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TRANSFER PRICING: RISKS AND BENEFITS

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Abstract. *Transfer pricing rules generally provide companies with the flexibility to set the conditions surrounding their intercompany transactions. Planning allows taxpayers to optimize the allocation of income within the group. The purpose of this study is to investigate the risks and benefits of transfer pricing, because globally it represents a major international tax planning opportunity and risk for many MNEs.*

Keywords: transfer pricing, parent company, subsidiary, OECD, tax advantages.

JEL Classification: M40; G10

1. Introduction

Transfer pricing is the setting of the price for goods and services sold between controlled (or related) legal entities within an enterprise. For example, if a subsidiary company sells goods to a parent company, the cost of those goods paid by the parent to the subsidiary is the transfer price. 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 pricing can be used as **a profit allocation method** to attribute a multinational corporation's net profit (or loss) before tax to countries where it does business. Transfer pricing results in **the setting of prices among divisions** within an enterprise.

Transfer pricing multi-nationally has **tax advantages**, but regulatory authorities frown upon using transfer pricing for tax avoidance. When transfer pricing occurs, companies can **book profits** of goods and services in a different country that may have a **lower tax rate**. In some cases, the transfer of goods and services from one country to another within an interrelated company transaction can allow a company to avoid tariffs on goods and services exchanged internationally. The international tax laws are regulated by the **Organization for Economic Cooperation and Development (OECD)**, and auditing firms within each international location audit financial statements accordingly.

The Goals

According to the OECD, there are three main objectives of transfer pricing documentation:

Objective 1: "*to ensure that taxpayers give appropriate consideration to transfer pricing requirements in establishing prices and other conditions for transactions between associated enterprises and in reporting the income derived from such transactions in their tax returns.*"
Documentation requirements create awareness and a culture of compliance. Taxpayers are forced to take a position, concerning transfer-pricing rules.

Objective 2: "*to provide tax administrations with the information necessary to conduct an informed transfer pricing risk assessment.*"
The documentation provides tax-authorities with a clear overview of the activities of a multinational enterprise. It tells them where there are risks.

Objective 3: "*to provide tax administrations with useful information to employ in conducting an appropriately thorough audit of the transfer pricing practices of entities subject*

to tax in their jurisdiction, although it may be necessary to supplement the documentation with additional information as the audit progresses."
If tax-authorities think that there is a risk, the documentation provides them with a good indication of where else to look.

Requirements
In order to reach the objectives mentioned above, there are three types of documentation that taxpayers need to provide.
1. The Master File:
The master file is intended to provide a high-level overview. It explains the dealings of a Multinational Enterprise on a global scale. With this information, governments have a high-level overview of the economic, legal, financial and tax arrangements of the MNE. This gives them a good idea if any risks exist.
2. The Local File:
The local file is where you go into detail. Here, you look at specific inter-company transactions that are relevant for the tax authority involved. The local file contains relevant financial data, like the transfer prices used and the transfer pricing method chosen to calculate them. Where the Master File provides the general overview, the Local File explains how the inter-company transactions happen at "Arm's Length."
3. The Country-by-Country Report
The Country-by-Country Report is an additional high-level report required from large Multinational Enterprises with a turnover of 750 Million USD or more per year. It requires details of the global allocation of income, taxes paid, and the location of economic activity among the jurisdictions in which the MNE group operates.
Concepts in Transfer Pricing:

- *Arm's Length Price:* The price charged in a transaction between unrelated parties.
- *Transfer Price:* The price charged in a transaction between two associated enterprises.
- *Uncontrolled Transaction:* Transaction between two unrelated parties.
- *Controlled Transaction:* Transaction between two associated enterprises or related parties.

2. Arm's Length Principle

Article 9 of the OECD Model Tax Convention is dedicated to the Arm's Length Principle (ALP). It says that the transfer prices set between the corporate entities should be in such a way as if they were two independent entities.
A framework has been provided by the OCED in the Transfer Pricing Guidelines issued by it which provides details regarding the arm's length price.
ALP is based on real markets and provides the MNE's and the governments **a single international standard** for the contracts that allows various different government entities to collect their share of tax at the same time creating enough room for the MNE's to avoid the double taxation.
The good thing about transfer pricing is that the principles and practices are quite similar all around the world. The OECD Transfer Pricing Guidelines provide 5 common transfer pricing methods that are accepted by nearly all tax authorities. Three of these methods are traditional transaction methods while the remaining two are transactional profit methods.
Traditional transaction methods:

1. CUP method
2. Resale price method
3. Cost plus method

Transactional profit methods:

1. Transactional net margin method (TNMM)
2. Transactional profit split method.

A taxpayer should select the most appropriate method. In general, the traditional transaction method is preferred over the transactional profit methods and the CUP method over any other method. In practice, the TNMM is the most used of all five transfer pricing methods, followed by the CUP method and Profit Split method. Cost Plus Method and Resale Margin Method are barely used.

3. Example

The regional headquarter of Google is in Singapore and it has a subsidiary in Australia. The sales and marketing support services are provided by the Australian subsidiary to users and Australian businesses and also provide research services to Google worldwide. The billing for Australian activities is done in Singapore and the payment is received from the Google entities. In 2012-2013 Google, Australia earned $46 million as profit on revenues of $ 358 million. The corporate tax payment was a $7.1 million, more so, as they had claimed a tax credit of $ 4.5 million.

Ms. Maile Carnegie, the Managing Director of Google Australia was asked to respond on why Google Australia did not pay more corporate tax in Australia. She Replied by saying that the lion's share of the taxes was paid to the country where they were headquartered. She was talking about the intellectual capital that Google owns which drives their business and it was owned outside of Australia.

Google declared that it paid US$ 3.3 billion as tax globally in 2014 on revenues of US$ 66 billion. The effective tax rate came up as 19%, while the statutory federal rate of 35% applied on Google in the US. Had Google been paying most of the tax in US, it would follow that it was not paying much taxes on the revenues that is generated from other countries.

In 2013, in Singapore Google paid US$ 4 million in corporate tax on undisclosed revenues from the Asia – Pacific countries as well as Australia. Compared to this, Google Australia made a payment of a $7.1 million as tax, and they did not account for most of that revenue that was booked in Singapore.

Moreover, Google did not provide the detail of the sources of revenue that was generated from Australia.

It was seen that some of the multinational companies were involved in tax minimization using the tax incentives that were offered in accordance with the overseas jurisdiction to them that led to the evasion of tax in Australia.

The internal revenue system has investigated that Microsoft is using transfer pricing, among other things or method of booking prices and sales between subsidiaries that lends to the opportunity to report earnings in lower tax jurisdiction.

Companies routinely and legally book profit overseas to avail lower tax rate and avoid hefty 35% levy on profit in the US.

Microsoft accumulated $44.8 billion non-US earning and reinvested aboard, accounting in deferred taxes of about $14.5 billion.

Microsoft did not specify how did they employ cash earned aboard but reinvestment could be anything from buying an office or parking money in the bank. While storing money overseas prevented them from repatriation tax.

Microsoft stated that "primarily due to a higher mix of earnings taxed at lower rates in foreign jurisdictions resulting from producing and distributing our products and services through our foreign regional operations centers in Ireland, Singapore and Puerto Rico, which are subject to lower income tax rates."

Forty-six percent (about $ 32 billion) of the total sales came from overseas in the year 2011, however, pre-tax profit tripled over the past six years to $19.2 billion. In contrast, its US earning

has dropped from $11.9 billion to $8.9 billion in the same period. Thereby now 68% of the total earnings are made by from foreign earning.

4. Benefits:

1. Transfer pricing helps in **reducing the duty costs** by shipping goods into high tariff countries at minimal transfer prices so that duty base associated with these transactions is low.
2. Reducing income taxes in high tax countries by overpricing goods that are transferred to units in those, countries where the tax rate is comparatively lower thereby giving them a higher profit margin.
3. Facilitating dividend repatriation when dividend repatriation is curtailed by government policy by inflating prices of goods transferred.

5. Risks:

1. There can be a **disagreement** among the organizational division managers as what the policies should be regarding the transfer policies.
2. There are **a lot of additional costs** that are linked with the required time and labor, which is required to execute transfer pricing and help in designing the accounting system.
3. It gets difficult to estimate the right amount of pricing policy for intangibles such as services, as transfer pricing does not work well as these departments do not provide measurable benefits.
4. The issue of transfer pricing may give rise to **dysfunctional behavior** among managers of organizational units. Another matter of concern is the process of transfer pricing is highly **complicated and time-consuming** in large multi-nationals.
5. Buyer and seller perform different functions from each other that undertake different types of risks. For instance, the seller may or may not provide the warranty for the product. However, the price a buyer would pay would be affected by the difference. The risks that impact prices are as follows: financial & currency risk, collection risk, market and entrepreneurial risk, product obsolescence risk, credit risk.

6. Conclusion:

Transfer pricing rules generally provide companies with the flexibility to set the conditions surrounding their intercompany transactions. Planning allows taxpayers to optimize the allocation of income within the group. At the same time, noncompliance with transfer pricing rules can be costly for multinational companies. Noncompliance can lead to double taxation, interest on tax underpayment and substantial penalties. It can also result in extended disputes with tax authorities, including litigation.

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