INTRODUCING "PRICING AND TRANSFER PRICING DECISION"

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Abstract

The essential feature of decentralization in large firms is the creation of responsibility centers (e.g. cost, profit, or investment centers). The performance of these responsibility centers is evaluated on the basis of various accounting numbers, such as standard and actual cost, divisional profit or return on investment. A central role of the management accounting system therefore is to evaluate the transactions between the different responsibility centers. Under the subject cost allocation we studied alternative methods to charge user departments for the services rendered by service departments (frequently cost centers).
Transfer pricing is a profit allocation method used to attribute a corporation's net profit or loss before tax to tax jurisdictions. Transfer prices are the charges made between controlled (or related) legal entities i.e. within the same group. Legal entities considered under the control of a single corporation include branches and companies that are wholly or majority owned ultimately by the parent corporation. Certain jurisdictions consider entities to be under common control if they share family members on their boards of directors.
Transfer prices are used to evaluate the goods and services exchanged between profit centers (divisions) of a decentralized firm. Hence, the transfer price is the price that one division of a company charges another division of the same company for a product transferred between the two divisions.
It refers to the setting, analysis, documentation, and adjustment of charges made between related parties for goods, services, or use of property (including intangible property). Transfer prices among components of an enterprise may be used to reflect allocation of resources among such components, or for other purposes.

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Introduction

Transfer pricing is a profit allocation method used to attribute a corporation's net profit or loss before tax to tax jurisdictions. Transfer prices are the charges made between controlled (or related) legal entities i.e. within the same group. Legal entities considered under the control of a single corporation include branches and companies that are wholly or majority owned ultimately by the parent corporation. Certain jurisdictions consider entities to be under common control if they share family members on their boards of directors.
It refers to the setting, analysis, documentation, and adjustment of charges made between related parties for goods, services, or use of property (including intangible property). Transfer prices among components of an enterprise may be used to reflect allocation of resources among such components, or for other purposes. OECD Transfer Pricing Guidelines state, "Transfer prices are significant for both taxpayers and tax administrations because they determine in large part the income and expenses, and therefore taxable profits, of associated enterprises in different tax jurisdictions."
Over 60 governments have adopted transfer pricing rules. Transfer pricing rules in most countries are based on what is referred to as the "arm's length principle" – that is to establish transfer prices based on analysis of pricing in comparable transactions between two or more unrelated parties dealing at arm's length. The OECD has published guidelines based on the arm's length principle, which are followed, in whole or in part, by many of its member countries in adopting rules.
The rules of nearly all countries permit related parties to set prices in any manner, but permit the tax authorities to adjust those prices where the prices charged are outside an arm's length range. Rules are generally provided for determining what constitutes such arm's length prices, and how any analysis should proceed. Prices actually charged are compared to prices or measures of profitability for unrelated transactions and parties. The rules generally require that market level, functions, risks, and terms of sale of unrelated party transactions or activities be reasonably comparable to such items with respect to the related party transactions or profitability being tested.
Most systems allow use of multiple methods, where appropriate and supported by reliable data, to test related party prices. Among the commonly used methods are comparable uncontrolled prices, cost-plus, resale price or markup, and profitability based methods. Many systems differentiate methods of testing goods from those for services or use of property due to inherent differences in business aspects of such broad types of transactions. Some systems provide mechanisms for sharing or allocation of costs of acquiring assets (including intangible assets) among related parties in a manner designed to reduce tax controversy.
Most tax treaties and many tax systems provide mechanisms for resolving disputes among taxpayers and governments in a manner designed to reduce the potential for double taxation. Many systems also permit advance agreement between taxpayers and one or more governments regarding mechanisms for setting related party prices.
Many systems impose penalties where the tax authority has adjusted related party prices. Some tax systems provide that taxpayers may avoid such penalties by preparing documentation in advance regarding prices charged between the taxpayer and related parties. Some systems require that such documentation be prepared in advance in all cases.

1. General tax principles

Commonly controlled taxpayers often determine prices charged between such taxpayers based in part on the tax effects, seeking to reduce overall taxation of the group. OECD Guidelines state, at 1.2, "When independent enterprises deal with each other, the conditions

of their commercial and financial relations ordinarily are determined by market forces. When associated enterprises deal with each other, their commercial and financial relations may not be directly affected by external market forces in the same way." Recognizing this, most national and some sub-national income tax authorities have the legal authority to adjust prices charged between related parties. Tax rules generally permit related parties to set prices in any manner they choose, but permit adjustment where such prices or their effects are outside guidelines.

Transfer pricing rules vary by country. Most countries have an appeals process whereby a taxpayer may contest such adjustments. Some jurisdictions, including Canada and the United States, require extensive reporting of transactions and prices, and India requires third party certification of compliance with transfer pricing rules.

2. Arm's length standard

Nearly all systems require that prices be tested using an "arm's length" standard. Under this approach, a price is considered appropriate if it is within a range of prices that would be charged by independent parties dealing at arm's length. This is generally defined as a price that an independent buyer would pay an independent seller for an identical item under identical terms and conditions, where neither is under any compulsion to act.

There are clear practical difficulties in implementing the arm's length standard. For items other than goods, there are rarely identical items. Terms of sale may vary from transaction to transaction. Market and other conditions may vary geographically or over time. Some systems give a preference to certain transactional methods over other methods for testing prices.

In addition, most systems recognize that an arm's length price may not be a particular price point but rather a range of prices. Some systems provide measures for evaluating whether a price within such range is considered arm's length, such as the *interquartile range* used in many countries regulations. Significant deviation among points in the range may indicate lack of reliability of data. Reliability is generally considered to be improved by use of multiple year data.

3. Comparability

Most rules provide standards for when unrelated party prices, transactions, profitability or other items are considered sufficiently comparable in testing related party items. Such standards typically require that data used in comparisons be reliable and that the means used to compare produce a reliable result. The OECD rules require that reliable adjustments must be made for all differences (if any) between related party items and purported comparables that could materially affect the condition being examined. Where such reliable adjustments cannot be made, the reliability of the comparison is in doubt. Comparability of tested prices with uncontrolled prices is generally considered enhanced by use of multiple data. Transactions not undertaken in the ordinary course of business generally are not considered to be comparable to those taken in the ordinary course of business. Among the factors that must be considered in determining comparability are:

- the nature of the property or services provided between the parties,
- functional analysis of the transactions and parties,
- comparison of contractual terms (whether written, verbal, or implied from conduct of the parties),and

- comparison of significant economic conditions that could affect prices, including the effects of different market levels and geographic markets.

3.1 Nature of property or services

Comparability is best achieved where identical items are compared. However, in some cases it is possible to make reliable adjustments for differences in the particular items, such as differences in features or quality.

3.2 Functions and risks

Buyers and sellers may perform different functions related to the exchange and undertake different risks. For example, a seller of a machine may or may not provide a warranty. The price a buyer would pay will be affected by this difference. Among the functions and risks that may impact prices are:

- Product development
- Manufacturing and assembly
- Marketing and advertising
- Transportation and warehousing
- Credit risk
- Product obsolescence risk
- Market and entrepreneurial risks
- Collection risk
- Financial and currency risks
- Company- or industry-specific items

3.3 Terms of sale

Manner and terms of sale may have a material impact on price. For example, buyers will pay more if they can defer payment and buy in smaller quantities. Terms that may impact price include payment timing, warranty, volume discounts, duration of rights to use of the product, form of consideration, etc.

3.4 Market level, economic conditions and geography

Goods, services, or property may be provided to different levels of buyers or users: producer to wholesaler, wholesaler to wholesaler, wholesaler to retailer, or for ultimate consumption. Market conditions, and thus prices, vary greatly at these levels. In addition, prices may vary greatly between different economies or geographies. Buyers or sellers may have different market shares that allow them to achieve volume discounts or exert sufficient pressure on the other party to lower prices. Where prices are to be compared, the putative comparables must be at the same market level, within the same or similar economic and geographic environments, and under the same or similar conditions.

4. Types of transactions

Most systems provide variations of the basic rules for characteristics unique to particular types of transactions. The potentially tested transactions include:

- Sale of goods. Identical or nearly identical goods may be available. Product-related differences are often covered by patents.
- Provision of services. Identical services, other than routine services, often do not exist.
- License of intangibles. The basic nature precludes a claim that another product is identical. However, licenses may be granted to independent licensees for the same product in different markets.
- Use of money. Comparable interest rates may be readily available. Some systems provide safe haven rates based on published indices.
- Use of tangible property. Independent comparables may or may not exist, but reliable data may not be available.

5. Testing of prices

Tax authorities generally examine prices actually charged between related parties to determine whether adjustments are appropriate. Such examination is by comparison (testing) of such prices to comparable prices charged among unrelated parties. Such testing may occur only on examination of tax returns by the tax authority, or taxpayers may be required to conduct such testing themselves in advance or filing tax returns. Such testing requires a determination of how the testing must be conducted, referred to as a transfer pricing method.

5.1 Best method rule

Some systems give preference to a specific method of testing prices. OECD provides that the method used to test the appropriateness of related party prices should be that method that produces the most reliable measure of arm's length results. This is often known as a "best method" rule. Under this approach, the system may require that more than one testing method be considered. Factors to be considered include comparability of tested and independent items, reliability of available data and assumptions under the method, and validation of the results of the method by other methods.

5.2 Comparable uncontrolled price (CUP)

Most systems consider a third party price for identical goods, services, or property under identical conditions, called a comparable uncontrolled price (CUP), to be the most reliable indicator of an arm's length price. All systems permit testing using this method, but it is not always applicable. Further, it may be possible to reliably adjust CUPs where the goods, services, or property are identical but the sales terms or other limited items are different. As an example, an interest adjustment could be applied where the only difference in sales transactions is time for payment (e.g., 30 days vs. 60 days). CUPs are based on actual transactions. For commodities, actual transactions of other parties may be reported in a reliable manner. For other items, "in-house" comparables, i.e., transactions of one of the controlled parties with third parties may be the only available reliable data.

5.3 Other transactional methods

Among other methods relying on actual transactions (generally between one tested party and third parties) and not indices, aggregates, or market surveys are:

- Cost-plus (C+) method: goods or services provided to unrelated parties are consistently priced at actual cost plus a fixed markup. Testing is by comparison of the markup percentages.
- Resale price method (RPM): goods are regularly offered by a seller or purchased by a retailer to/from unrelated parties at a standard "list" price less a fixed discount. Testing is by comparison of the discount percentages.
- Gross margin method: similar to resale price method, recognized in a few systems.

5.4 Profitability methods

Some methods of testing prices do not rely on actual transactions. Use of these methods may be necessary due to the lack of reliable data for transactional methods. In some cases, non-transactional methods may be more reliable than transactional methods because market and economic adjustments to transactions may not be reliable. These methods may include:

- Comparable profits method (CPM): profit levels of similarly situated companies in similarly industries may be compared to an appropriate tested party.
- Transactional net margin method (TNMM): while called a transactional method, the testing is based on profitability of similar businesses.
- Profit split method: total enterprise profits are split in a formulary manner based on econometric analyses.

CPM and TNMM have a practical advantage in ease of implementation. Both methods rely on microeconomic analysis of data rather than specific transactions. These methods are discussed further with respect to the OECD system.
Two methods are often provided for splitting profits: comparable profit split and residual profit split. The former requires that profit split be derived from the combined operating profit of uncontrolled taxpayers whose transactions and activities are comparable to the transactions and activities being tested. The residual profit split method requires a two step process: first profits are allocated to routine operations, then the residual profit is allocated based on nonroutine contributions of the parties. The residual allocation may be based on external market benchmarks or estimation based on capitalized costs.

5.5 Tested party and profit level indicator

Where testing of prices occurs on other than a purely transactional basis, such as CPM or TNMM, it may be necessary to determine which of the two related parties should be tested. Testing is to be done of that party testing of which will produce the most reliable results. Generally, this means that the tested party is that party with the most easily compared functions and risks. Comparing the tested party's results to those of comparable parties may require adjustments to results of the tested party or the comparables for such items as levels of inventory or receivables.
Testing requires determination of what indication of profitability should be used. This may be net profit on the transaction, return on assets employed, or some other measure. Reliability is generally improved for TNMM and CPM by using a range of results and multiple year data.

6. Intangible property issues

Valuable intangible property tends to be unique. Often there are no comparable items. The value added by use of intangibles may be represented in prices of goods or services, or by payment of fees (royalties) for use of the intangible property. Licensing of intangibles thus presents difficulties in identifying comparable items for testing. However, where the same property is licensed to independent parties, such license may provide comparable transactional prices. The profit split method specifically attempts to take value of intangibles into account.

6.1 Services

Enterprises may engage related or unrelated parties to provide services they need. Where the required services are available within a multinational group, there may be significant advantages to the enterprise as a whole for components of the group to perform those services. Two issues exist with respect to charges between related parties for services: whether services were actually performed which warrant payment, and the price charged for such services. Tax authorities in most major countries have, either formally or in practice, incorporated these queries into their examination of related party services transactions.

There may be tax advantages obtained for the group if one member charges another member for services, even where the member bearing the charge derives no benefit. To combat this, the rules of most systems allow the tax authorities to challenge whether the services allegedly performed actually benefit the member charged. The inquiry may focus on whether services were indeed performed as well as who benefited from the services. For this purpose, some rules differentiate stewardship services from other services. Stewardship services are generally those that an investor would incur for its own benefit in managing its investments. Charges to the investee for such services are generally inappropriate. Where services were not performed or where the related party bearing the charge derived no direct benefit, tax authorities may disallow the charge altogether.

Where the services were performed and provided benefit for the related party bearing a charge for such services, tax rules also permit adjustment to the price charged. Rules for testing prices of services may differ somewhat from rules for testing prices charged for goods due to the inherent differences between provision of services and sale of goods. The OECD Guidelines provide that the provisions relating to goods should be applied with minor modifications and additional considerations. A different set of price testing methods is provided for services.

It is common for enterprises to perform services for themselves (or for their components) that support their primary business. Transfer pricing rules recognize that it may be inappropriate for a component of an enterprise performing such services for another component to earn a profit on such services. Testing of prices charged in such case may be referred to a cost of services or services cost method. Application of this method may be limited under the rules of certain countries, and is required in some countries.

Where services performed are of a nature performed by the enterprise (or the performing or receiving component) as a key aspect of its business, OECD rules provide that some level of profit is appropriate to the service performing component. Testing of prices in such cases generally follows one of the methods described above for goods. The cost-plus method, in particular, may be favored by tax authorities and taxpayers due to ease of administration.

Conclusion

- Transfer pricing is a profit allocation method used to attribute a corporation's net profit or loss before tax to tax jurisdictions. Transfer prices are the charges made between controlled (or related) legal entities.
- Most systems allow use of multiple methods, where appropriate and supported by reliable data, to test related party prices. Among the commonly used methods are comparable uncontrolled prices, cost-plus, resale price or markup, and profitability based methods.
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