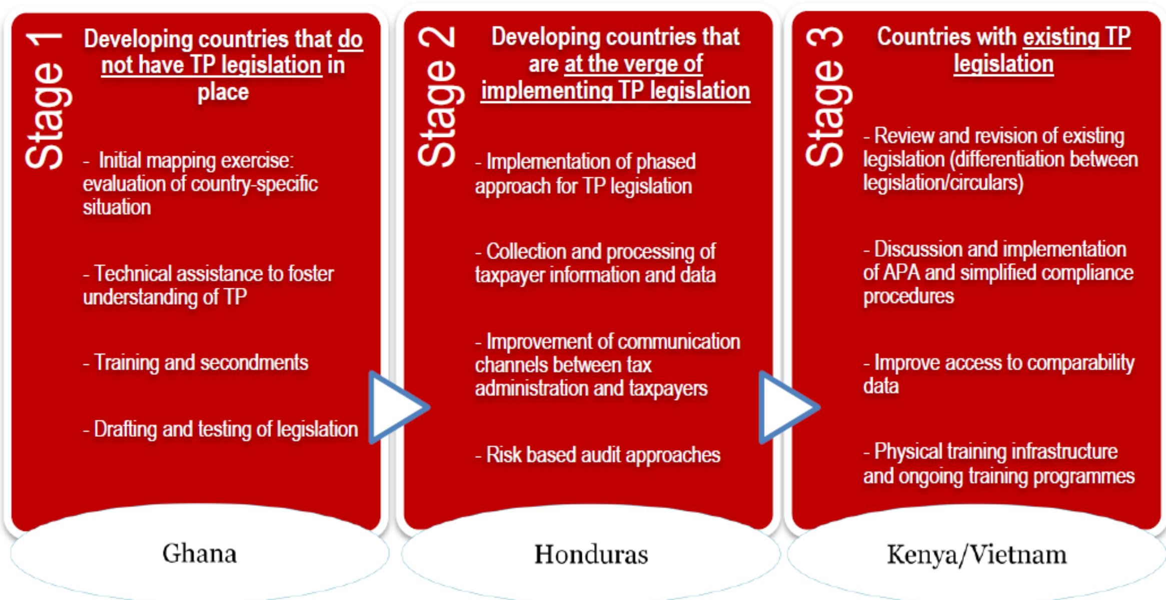
1. **Comparable Uncontrolled Price (CUP) Method**: This is based on the comparison of prices charged in a controlled transaction to the price charged in an uncontrolled transaction in comparable circumstances for comparable products and services.
2. **Resale price method (RPM)**; which is based on the resale price at which a product purchased from a related party is sold to an independent enterprise. The transfer price of the inter-company transaction is calculated by deducting the resale price margin from the resale price in the uncontrolled transaction.
3. **Cost plus method (CPM)**; which uses the costs incurred by the supplier of property/services in a controlled transaction. A mark-up taking into consideration the functions performed, risks assumed and assets employed is added to the costs to determine the arm’s length price in the controlled transaction.
4. **Transactional net margin method (TNMM)**; which examines the net profit margin relative to an appropriate base (e.g. cost, sales, assets) realized from a controlled transaction.
5. **Profit split method (PSM)**; which is based on identification and appropriate split of the profit realized by related entities from a controlled transaction.

A General Approach to Transfer Pricing Reform in Developing Countries: -

Given the differing levels of progress in some countries by comparison with others, it is difficult to set down a one-size-fits-all approach. Accordingly, the costs of technical assistance programmer for different countries can vary significantly. A thorough analysis of the specific needs for each developing country with regard to its TP practices is necessary in order that available donor resources are used as efficiently as possible.

However, prior to donor support being provided, it should be analyzed at what stage of development the country is with regard to both the preconditions and TP-specific legislation (see Figure 1). Experience from other countries such as the USA, China and India show that the process of TP reform is lengthy and that it requires ongoing training and support

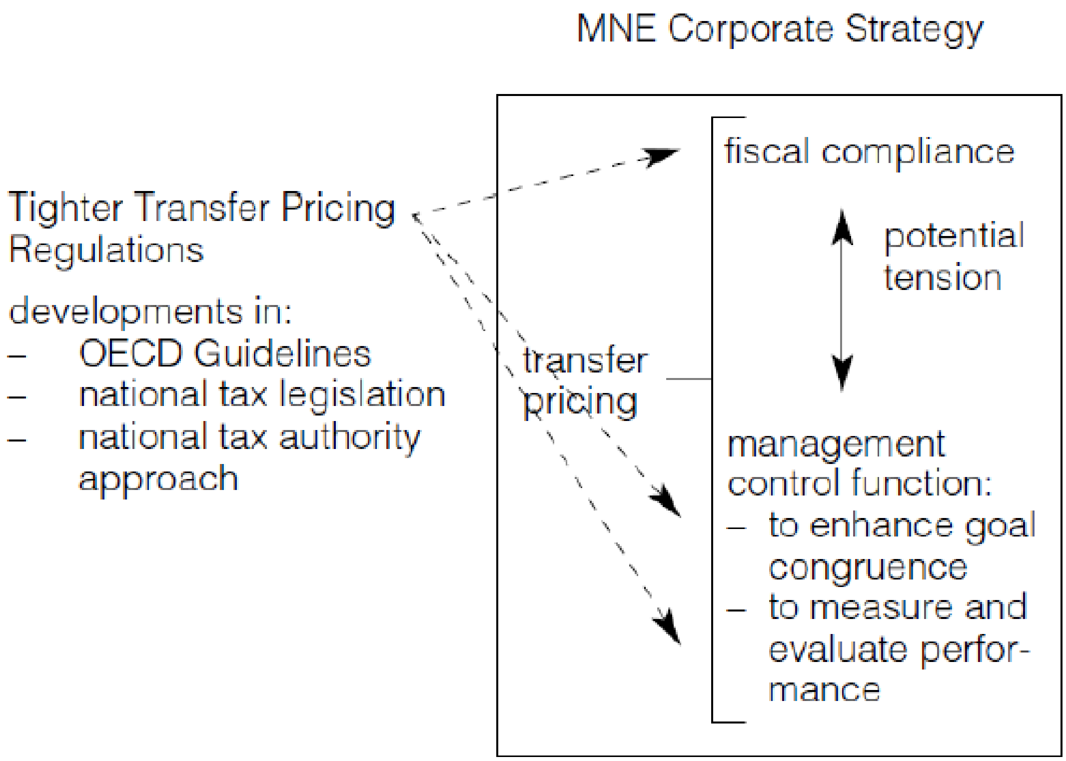
In general, developing countries without any kind of TP experience should be assisted in becoming acquainted with the arm's length principle on a high level. Based on this, a TP strategy should be developed that takes into account country-specific circumstances and outlines the different steps in introducing TP legislation. Special attention should be paid to the recruitment and training of specialized TP staff. Issues such as risk-assessment procedures for audit purposes and APA or simplified compliance procedures are equally important, but should form part of subsequent efforts



Transfer Pricing and the Investment Climate: -

The issue that has to be wrestled with is this—what is the fair price for those transactions, in particular (from the development perspective) when you bear in mind the real economic engagement of the multinational in a particular developing country, and where the multinational's profits are truly being made. This finding provides more direct evidence that transfer pricing is occurring since it considers the direct relationship between the taxes faced by affiliates abroad and their actual intra firm trade transactions (Clausing, 2001). If transfer pricing does not reflect the true profits earned in that country, the country is unfairly deprived of funds and opportunities for development. And, of course, it is ultimately the people of that country who bear the costs, in food, water, health and education especially.

A study by Cools finds that "the empirical findings confirmed that, because of the real threat of audits and penalties, the tax requirements of transfer pricing play a prominent role in the multinational enterprise's decision-making process" (see figure 1). As an increasing number of countries introduce transfer pricing legislation and increase the resources available to their tax administrations for transfer pricing audits (see below), the role of the tax requirements of transfer pricing will only increase.



(Cools, 2003).

Transfer pricing developments in selected countries with established transfer pricing regimes:-

Australia: -

On November 1, 2011, the Treasury released a consultation paper on proposed changes to Australia's transfer pricing rules intended to bring them in line with Australian and international developments (Australian Treasury 2011). The paper outlines the history of transfer pricing rules and proposes a number of areas for change. Suggested changes include the introduction of an arm's length standard that reflects international norms, interpretation of new rules in a manner that best secures consistency with guidance from the Organization for Economic Co-operation and Development (OECD) and application of the new rules on a self-assessment basis. On 22 November 2012 an expose draft was released that included draft legislation and explanatory memorandum (Australian Treasury 2012).

United Kingdom:-

In June 2008, Her Majesty's Revenue & Customs (HMRC) issued its "Guidelines for the Conduct of Transfer Pricing Enquiries," which included the creation of a specialized transfer pricing group, a transfer pricing review board, and a risk-based approach to transfer pricing enquiries. In late 2010, HMRC also issued guidance to its field teams on more extensive use of penalties in transfer pricing cases.

United States:-

The Internal Revenue Service (IRS) added 1,200 employees in 2009 to deal with international issues, with another 800 added through the end of 2010. The IRS has established a goal of achieving a staff of 120 transfer pricing economists, the largest number in its history. As part of its transfer pricing focus, in December 2009 the IRS announced a number of important changes, including creation of a transfer pricing practice, establishment of a transfer pricing council to coordinate transfer pricing reviews, and establishment of a tiered approach to targeting intercompany transactions based on their potential for abuse (Ernst & Young 2011).

Conclusion: -

a transfer price is used to determine costs. Setting transfer prices enables multinational corporations to attribute net profit or loss before tax among the countries where they do business. Developing countries have particular difficulty in obtaining reliable comparable data for the purposes of determining transfer prices. A wide range of actions is possible to assist in this regard, with some of these actions building on work already done by the OECD or other stakeholders. Given the broad range of possible actions, further prioritization based on country needs and resource availability will be necessary.

Existing transfer pricing documentation rules can be divided into two groups. The first of these are the rules of individual countries. The second group of documentation rules and guidelines are those adopted by international organizations in an attempt to simplify and streamline the patchwork of local country rules. The OECD Guidelines are recommendations addressed to enterprises operating in OECD countries and have largely been followed in domestic transfer pricing regulations of these countries. The members of the OECD, which are mainly developed countries but also include some developing countries, have agreed common methods and practices in the area of TP, which are outlined in the OECD Guidelines.

The OECD Guidelines outline five methods to determine the arm’s length nature of transfer prices. Applying the arm’s length principle to review transfer prices set in transactions between associated enterprises often requires a comparison to be made between these prices and the prices set in similar transactions between independent enterprises in similar circumstances. In general, developing countries without any kind of TP experience should be assisted in becoming acquainted with the arm's length principle on a high level.

Finally, it can be concluded that transfer pricing is occurring since it considers the direct relationship between the taxes faced by affiliates abroad and their actual intra firm trade transactions. If transfer pricing does not reflect the true profits earned in that country, the country is unfairly deprived of funds and opportunities for development.

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