TRANSFER PRICING: ACCOUNTING POLICIES APPLICATION

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Abstract

This thesis studies how transfer pricing policies are applied. Working for a small multinational enterprise, I discovered how transfer pricing is fundamental when dealing with intra-group transactions. That’s the reason why I decided to focus my attention on this topic. The aim is therefore based on its practice and on its related facts. Starting from the literature review, from the analysis of transfer pricing theories and models, from application methods and from the study of the arm’s length principle, I was keen to discover what was the correct way of deciding the transfer price in compliance with regulations. As we will find out, transfer pricing is not a scientific rule but it relates to the type of business that the company makes, to the type of market in which the company operates and to the type of transaction that is made. This means that in order to select the correct transfer price and the correct model to be applied, it is necessary for the management to make specific assumptions and specific analysis in order to determine the correct transfer pricing method in compliance with OECD regulations and in compliance with the company’s strategy. One of the first things to be analyzed when companies are audited is the arm’s length principle together with comparable transaction. These will be adequately examined in the following pages because they are fundamental in order to avoid problems. To mitigate risks, it is recommended that every company have a good transfer pricing documentation or enter APA programs to avoid penalties and fines. Transfer pricing is not only related to profit shifting activities, but as we will see, it is also used as strategic support for companies that want to penetrate markets or gain new markets shares. It is a tremendously complex issue since it regards and involves so many different dimensions. Guidelines provide tools for companies to develop their transfer pricing strategy, but they can rarely use models and methods provided straight off. They need to evaluate their situation and in most cases modifications are necessary to adjust the model to suit them. Theory, as we will see, is only a framework that can help explain the consequences of different features and choices in the development of strategic transfer pricing.
Chapter 1

1. Introduction

“The issue of transfer pricing arise when large entities develop separate divisions within the organization in order to achieve benefits from decentralization in decision making. These divisions or units are in most cases practically independent profit centers and they often transfer and sell goods and services between one another. These transfers are referred to as transfer pricing.”

Transfer pricing has been around for the past 100 years, and the first draft of OECD Guidelines was issued only in 1995. In addition, it is only within the past 10-15 years, that transfer pricing has generated as much awareness as it has today. It has caught the attention of many local governments after the financial crisis. One of the main areas on which the focus is put is the remuneration related to inter-company financing and inter-company loans. The business environment has changed leaning towards larger organizations creating and increasing the number of transactions that happens in the world. The share of transactions that happen between related parties are estimated to be between 60% and 80% of all transactions. These changes are reflected on the international trade, and multinationals are having a greater effect on the local tax base than before. In addition to this, the scope of transactions involves more complicated products and services, which can be difficult to price. They may refer to a normal transfer of goods over to today’s intercompany transactions, which can involve specific knowledge, IP, financial instruments, management services etc. As we know, in the current global situation, tax authorities are under heavy political pressure; governments are always searching to reduce tax evasion, so in order to do it more transfer pricing adjustments are made to test the local legislations and ensure that companies are not using transfer pricing as a mean to avoid taxation. So as mentioned before, one of the important areas on which there is an increased focus is transfer pricing related to financial transactions, for example intercompany financing. Tax authorities are challenging the pricing of these transactions and also testing the economical reason behind them in order to secure the local tax base. This has put the principles in the OECD Guidelines to the test and companies are always trying their best in order to be more efficient and compliant with regulations.

1 Hirshleifer 1956
“International transfer pricing is the pricing of goods, services or intangibles that are transferred between members of the same group that cross national boundaries”\(^2\)

This is something all multinational enterprises (MNEs) have been aware of and one positive thing with the transfer pricing laws is that many countries are using similar approaches. (Abdallah 2004). The transfer pricing requirements in most international laws are based and built on the guidelines that are published by the Organization for Economic Cooperation and Development’s (OECD). It is a forum where governments seek solutions for economical, social and environmental problems; it is formed by 34 countries and was created in 1948 to administer the Marshal Aid provided by the USA and Canada after the Second World War. Today it aims to improve policies and implement soft law which are not binding laws but could lead to international treaties or support local law becoming then binding law. (Tvarno & Nielsen, 2008). It has developed The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. They are accepted as a framework and are used to analyze the Arm’s length prices and conditions, as well as solve international tax issues. Therefore it provides guidance on the application of the arm's length principle that could be easily summarized with the following statement.

“Transactions within a multinational group should reflect the conditions that would occur between independent enterprises (E&Y 2009).”

The price of transactions between members of a MNE can have a huge impact on which part of the group profits are registered, especially in relation to the country in which the tax is payable. An effective transfer pricing strategy affects all parts of an organization; not just prices of goods and services but also intangible fixed assets and financial transactions. (SKV 607 2007). For a MNE’s transfer pricing policy that is very important not only for tax purposes but also to achieve profit maximization and sustainable growth. There are different goals of establishing a transfer pricing policy such as: reduction of income taxes, reduction of tariffs, minimization of foreign exchange risk, avoidance of conflicts with host countries’ governments, management of cash-flows, competitiveness, performance evaluations, motivation and global harmonization. (Abdallah 2004).

\(^2\) Elliot and Emanuel 2000
The OECD standard has done a great job in contributing to a uniform global standard even though there are domestic considerations and peculiarities to manage. These are of course superior when dealing with non-member countries. (Mahalingham 2009). There are also other factors than laws and regulations, which can affect the transfer pricing strategies; the business environment differs among countries and there are cultural aspects and principles that can affect them. (Ho 2009). The principles for building a transfer pricing strategy within a business group often have their basis in the domestic taxation law, but also in other external environmental factors such as for example customs duty rates and other regulations. Above this, there are also political issues, social-behavioral concerns and internal environmental factors that can affect the principles. These factors can appear completely different in different countries and might lead to conflicts within the group. (Ho 2009)

2. Literature Review

As we were saying before, there are many variables that could affect the decision on how to build a transfer pricing policy, and that could affect the result of such policy. Analyzing the literature, we find different results in relation to the country that has been examined. Tang and Chan (1979) focus on the environmental variables considered by US and Japanese MNEs in building their transfer pricing policies. They also identify the environmental variables that discriminate between US and Japanese MNEs on international transfer pricing practices. Analyzing the results, they found that these are the most relevant variables for US firms:

- profit to the company;
- restrictions on profit remittances imposed by host countries;
- competitive position of foreign subsidiaries;
- differentials in income tax rates and income tax legislation among countries;
- performance evaluation of foreign subsidiaries
Japanese firms most relevant variables are instead the following:

- profit to the company;
- competitive position of foreign subsidiaries;
- devaluation and revaluation of foreign currencies;
- restrictions on repatriation of profits imposed by foreign countries;
- performance evaluation of foreign subsidiaries;

They find that interest of local partners, devaluation and revaluation of foreign currencies, anti-dumping legislation, import restrictions imposed by foreign countries and differentials in income tax rates and income tax legislation among countries contribute the most to the different perceptions between the rating of US and Japanese firms. Tang (1981) also analyze the similarities and differences between groups of MNEs (the US, Japan, Canada, and the UK) in their consideration of environmental variables for transfer pricing decisions. His results show that the four national groups consider profits to the company and competitive position of subsidiaries in foreign countries the most important variables. UK and Japanese companies rank the interest of local partners in foreign subsidiaries higher than Canadian and US companies. Compared with the other national groups, Japanese companies give more importance on the devaluation and revaluation of foreign currencies. Tang (1993) finds that overall profit to the company is still the most important environmental variable for US MNE’s transfer pricing decisions. Compared with Tang (1979), management ranked differentials in income tax rates and income tax legislation among countries, maintaining good relationships with host governments, the need of subsidiaries in foreign countries to seek local funds, and antitrust legislation of foreign countries as more important to transfer pricing decisions. In Tang’s study (2002) there is an update showing that for transfer pricing, tax regulations in the United States has become the most important variable for transfer pricing decisions, followed by the overall profit to the company. In Burns (1980), the aim of the study is to find the extent to which firms’ transfer pricing decisions are influenced by various environmental factors. He analyzes the responses from financial executives of 62 US-based MNEs. They were asked to rate the importance of each environmental variable on their firms’ transfer pricing decisions and to select five environmental variables which are the most important to their firms’ transfer pricing decisions.
These were the results that emerged from the investigation:

- market conditions in foreign countries;
- competition in foreign countries;
- reasonable profit for foreign affiliates;
- US federal income taxes
- economic conditions in foreign countries

Mostafa et al. (1984) studied the phenomenon using a discriminant analysis to test whether the environmental variables, including the overall profit of the company, divisional autonomy, and compliance with foreign tax and tariff regulations, would affect the choice of transfer pricing methods by MNEs. After an analysis through 46 UK companies using a questionnaire survey the results showed that the perceived importance of the variables, including the overall profit of the company, divisional autonomy, compliance with foreign tax and tariff regulations and performance evaluation of divisions, are significantly related to the international transfer pricing methods used, thus confirming prior studies. Borkowski (1992) studied the organizational and environmental variables affecting transfer pricing decision thanks to a questionnaire submitted to 247 US-based MNEs. Results showed that the choice of a transfer pricing method is affected by specific organizational and environmental characteristics such as the ease and cost of implementation, the use of subsidiary profit as the primary performance evaluation measure, the degree of decentralization in the MNE, the tax and tariff regulations and the economic stability of the host MNE country. In a subsequent study, Borkowski (1997a) tries to determine whether organizational factors, environmental factors, and financial factors affect the choice of transfer pricing methods using univariate tests. A questionnaire survey was submitted to 39 Japanese MNEs and 28 US MNEs. Results show that Japanese and US MNEs utilize different transfer pricing methods with Japanese MNEs more likely to use non-cost-based methods than the US MNEs. Findings also highlight that the choice of transfer pricing methods is affected by differences in environmental (including the risk of audits by tax authorities and the market conditions in subsidiary countries) and financial factors (including return on equity and return on assets), but not by organizational factors (including industry and performance evaluation criteria). Environmental variables have a significant impact on the choice of transfer pricing methods. Borkowski (1997b) analyzes the importance of environmental factors on transfer pricing decisions using similar
statistical methods as Borkowski (1997a). Her sample included 28 Canadian MNEs with US subsidiaries and 62 US MNEs with Canadian subsidiaries. Canadian and US MNEs have similar views on the importance of different environmental variables on transfer pricing decisions, and “economic conditions of Canada” and “risk of audits by US tax authorities” are significant factors affecting the choice of transfer pricing methods. Klassen et al. (1993) evaluated changes in the reporting of taxable income by US MNEs in response to the changes in income tax rates. They analyzed accounting data from 191 US MNEs and found evidence of income shifting related to tax rate changes in Canada, Europe and the US. Results show that with increasing Canadian tax rates, MNEs shift income to the United States from Canada, whereas with decreasing rates in Europe, they shift income to Europe from the United States. Cravens and Shearon (1996) tried to understand if transfer pricing policies had an impact on financial consequences through a questionnaire survey of US MNEs. They found that the number of countries of operation and the dollar value of transfers are important factors that explain the total tax burden of MNEs. They also found that the value of transfers and the foreign sales percentage have an effect on the financial outcomes of the firm as measured by the return of assets. Jacob (1996) studied the relationships between intrafirm sales, differential tax rates and tax payments. He collected data from annual reports of US firms from 1982 to 1984 and from 1988 to 1990. He discovered that firms with an important amount of intrafirm transfers paid lower global taxes, lower US taxes in the period of 1982-1984 (i.e. when foreign tax rates were lower than US tax rates) and higher US taxes in the period of 1988-1990 (i.e. when US tax rates were lower than foreign tax rates). This study highlights that transfer pricing is an effective policy to adopt when trying to reduce tax payments. Oyelere and Emmanuel (1998) worked on the use of international transfer pricing as a way to shift income by foreign-controlled enterprises operating in the UK. They compared the profitability and dividend distributions of a sample of 36 foreign-controlled enterprises and 36 UK-controlled enterprises over a two-year period. They found that foreign-controlled enterprises have lower profitability and higher dividend distribution than UK-controlled enterprises. This proves that foreign-controlled enterprises in the UK shift income through international transfer pricing. Conover and Nichols (2000) evaluated the effect of firm size on income shifting between tax jurisdictions using transfer pricing. They expanded the sample of Jacob (1996) by including 127 additional observations. By doing so, their study extended prior studies including smaller and financially distressed firms in the sample. They found that smaller and financially distressed firms are less likely to shift income through transfer pricing.
than larger firms. Prior studies revealed that transfer price negotiators expect fairness-based price concessions that moderate the influence of an outside market price when it strongly favors one of the parties. Based on an experimental study, Kachelmeier and Towry (2002) examined whether the expectations of fairness-based price concessions extended to the actual prices that result from a real-cash negotiation. They found that expectations of fairness-based price concessions do not survive actual 20 negotiations when participants negotiate over a computer network with no communication other than bids, asks, and acceptances. Conversely, both expectations and actual negotiated outcomes reflect fairness-based price concessions when participants negotiate in a face-to-face setting with unrestricted communication.

In conclusion, as we saw from the results of the studies above mentioned, environmental variables are likely to have a significant impact on the choice of transfer pricing methods. Differentials in income tax rates, income tax and transfer pricing regulations among countries, competition in foreign countries, shifting due to tax rate changes and other tax considerations as well as the volume of transfer are actually important environmental variables for transfer pricing decisions. Transfer pricing may also be affected by the nature of negotiations. In the end, we can observe that transfer pricing is always done in order to make the firm profit from either situation of the ones that we just saw.

3. Transfer Pricing Theory and Models

We know that MNEs are formed by different divisions that are practically independent profit centers that often transfer and sell services and goods between each other. The prices, as seen in the introduction, are called transfer prices and they should be decided according to the arm’s length principle, which means that the pricing should be related to external market conditions (OECD 2009). Hirshleifer states that prices must be set in order to encourage each division to act to maximize the profit of the firm as a whole. This is a highly important issue since the prices set on internal transfers affect the activity within divisions, the rate of return on investments by which each division is judged and therefore the total profit that is achieved by the firm as a whole. Internal and external goals could be determined by the use of transfer pricing method/policies. Performance evaluation of subsidiaries, motivating managers, tax reduction and strengthening of foreign subsidiaries, reducing foreign exchange risk, increasing market shares, profit maximization and tax burden minimization are common goals.
that could be reached through transfer pricing. (Cuzdriorean and Jurcău 2009). There is always a trade-off between arm’s length prices and profits. For example, when entering a new market, low prices might be linked to a strategy of expansion through market shares gains. However the strategy has to consider arm’s length prices in order to avoid exposure of tax risks. (Przysusky et al. 2005). There are different models for transfer pricing decisions.

*Market price model*

“The fundamental principle is that the transfer price should be similar to the price that would be charged if the product were sold to outside customers or purchased from outside vendors.”

This model is based on an existing competitive external market where an identical or similar product or service is traded as on the internal market. It is however important that the market is perfectly or highly competitive, otherwise the market price can give a misleading picture, resulting in a non-optimal transfer price. (Merchant & Van der Stede 2007, Emmanuel & Mehafdi 1994). Using this transfer pricing model based on market prices will guarantee the fact that congruent decisions are made without the need of the central administration. (Anthony and Govindarajan 2007). Managers in both profit centers will make decisions that are optimal from the firm’s perspective and this provides good information for evaluating the performance of the different units. (Merchant & Van der Stede 2007). What if companies do not buy or sell the product in the market? They can find published market prices that are actually paid in a market place, which can be used to decide the transfer price. The outside conditions must reflect the conditions within the company in order to give a correct comparison. (Anthony and Govindarajan 2007, Merchant & Van der Stede 2007). Companies could also use quasi market-based transfer prices if the external conditions are different from internal ones. Using this type of pricing model allows deviations from the actual market prices. Companies have to adjust the market price so that it suits the internal conditions and reflects the differences between the internal and external sales. (Merchant & Van der Stede 2007). This can be done by calculating the cost of the differences in design, quality and other conditions between the comparative products. (Anthony and Govindarajan 2007, Merchant & Van der Stede 2007). The same is valid if production profit centers sell similar products to the outside market. If the normal profit is 30% over the standard cost on the products sold to the

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3 Anthony and Govindarajan 2007 p.231
outside market, the company can add 30% to the standard cost to find the competitive price to the product sold within the company. (Anthony and Govindarajan 2007). Hirshleifer (1956) states that the market price is only the correct transfer price when the transferred product is produced in a perfectly competitive market. The problem is that perfectly competitive markets are very rare. (Merchant & Van der Stede 2007, Emmanuel & Mehafdi 1994). Imperfectly competitive markets force managers to make trade-offs between economically favorable solutions at the expense of divisional autonomy, or of a sub-optimal solution that maintains divisional autonomy.

**Negotiated Price Model**

This model allows negotiation of transfer prices between themselves. This is an effective method if both units have the same “bargaining power”. Both parties have the possibilities to trade with external companies and therefore are independent from each other. (Merchant & Van der Stede 2007). The advantage of this model is that it allows the most competent and informed employees, for that specific product or service, to make the price decision (Anthony and Govindarajan 2007). There is a danger when using this model, and basically it is related to the fact that business units might spend too much time negotiating internal transfer prices and lose focus on external sales and prices causing an efficiency problem for the group as a whole (Anthony and Govindarajan 2007). Other disadvantages can be conflicts within the company, causing management to waste time on solving them instead of focusing on tasks that are more important. Another problem can be that the two negotiators have different bargaining power and skills so that the result depends more on the employees negotiating than on the prices of production etc. Competitive employees can also become egoistic and try to beat each other instead of acting in the interest of the company. (Merchant & Van der Stede 2007). These are quite significant cons for this model and from my perspective quite limiting for the correct and more efficient outcome.
Cost-based Model

This model is related to the company’s cost. When analyzing this model we have to pay attention to the definition of cost and on how to calculate the profit mark-up. (Anthony and Govindarajan 2007). The definition of cost divides this model into two sub-categories: Marginal cost and Full-cost. Marginal cost is defined as the total cost for a company to produce an additional unit of a product. The transfer price should then be set at the marginal cost of the supplying division at the optimal output level (Emmanuel & Mehafdi 1994). You can use both actual costs and standard costs when calculating the marginal cost, which can create different outcomes. (Merchant & Van der Stede 2007). If using actual costs, it allows inefficiencies to be passed on to next division without any penalties for the inefficient division. Standard costs achieve awareness of the costs within the division and create an incentive to improve efficiency. The definition of full cost is the total cost of all resources used or consumed in production, including direct, indirect and investing costs. This model is more utilized and offers more advantages. It provides a measure of the long run capability, it is easy to implement and it works well for evaluation purposes. As every model, it has its negative aspects. It rarely reflects the actual costs of production and it does not provide an incentive for the selling division to transfer internally, since there is no profit margin included (Merchant & Van der Stede 2007).

Analyzing the profit mark-up, there are the questions of what it should be based on and what level of profit is allowed. The most used basis is the percentage of cost, but then there is no consideration taken to investment. Therefore, a conceptually better base is a percentage of investment, but the disadvantage here is the calculation of the investment that poses a major practical problem. The second difficulty comes with the level of profit. It should as far as possible approximate the rate of return that would be earned if the business unit were an independent company dealing with outside customers. The conceptual solution is to base the profit allowance on the investment required to meet the needed volume, and each investment should be calculated at a standard level with fixed assets and inventories at current replacement costs. (Anthony and Govindarajan 2007). The use of a profit mark-up creates incentives for internal trading and can provide a rough approximation of market price.

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4 Merchant & Van der Stede 2007, Emmanuel & Mehafdi 1994
5 Business Dictionary – “marginal cost”
6 Business Dictionary – “full cost”
problem with this is that the prices do not respond to changes in market conditions (Merchant & Van der Stede 2007).

**Economic model**

The classical economic model concludes that the most profitable price-output combination is where the marginal revenue and the marginal cost are equal at the optimal output level. (Emmanuel & Mehafdi 1994). Jack Hirschleifer first described the combination of this model and transfer pricing; he developed a series of marginal revenue, marginal costs and demand curves for the transfer of an intermediate product from one business unit to another. These curves were used to establish transfer prices that would, under certain economic circumstances, optimize the total profit of the two units. (Anthony and Govindarajan 2007). This model should be used in the absence of a competitive market. Then it is assumed that the divisions should reach joint level of output so that the buying decision would handle as much output as the selling division would produce. The optimum transfer price is then set at the selling division’s marginal cost at the optimum output level that will maximize company profits. (Emmanuel & Mehafdi 1994). Even though this model finds a lot of support in literature, it has a number of shortcomings. (Emmanuel & Mehafdi 1994). It is only applicable when certain conditions exist; it has to be possible to estimate the demand curve and the conditions have to remain stable. There can be no alternative use for the facilities, and the selling unit can only produce one product, which it transfers to one single buying unit who in its turn use the product in one single final product. The model assumes that the central management sets the transfer price so that no negotiation between business units is possible. These conditions rarely exist in the real world so the model is hard to apply in real business situations. (Anthony and Govindarajan 2007).

**Linear Programming Model**

This model is based on opportunity costs and includes capacity constraints. It calculates an optimum company production pattern that is used to calculate a set of values that impute the profit contributions of each of the scarce resources. (Anthony and Govindarajan 2007). Two groups have emerged within this model: one that focuses on imperfectly competitive markets
and develops algorithms to determine the transfer price, and one group that applies the agency theory and how management can provide incentives for managers to optimize results. (Emmanuel & Mehafdi 1994). Even on a computer, this can lead very complex calculations, so to make the model manageable many simplifying assumptions must be made. These assumptions make the model hard to use in reality since the assumed conditions rarely exist. (Anthony and Govindarajan 2007).

So what is the best model to use? There is not an answer. It depends on variables. As we saw before variables affect the decision very strictly. It is easier to find comparable prices to mature products that have been on the market for some time. But when products are new there might not exist a market and therefore no market price can be found. The life cycle of a product affects the transfer pricing decision and firms are more likely to use external market prices for mature products and cost-based prices for new products. Even organizational structure my affect the selection of the model. Let’s say that company B cannot perform its task until company A has successfully completed their task. Li & Ferriera calls this the long linked technology and they believe that the most suitable transfer price for this type of company is to use a cost-based pricing method. For companies that rely on feedback from their products with technologies that are largely customized it could be difficult to determine the internal prices. For this scenario, the model proposed is the negotiating transfer pricing. (Li & Ferriera 2008).

Another big problem that may arise is the one related to information. As we all know, we have asymmetric and imperfect information that can create incorrect pricing decisions especially when the decisions are made by the central management. Managers or competitors might also be resistant to disclose information if they believe it will come to their disadvantage (Li & Ferriera 2008). So the social aspect come into the game and must be highly considered.

“The collectivity of individuals, or individual groups, among whom exchanges take place and are supported by shared norms of trustworthiness and social control mechanisms.”

Large organizations consist of social networks and therefore it is important for management to realize the significance of coordination of social capital. If trust, authority and transfer pricing are related they are important control mechanisms for operational efficiency. Trust among

7 Li & Ferriera 2008
units will make information flow quicker and the management needs less intervention since the units would be working towards shared goals. When trust is high, it is appropriate with negotiated transfer prices. With lower levels of trust, the mutual understanding is lower and often requires involvement of the central management or centrally decided transfer pricing systems. External market prices and cost-based prices are more commonly used when internal trust is low. (Li & Ferriera 2008). Let’s make an example. The profit center that is selling the final product may not be aware of the fixed costs and profits included in the internal transfer price. So the selling unit can be reluctant to reduce its own profits in order to optimize the company profit.

There is however some methods companies can use to reduce this problem:

- Agreements between business units through the establishment of a formal mechanism deciding on outside selling prices and sharing of profits between units
- Two-step pricing with a transfer price that includes two parts: a charge equal to the standard variable cost of production and a periodic charge equal to the fixed costs associated with the facilities. One or both of these components should include a profit margin.
- Profit sharing where the internal transfer price is set to the standard variable cost and after the product is sold, the business units share the contribution earned
- Two sets of prices. The manufacturing unit’s revenue is credited at the outside sales price and the buying unit is charged the total standard costs. The difference is charged to a headquarters account and eliminated when the business unit statements are consolidated. (Anthony and Govindarajan 2007).

4. **Risks and complication when dealing with transfer pricing**

A MNE has to overcome lots of complication related to the fact that it is actually a multinational enterprise. It has to cope with different international tax rates, foreign exchange rates, governmental regulations, currency manipulation, and other economic and social problems. These issues can make transactions very costly and the MNE has to create routines to avoid such costs. One of the most important things is to reduce the global income tax liability. This can be achieved by transferring goods to countries with low income tax rates at
the lowest possible transfer price and by transferring goods from these countries with the highest possible transfer price. This ability is however limited by transfer pricing regulations and some important issues are double taxation and unjustified additional taxation that can occur when countries have laws and regulations that are different (Abdallah 2004). We talk of economic double taxation situation when the same income is taxed twice. This happens when there is a conflict of interest between the tax authorities in the countries involved in the transaction. The tax authority in each country wants to protect their tax base, and gain as large income as possible. They can have laws and regulations that differ and raise claims on the same income. For example, there can be differences on what is considered to be the permanent place for the operation or different rules of what is considered to be incorrect pricing or transfer loss (Nguyen 2009). Example: Assume that there is a difference in definition of associated enterprises. Country A requires at least 50% holding to consider companies associated while country B requires 30%. In country A, the income tax is 25% while in country B 35%. Then assume that company B in country B buys goods from company A in country A in which they hold 31% of the shares. The cost of goods sold is 50 and the price is set to 100.

![Cross Border Transaction](image.png)

In country A no transfer pricing adjustments is required since the transaction does not meet the requirements for the definition of associated companies. They produce it for 50 and sell it for 100. If we then assume that Company B buys the goods for 100 and then resells them for 80, they make a loss at the transaction and income are shifted from Country B to Country A which has a lower income tax. If both countries didn’t consider this as a transaction between associated companies the income tax would have been 12.5 payable for company A (50 x
0.25) and 7 receivable for company B (-20 x 0.35). This means a global income tax at 5.5 for the group since they transfer goods to a high price from a country with lower income tax to a country with higher. Country A 50% holding 25% income tax, Country B 30% holding 35% income tax, Cost 50, Price 100, Holdings 31%. (Strategic Transfer Pricing Ida Hjertberg & Sanna Pettersson Spring Semester 2010). But since the transaction lives up to the requirements for associated companies in country B, the tax authority will probably assert incorrect pricing and instead adjust the price at the purchased goods from 100 to let’s say 60. Company B (in a tax point of view) suddenly make a profit at 20 on the transaction instead of a loss, which would lead to a payable income tax at 7 (20 x 0.35). So the total global tax would be 19.5 since a part of the profit is rated in two countries. This incorrect pricing will not be advantageous for the associated companies due to the transfer pricing regulations since it leads to double taxation. If the group sets a correct price, according to the arm’s length principle, they can avoid these extra costs. Assume that an added margin at 20% of the cost of goods sold is a result of the arm’s length principle between the companies. Then Company A would sell for 60 to Company B and pay 2.5 in tax (10 x 0.25), while company B buys for 60 and sells for 80 which means a payable income tax at 7. This gives us a global income tax at 9.5. Not as good as 5.5 but way better than 19.5.

**Scenario 1: No associated interest between the companies**

A: 12.5 payable  
B: -7 receivable  
**Total global taxation 5.5**

**Scenario 2: Associated interests between the companies with incorrect pricing**

A: 12.5 payable  
B: 7 payable  
**Total global taxation 19.5**

**Scenario 3: Associated interests between the companies with correct pricing**

A: 2.5 payable  
B: 7 payable  
**Total global taxation 9.5**

Another easier example at double taxation is when a profit in a subsidiary in country A is taxed and then transferred to the parent company in country B where it is taxed again. (Nguyen 2009). An entity on the open market is generally free to determine the price in the business contract with regard to the business strategy. It does not necessarily mean that the
price has to be similar to prices charged between other independent parties on the market. With regard to the strategy, there could be other incentives behind the price. Say for example that the two companies A and B above are in a joint venture. Let’s assume that these companies are engaged in a transaction outside the scope of the joint venture. In that transaction they are two independent entities since there are no relationships with respect to shareholding, management or control between them. Each party act for its own interest and there is no economic interest between them. Hence, this transaction would in some countries be considered as a transaction between associated parties because they have joint venture as a single definition of the concept associated companies. (Nguyen 2009). Double taxation is a barrier that discourages investors from conducting business and investments in foreign countries so it may be a deterrent for transfer pricing policies. It is not beneficial for anyone and therefore tax authorities have developed double tax relief measures to reduce or eliminate international double taxation.
Chapter 2

1. The OECD Guidelines and the Arm’s Length principle

The Arm’s length principle described in the OECD Guidelines is the main key when analyzing transfer pricing issues. It is the final argument used between tax authorities and multinationals, arguing that intercompany transactions have been conducted on market conditions, thus no profit has been allocated to jurisdictions, which were not entitled to taxing. The principle does not stand alone, as it is supported by a range of tools, which can be applied in order to establish a reliable foundation for the dispositions taken by the multinational company. Eventually it supports the company in convincing the tax authorities, that the tax base follows the activities performed by each entity in the group and by that avoids double taxation. It is the international standard, which the countries that are members of the OECD have agreed on. The Arm’s length principle states that transactions taking place between companies that are related should be priced as if the companies where unrelated parties therefore at a market price. In this way, every part of the value chain in a multinational company is allocated with profit accordingly to the value that is being created; it leads to each country getting a tax base equivalent to the actual value created in the country. If companies are not following the principle, they will be able to shift profits between countries in order to have low margins in high tax countries and higher margins in low tax ones (Hansen & Andersen). Evaluating an Arm’s length price, it has to be considered not only the circumstances under which the transaction takes place but also the price of the transaction. Initially they must be identified the characteristics of the transaction, the functions performed, the risks assumed and assets employed, and based on that, determine the market price. It can be necessary to change the characteristics of the transaction if these are evaluated to be so far from what any unrelated parties would agree on, and then re-evaluate the price. According to the OECD Guidelines a tax administration’s examination of a controlled transaction should ordinarily be based on the transaction actually undertaken by the associated enterprises, as it has been structured by them, using the methods applied in compliance with the OECD. Only in exceptional cases, the tax administration should deviate from the actual transaction or substitute other transactions for them. Ernst & Young (2008 via Eden 2009) found that transfer pricing is currently seen as an international tax issue by MNEs and tax authorities. Many researchers, for example Sikka and Willmott (2010) and Kuschnik (2008), state that tax authorities increased their scrutiny in their tax audits especially on those related-party
transactions as the result of their increasing concerns on transfer pricing role in tax avoidance. In their studies, they find that the unfair assessment of the transfer of goods, services and intangible assets between MNEs can increase private gain while deteriorating the social welfare. That’s why in order to achieve the appropriate assessment of transfer price, OECD came up with the arm’s length principle, which states that the price of the related-party transactions will be similar as those transactions taken in the opened market (KPMG 2011: 4, Kuschnik 2008). According to OECD and lots of nation’s legislations, when the transfer price does not represent true market condition, an adjustment to the income has to be made by the authorities (KPMG 2011: 4-6). As said before the adjustment will be made by establishing the commercial and financial conditions that are expected to be incurred in the transactions between the independent parties. In order to adjust the price in accordance with the principle, a separate entity approach will be applied. The separate entity approach will treat the members of MNEs as if they were separate independent parties. Therefore, all companies within the jurisdiction will be treated similarly for tax purposes. This is to prevent the MNEs from taking tax advantages of tax break through mergers, acquisitions or even tax holidays, thus promoting the competition in business environment (OECD 2010). It is sometimes difficult for tax authorities and taxpayers to implement the arm’s length principle since the MNEs may engage in the businesses where the adequacy of data may not be available. Therefore, it requires lots of judgement on both parts of tax authorities and taxpayers when it comes to set the appropriate transfer price, the price at which can be accepted by both tax authorities and taxpayers (OECD).

2. Transfer pricing Methods

The OECD has provided guidelines listing methods in order to determine the correct transfer price (OECD 2010a: 59). These guidelines aim at searching the method that is most appropriate for the transactions in question. In choosing the best method, the tax authorities and taxpayers need to consider:

- strength and weakness of the methods
- the reliability of the data
- sufficiency of comparable transactions and
• the reliability and accuracy of the adjustment made to eliminate the significant differences between the transactions.

In order to choose the most appropriate, it is not necessary to analyze every one for the transactions in question. Taxpayers are still recommended to keep the transfer pricing documentation on hands. It may contain informations regarding the establishment of the transfer price, such as reasons supporting the choosing and rejecting of a particular transfer pricing method, basic informations on the business industry, and reasons for entering the related-party transactions\(^8\). It is important to notice that there is not a universal method that is suitable to every transaction in every circumstance. Therefore, the taxpayers have to choose the method that can best estimate the transfer price of a specific transaction under particular circumstance. The reliability of the method chosen will depend on the accuracy of the adjustment made to establish the comparability of the transaction (OECD 2010a).

**Traditional methods**

*Comparable uncontrolled price method (CUP)*

The comparable uncontrolled price method compares price charged for goods or services by related party to price charged for comparable transactions by independent parties in comparable circumstances (Eden & Smith, 2001). The independent transaction will be compared to the related party transaction for the purpose of the comparable uncontrolled price method if one of the following conditions is met:

- There is no difference that can significantly affect the arm’s length price;
- If such difference does exist, the accurate adjustment will be made to the transaction to eliminate any significant effect of such difference (OECD 2010a).

This method is considered to be the most direct way for determining the arm’s length price since it is made through direct price comparison. Minor difference on goods or services being

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\(^8\) OECD 2010a: 59-61 & 181-189
transferred can significantly affect the price of the transaction, so it may be difficult to find the comparable under this method. Therefore, the CUP is most used in transactions involving commodity products where the degree of similarity is high (OECD 2010a). In order to apply this method, taxpayers and tax authorities can search for either external or internal comparable. When the comparable transaction is transacted between one of the related-party and independent party, it is called internal comparable. In contrast, external comparable will incur when the comparable transaction is transacted between two independent companies (United Nations 2013: 193). If there is difference that have an effect on the arm’s length price, the appropriate adjustment will be made to eliminate such difference. In the case where reasonably accurate adjustment cannot be made, the alternative method will be taken into consideration (OECD 2010a).

- **Pro**

  It is the most direct and reliable method of determining the arm's length price wherever comparable uncontrolled transactions are found\(^9\).

- **Cons**

  CUP is built on comparable. In the contemporary era, when the vast majority of transactions are intra-group, it is very difficult to find comparable.\(^10\) The MNEs usually do not enter into transactions with un-related entities except with the end-consumer, so the chances of finding comparable in respect of intermediate transactions are rare.\(^11\)

**Resale price method**

The resale price method compares gross profit margin percentage of the related-party to those of the independent parties performing the comparable transaction under comparable circumstance. It will then deduct the appropriate gross profit margin from the resale price to determine the arm’s length price. The gross profit margin will be high enough to cover

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expenses and earns sufficient profit (OECD 2010a). Gross profit margin can be determined by reference to either internal comparable or external comparable. When the gross profit margin is obtained from the comparable transaction between a related-party and independent party, it is called internal comparable, while those obtained from the comparable transaction between independent parties are called external comparable (OECD 2010a). The independent transaction will be compared to the related party transaction for the purpose of comparable uncontrolled price method if one of the following conditions is met:

- There is no difference that can significantly affect the arm’s length price;
- If such difference does exist, the accurate adjustment will be made to the transaction to eliminate any significant effect of such difference (OECD 2010a)

OECD (2010a) suggests that the resale price method is probably most useful for marketing operations where no unique intangible assets were added to goods or services before resale. They also state that when the product difference exists, fewer adjustments are needed under this method since gross profit is less likely to be affected by the product difference. In contrast, resale price method is more concerned with functional comparability; therefore, the tax authorities and taxpayers need to take the functions performed, risks assumed and assets used by resellers into account when determining the gross profit, the profit after the cost of goods (United Nations 2013: 200-209). Since this method compares the gross profit of the related-party with those of independent parties, it is important to ensure the accounting consistency. Tax authorities and taxpayers will keep in mind that gross profit will not be comparable if there is the difference in accounting practice between the related-party and independent parties; therefore, the appropriate accounting adjustment is needed to achieve the data consistency for calculating the appropriate gross profit margin (OECD 2010a: 65-69, United Nations 2013: 200-209). Because of its dependence on comparability of functions between transactions of related-party and independent parties, there must be no difference that significantly affects the attribute being used to measure the arm’s length condition of the transaction.

Whenever such difference does exist, the reasonably accurate adjustment is needed to eliminate the significant effect of such difference. It is recommended that the alternative methods will be taken into consideration if the reasonably accurate adjustment cannot be made (OECD).
• **Pro**

It is more useful where product comparable are not available and there is no value addition to the product by the intermediary before resale.\textsuperscript{12}

• **Cons**

This method is not of much help where the intermediary party is engaged in significant value-addition to the product before resale.\textsuperscript{13} If there is too much time-interval between the purchase and subsequent resale, some additional factors also needs to be considered like changes in market conditions, interest rates etc.\textsuperscript{14} The final price may be artificially increased for various motives including gaining a monopoly, making this method having a wrong starting point.\textsuperscript{15}

**Cost plus method**

Cost plus method compares mark-up of the related-party to those of the independent parties performing the comparable transaction under comparable circumstance. It will then add the appropriate mark-up to the transaction cost of related-party to determine the transfer price (Eden & Smith 2001). According to OECD (2010a: 70-75), the mark-up will be decided after the computation of direct and indirect costs of production, but before the operating expenses. Furthermore, the mark-up added to these costs will be high enough to earn sufficient profit for the function performed, risks assumed and assets used. The mark-up can be determined by reference to either internal comparable or external comparable. When the mark-up is obtained from the comparable transaction between a related-party and independent party, it is called internal comparable. On the other hand, the mark-up obtained from the comparable transaction between independent parties is called external comparable (OECD 2010b). For the above methods, the independent transaction will be compared to the related party transaction.


\textsuperscript{14} Ibid, Page 43

\textsuperscript{15} Peter Muchlinski (1993) Multinational Enterprises and the Law, Blackwell Oxford UK and Cambridge USA, Page 284
for the purpose of comparable uncontrolled price method if one of the following conditions is met:

- There is no difference that can significantly affect the arm’s length price;
- If such difference does exist, the accurate adjustment will be made to the transaction to eliminate any significant effect of such difference (OECD 2010a)

This method is also less sensitive but is more sensitive to functional comparability. Anything that significantly affect the gross profit mark-up as a result of differences in functions performed, risks assumed and assets used, must be taken into account and necessary adjustments will be made to eliminate such difference. This method is most useful for manufacturers or service providers, where no valuable or unique intangible asset is added to goods being sold or services being rendered (OECD 2012b). Accounting consistency is therefore very important. Tax authorities and taxpayers have to know that the appropriate gross profit mark up will not be able to determine if there is a difference in accounting practices between related-party and independent parties. Therefore the appropriate accounting adjustment is needed to achieve the data consistency for calculating the appropriate gross profit mark-up. As for the other methods, the reliability of cost plus method depends on the comparability of the tested transaction with those of-with independent parties. When there is a difference that can significantly affect the arm’s length price of the transaction, the appropriate adjustment will be made to eliminate such difference. Alternative methods will be taken into consideration if such adjustment cannot be made (OECD 2010a).

- Pro

This method is most suitable in respect of transfer of semi-finished goods, rendering of services and long-term buy and sell arrangements.16

- Con

The profit margin cannot always be calculated accurately and objectively as no business can always generate income as a percentage of its cost all the time under all circumstances.17

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Transactional methods

When traditional transaction methods are not good enough for setting transfer price due to lack of comparability or reliability, OECD (2010a) suggests the use of transactional profit methods. The transactional profit methods are based on the profit that arises from particular transactions among related-party to those independent parties. Two transactional profit methods that are accepted under the OECD Guidelines are the profit split method and the transactional net margin methods (OECD 2010a).

Profit split method

The profit split method is used when comparability doesn’t exist due to the fact that the transaction of related-parties is too interrelated that it is not possible to evaluate the transactions independently (United Nations 2013) or in cases where both related-parties have contributed unique or valuable intangible assets to the transaction (OECD 2010a). Such unique conditions can be eliminated by determining the profit of each related-party that will be expected to earn from engaging in the comparable transactions of the independent parties (OECD 2010a). To apply this method, it is necessary for tax authorities and taxpayers to identify the combined profit. The combined profit will be divided by the related-parties based on their contributions to the transaction by taking the account of functions performed, risks assumed and assets used. In cases where the comparable market data are available, it is possible for the tax authorities and taxpayers to divide the combined profit based on such comparable data. By doing so, the division of profit will most likely reflect what will be expected from the comparable transaction of the independent parties. This method will be equally applied in case of losses (OECD 2010a, United Nations 2013). There are two approaches used to split the profit among related-parties:

- Contribution analysis: The main idea of this approach is to allocate the combined profit among related-parties as if it is expected to be split among independent parties. In cases where the external market data is available, such combined profit will be allocated by reference to the market data to reflect the division of profit in the comparable transactions of independent parties. However, in cases where such

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external market data is not available, the profit will be split based on the value of their relative contributions by taking the account of functions performed, risks assumed and assets used (OECD 2010a, United Nations 2013).

- Residual profit split analysis: OECD (2010a) states that there are two stages of profit division under this approach. In the first stage, after the combined profit has been identified, the sufficient profit will be split among the related-parties based on their functions performed. In this stage, the profit being allocated will account for the routine functions performed by each related party. Practically, this part of profit can be determined by using either traditional transaction methods or transactional net profit margin (TNMM). In the second stage, the residual profit will be split among the related-parties based on the facts and circumstances of the transactions; therefore, the treatment of this part of profit division will be varied case-by-case. The division of profit in this stage will account for the unique or valuable assets used in the transactions. The residual profit split analysis is often used in cases where the unique or valuable assets are contributed by both the parties of the transaction. On the other hand, resale price method, cost plus method or TNMM will be used where the unique or valuable assets are contributed by only one party of the transaction (United Nations 2013).

In order to determine the combined profit under this method, it is necessary for the tax authorities and taxpayers to find the relevant transactions needed to be covered and all parties involved in the transactions. The combined profit used to split among the related-parties under this method is usually the operating profit (loss); however, gross profit can be used if it deems appropriated (OECD 2010a). To apply the profit split method, it is necessary to take the reliability of the method into account. Since the implementation of this method generally depends on facts and circumstances of cases and on the availability of information’s, tax authorities and taxpayers must allocate profit that will be most likely expected in the comparable transactions of independent parties. To be able to approximate such division of profit the functional analysis, the determination of combined profit and splitting factors and the approach used for determining the division of profit of the related-party, will be consistent with those used by independent parties. Moreover, accounting practice can be different between businesses, therefore the adjustment of the accounting data is needed to maintain the accounting consistency. Without this consistency, the
appropriated division of profit and thus the arm’s length price can’t be done (OECD 2010a).

➢ Pro

The method does not place reliance on comparable and so can be used in their absence.\(^\text{18}\) It gives due consideration of specific and unique factors present in an MNE and absent in comparable unrelated entities.\(^\text{19}\) It avoids arriving at the unrealistic figure of profit, because both parties to the transaction are examined.\(^\text{20}\)

➢ Cons

The method is less direct and less reliable than traditional methods.\(^\text{21}\) Allocation of costs to property and services rendered in controlled transactions between related parties may be difficult to decide.\(^\text{22}\)

**Transactional net margin method**

The transaction net margin method (TNMM) is the indirect method used to find the arm’s length price of the related-parties transactions by comparing the level of profitability of related-parties transaction with those of independent parties. It is usually used to compare the net profit margin acquired by related-parties transaction with those acquired by independent parties. When determining the net profit margin, the appropriate base such as cost, sale or asset, must be chosen carefully (United Nations 2013). Similar to resale price and cost-plus methods, the net profit indicator of TNMM can be determined by reference to either internal or external comparable. When the net profit indicator of related-parties is reference to the net profit indicator obtained in the transactions between related-parties and independent parties, it is called internal comparable. On the other hand, the external

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\(^{19}\) Ibid, Page III-3


\(^{22}\) Ibid, Pages 18-19.
comparable is obtained in the transactions between independent parties. To implement this method, the tax authorities and taxpayers need to identify the tested party, the participant of the related-party transaction used to apply transfer pricing. Basically, the least complex party with no valuable or unique asset will be chosen since it has more reliable information available and less adjustment needed to establish the comparability (OECD 2010a & 2012b, United Nations 2013: 223-224). Unlike the resale price and cost-plus methods, TNMM uses the net profit instead of gross profit. Therefore, TNMM is more appropriate in cases where two previous methods cannot be used due to the inaccurate adjustment of gross profit. The net profit used to determine the transfer price under this method is generally the operating profit, the profit before interest and income tax expenses. Operating profit under TNMM will only include incomes and expenses from normal operating activities that are related to the transactions in question into transfer pricing calculations; any extraordinary items, such as nonrecurring activities, will be excluded from such calculation (OECD 2010a). The comparability analysis is also required in applying the TNMM. Where price and gross profit margin can be significantly affected by product and function differences, respectively, net profit margin under TNMM is less likely to be affected by such differences. However, the net profit margin can be significantly affected by elements such as difference in cost of capital, degree of business experience and management efficiency, that are unrelated to transfer pricing. To mitigate the impact of the inaccuracy of comparative informations due to the effect of such factors, TNMM has established the arm’s length range for the transfer price instance of one single transfer price. Furthermore, the accounting adjustment is needed to maintain the accounting consistency and thus comparability between parties. Without the accounting consistency, the reliability of comparable will not be established. Similar to other methods, the reasonable adjustment will be made to eliminate any differences between the tested parties and comparable that significantly affect the comparability of the transactions (OECD 2010a). The appropriateness of profit level indicator (PLI) to be used for comparing the level of profitability between comparable and tested parties depends on the facts and circumstances of the cases. The PLIs that are commonly used in practice are the return on equity employed (ROEC), the return on equity (ROE) and the operating profit margin (OM). According to various studies, it was found that when the assets have played a significant role in generating income, for example in manufacturing businesses, it is recommended to use the ROEC or ROE, in which denominators come from balance sheet.
On the other hand, the businesses such as service providers and distributors that are not relied on fixed assets to generate income will use the PLIs with income statement figure as denominator. Sometimes, it may be useful to examine several profit level indicators for particular transactions. If the multiple PLIs are used and such indicators yield the consistent results, it will reassure the reliability of the examination. Instead, the inconsistent results may inform that additional functional analysis may be needed (United Nations 2013).

➢ Pro

Net margin is less likely to be affected by transactional differences than it is with the price (like that in CUP) or with the sale price margin (like that in RSM).23 The determination of functions performed and risks involved is not required.24 This method is relatively simple because it examines only one party to the controlled transaction.25

➢ Cons

Unlike tax authorities, the taxpayers may not have access to the information on comparable transactions.26 The taxpayer or tax authorities in accordance with their desired value can manipulate this method by choosing the comparable companies that suit them for this purpose.27

23 Ibid, Page 20
3. **Comparability analysis**

To establish the transfer price that will be justifiable for the tax purpose, it is important to find the arm’s length price of the comparable transactions under comparable circumstances of the independent parties. Since such arm’s length price relies on the reliability and comparability of the transaction, the comparability analysis comes into play. The aim of this comparability analysis is to obtain the highest degree of comparability of the transactions. It will be kept in mind that reliability and availability of the data are needed to be taken into consideration when searching for the comparable to establish the closest approximation of the arm’s length price\(^\text{28}\). As always, the transactions will be comparable if there is no difference that can significantly affect the arm’s length price or such difference can be eliminated by the appropriate adjustments. To establish the comparability and make any appropriate adjustments as needed to achieve the arm’s length conditions, the attributes of transactions such as the characteristic of goods and services, the functional analysis, the contractual terms, the economic circumstances and business strategies that can significantly affect the arm’s length price, must be compared. The degree of importance of such attributes to the comparability depends on the nature of transactions and transfer pricing methods being used. (OECD 2010a: 43).

*Characteristics of assets and services*

We know that the difference in characteristic of assets and services can end up with difference in value of assets and services. Therefore, tax authorities and taxpayers need to consider this when evaluating the comparability of the transactions. There are several important characteristics that need to be considered when making comparison; for example in the case of transfer of tangible assets, they are physical features, quality of the assets, volume and availability of supply and demand. Nature and extent of service will be taken into account when determining the transfer price for services transferred. In case of intangible asset, the duration and form of assets, for example, will be taken into account (OECD 2010a: 44). Different transfer pricing methods will give different weight to this feature. Since CUP is the

\(^{28}\) OECD 2010a: 41-51; United Nations 2012
direct transfer pricing method, it gives the highest weight to this feature. Any difference in this feature can lead to the price difference; therefore, the appropriate adjustment will be made to establish the comparability. In contrast, there are few characteristics of assets and services that can significantly affect gross profit margin under resale price and cost-plus methods; it is even less likely to affect the net profit margin in TNMM.  

*Functional Analysis*

In the opened market, the compensation of the transaction between independent parties will reflect the functions performed, assets used and risks, assumed that each party to the transaction undertakes them. The functional analysis will compare economic activities and responsibilities, which can significantly affect the arm’s length price undertaken by the parties to the transaction. When making the comparison, the activities that need to be considered are for example research and development, marketing, distribution, manufacturing and production process. Furthermore, the consideration in assets used and risk assumed will also be included in this comparability analysis. The assets mentioned here can be either tangible assets such as research and development equipment, vehicle and property and plants and equipment’s, or intangible assets such as patents or trademarks. Furthermore, tax authorities and taxpayers are required to identify who bears the risks, for example financial risks, market risks and production risks assumed in the transaction, since such risks can also reflect in the arm’s length price.

*Contractual terms*

The contract generally will consist of the sections that state how responsibilities, risks and benefits will be divided among the involved parties in the transactions. The terms of transactions can be found in either written or verbal arrangement. However, where such arrangement is impossible, the terms of transaction can be evaluated from the economic substances or functions performed by the involved parties. The tax authorities will examine whether the arrangement made between the related parties has been implemented since the

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29 (OECD 2010a: 44-45).
30 (OECD 2010a: 45-46)
incompliance can mislead the tax authorities in evaluating the appropriated transfer price. Furthermore, it will be noted that difference in contractual terms between those of related-parties and independent parties can significantly affect the price or margin of the transactions; therefore, the appropriate adjustment is required as necessary\textsuperscript{31}.

\textit{Economic circumstances}

Since the price of the transactions can be varied across the markets even though the products sold or services are similar, there is a need to identify the relevant market when finding the comparable. Furthermore, there are additional several economic circumstances, for example the business cycle, the extent of competition, the nature of government regulation and the time of transactions, which will be taken into considerations when making the comparability analysis. Depending on the fact and circumstance of the cases, the difference in economic circumstance that can significantly affect the price of the transactions will be identified and appropriate adjustments will be made to eliminate such effect.\textsuperscript{32}

\textit{Business Strategy}

This feature compares the factors that are relating to the daily operations of the businesses. Such factors are the diversification of businesses, the launching of new products and market penetration. If the taxpayers have implemented the business strategy for market penetration, for example by setting low transfer price with the hope to earn higher income in the future, there are several things tax authorities will do when evaluating the transfer price of related-parties transactions. The tax authorities will investigate the conducts of the related-parties to ensure that they are consistent with the business strategy. Furthermore, the nature of the relationship between the involved parties will reflect the taxpayers who bear the cost of such business strategy. Tax authorities sometimes can challenge the MNEs on the transfer pricing

\textsuperscript{32} (OECD 2010a: 48-49, United Nations 2013: 139-145).
issue if the implementation of the business strategy has not earned sufficient profit over several years (OECD 2010a: 49-51 United Nations 2013: 145-148).

As described above, the most important things when evaluating an intra-group transaction are its characteristics, the kind of risks carried by each party, assets invested and functions undertaken. If a similar transaction is undertaken by third parties this can be used to determine the most appropriate arm’s length price. If this is not the case, for example there are differences in the risks assumed, an adjustment compensating for the differences has to be made. But also, in the light of the financial crisis, the economical circumstances in a country could mean greater adjustments, especially if comparable that are between one and five years old are used. When selecting the transfer pricing method, the most appropriate method in each given situation should be used in order to determine the correct arm’s length price. One method is not preferred to the other, and each situation calls for an evaluation of which method to apply. Thus, it is important to know the characteristics of the transactions, as well as what comparable data is available. In the figure below, the impact on the company’s profit and loss statements by each transfer pricing method is showed.

![Picture 2 - Transfer pricing methods and price basis](image-url)
4. Anti-Transfer Pricing Measures

Measures undertaken by the International and Multilateral Organizations

The United Nations (UN) in its Guidelines 1984 encouraged the exchange of information on transfer pricing among member states and discussed the mechanism of tax evasion and tax avoidance providing CUP, RSP and CPP, the methods for the determination of the arm's length price. The UN Model Double Taxation Convention between Developed and Developing Countries 2001 (UN MC) adopted the concept of transfer pricing in the Article 9 of the OECD MC. It also has provisions for a mutual agreement procedure (Article 25) and exchange of information (Article 26). The OECD, as already seen, has dedicated a lot of time and energies to determine its tax implications and to evolve the measures to counter its undesirable effects. The Committee on Fiscal Affairs, which is the main body of the OECD regarding tax policy, issued various reports on transfer pricing, which include: Transfer Pricing and Multinational Enterprises (the “1979 Report”), Transfer Pricing and Multinational Enterprises: Three Taxation Issues (the “1984 Report”), Tax Aspects of Transfer Pricing within Multinational Enterprises: The United States Proposed Regulations (1993) and Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the “1995 Guidelines”). The 1995 Guidelines suggest to use any of the traditional methods for the computation of the arm's length price and reserves the other methods in circumstances when the traditional methods cannot be applied. The OECD Model Tax Convention on Income and Capital (OECD MC) provides for the adjustment of profits between associated enterprises in Article 9. This provision is usually construed to be recognition of the arm's length price, as stated within the OECD Guidelines 1995. There are only few such treaties, like between the Nordic and Benelux countries. These have provisions for exchange of information. With the diffusion of transfer pricing as a tool of tax avoidance and shifting of profit, the governments of most countries enacted counter-acting legislations and framed rules and regulations to try to reduce the efforts on tax avoidance, enabling them to receive their fair share in the tax revenue relatable to the income generated from economic activities having nexus with that country. Let’s see s briefly the example of the USA and the UK.

33 UN (1984), Guidelines for International Co-operation against Tax Evasion and Avoidance of Taxes (with special reference to Taxes on Income, Capital and Capital Gains) UN, Pages 4-5
34 UN (2001) United Nations Model Double Taxation Convention between Developed and Developing Countries, UN, Page 138
The section 482 (allocation of income and deductions among taxpayers) of the Internal Revenue Code (IRC) empowers the Internal Revenue Service (IRS) to apportion and allocate income and deductions among the related enterprises. Section 482 is short and simple consisting of only two sentences. The first sentence sets up a general rule empowering the IRS to apportion and allocate income, deductions, credits or allowances between entities related to each other by common ownership or direct or indirect control when such apportionment or allocation is necessary to prevent tax evasion or to reflect their true income. The second sentence deals with super royalty and provides that any transfer or license of intangible assets must be at the price considering the subsequent income generated from them. Section 482 has been supplemented by detailed regulations (regulations 1.482-0 to 1.482-8, 1.901-2(e)(5)(i) and 1.6662-6). Like section 482, the transfer of tangible and intangible properties has been dealt separately by providing separate methods in the regulations. Under these regulations, the prescribed methods for the determinations of the arm's length price for the transfer of tangible property are CUP, RSP, CPP, Comparable profit method and other reasonable methods. For the transfer of intangible property the methods are CUP, CPM and other reasonable methods. The IRS has also issued guidelines on the enforcement of the section 482 cases incorporated in the Internal Revenue Field Manual. Case’s laws decided by US courts on this issue are also helpful in this regard. Transfer pricing adjustments by tax authorities on basis of section 482 are frequently disputed by taxpayers leading to litigation. According to Judge Nims, Chief Judge of US Tax Court, in 1990, more than 200 cases of alleged transfer pricing manipulations were filed by the IRS which involved understatement of profit from $ 10 millions to $ 6 billions.\textsuperscript{37}

General and special provisions on transfer pricing have been incorporated in domestic legislation in accordance with the Article 9 of OECD MC and OECD Guidelines.38

5. Formulary apportionment

Right now the normal approach in taxation is to treat the affiliated entities as separate legal persons maintaining separate accounts, filing tax returns and paying taxes to the tax authorities of the country which holds jurisdiction over them on basis of nationality, residence or source. An adjustment is made to transactions in regards to transfer prices which fail to meet the arm’s length standard. Any resultant double taxation is remedied by unilateral relief (either by straight exemption or credit method) or by bilateral double taxation treaties. Unitary taxation has been suggested as an alternative to this separate entity approach and arm's length principle. It is claimed that this system would remove all the anomalies and drawbacks associated with the current practices to avoid the inappropriate transfer pricing. First introduced in California it is in use at sub-national level by provinces of Canada and US states. Its use has been suggested for cases involving the North America Free Trade Agreement (NAFTA). All the related entities carrying out income-generating economic activities within or out of the country of origin are treated as one unit (“unitary business enterprise”, “unitary business group”, “unitary business,” or “global taxable unit”). The total world income or global taxable income (or loss) of this unitary business enterprise (generated by all its related entities) is computed (global profit assessment). Thereafter, this income is apportioned in a pre-determined mathematical formula (“apportionment formula”) evolved on the basis of predetermined factors (“apportionment factors”). The share of each state is distributed to all states that apply its own tax rates in accordance with its domestic tax laws and rules.39

38 General and special provisions on transfer pricing have been incorporated in domestic legislation in accordance with the Article 9 of OECD MC and OECD Guidelines.

39 Ibid, Page 78.
“A unitary business is the smallest division of a firm or a group of firms, the income of which can generally be accurately indicated by separate accounting.”\textsuperscript{40}

It is important to know in what way entities are to be clubbed together for unitary business and what should be the basis for such inclusion. The US system, which is the pioneer in this approach, does not provide any strict objective criteria for that. Generally, different approaches have been set by the US courts.

**Three unities approach**

This approach was adopted by US court in Butler Brothers v McColgan by declaring that a business is unitary if there are three unities:

- unity of ownership (like shareholding etc),
- unity of operation (like purchase of equipments and incidental items, advertisement, common accounting facilities, common legal representation, joint efforts in expanding the business and inter-company financing, parent guarantees etc)
- unity of use (like inter-company transfer of products, shared directors and officers, transfer of executive personnel and public image).\textsuperscript{41}

**Contribution and dependence approach**

This approach was adopted by US court in Edison California Store declaring a business unitary when an economic activity carried on in one state is dependent on or contributes to business activity in another state.\textsuperscript{42}

**Centralized management, functional integration and economies of scale**

These factors were considered relevant by the US Supreme Court in Mobil Oil v Commissioner of Taxes of Vermont.\textsuperscript{43}

\textsuperscript{40} Charles E. McLure, Jr; (1984) The State Corporation Income Tax-Issues in Worldwide Unitary Combination, Hoover Institution Press, Stanford University, Stanford, California, Pages 90-91


\textsuperscript{42} Ibid, Pages 141. [30 Cal 2d 472 (1947)]

**Flow of values**

The flow of values as against the flow of products was considered to be the main characteristic of the unitary business by US Supreme Court in Container Corp of America vs. Franchise Tax Board. It may exist when there is functional integration, centralized management, economies of scale, management of affiliates by the parent, engagement in the same line of business and non-arm’s length transactions.

**Computation of Total Taxable Income**

The total divisible income of the unitary business enterprise from all economic activities is determined.

**Apportionment Formula**

At present different apportionment factors are being the basis of the apportionment formula. These include supply or sale factors (quantum of sales of goods and receipts from rendering services), property factors and payroll factors (contribution of labor in generating income).  

So analyzing this way of counteracting transfer pricing problems we can see that if the unitary taxation is adopted worldwide, it would result in lots of benefits for states and taxpayers. First of all entities within a unitary business, earning taxable profits from economic activities in different countries, will be taxed only once at one place; no further tax liability would arise and the taxpayers will no longer be subjected to different tax jurisdictions in respect of its foreign affiliates. It will boost and facilitate international trade since there will be freedom of transactions between affiliates and major uncertainties in matter of international taxation like transfer pricing adjustments resulting in the elimination of conflicting and overlapping jurisdictions. Since all the states will be getting their due fair share in tax revenue, these will no longer need to appease the MNEs for making investments in their jurisdiction by indulging in harmful tax practices like tax havens and harmful preferential tax regimes. There will be no race to the bottom or harmful tax competition between states. There will be a reduction of the administrative cost of tax collection by states and the compliance cost (monetary and time costs) of taxpayers. Shifting of profit by the MNE from one country to another for tax

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46 S.O. Lodin and M.Gammie (2001) Home State Taxation, IBFD Research Department, Page 16
consideration will be discouraged. Finally, neither the transfer prices between related-parties will need to be monitored, nor will determination of the arm’s length price be necessary and consequently the problems of transfer pricing related tax avoidance will be solved once and for all. But this approach doesn’t have only positive things. It also has negative aspects. It has not been favored by international organizations so far. It was considered and rejected in Ruding Report, 1992133, in the OECD Guidelines and disapproved by the Group of Four Report of April 19882. Secondly, it has received a lot of criticism from the US and foreign MNEs as well as foreign governments. MNEs have threatened the boycott and foreign governments have announced retaliatory legislations. The UK government, vide section 54 of the Finance Act 1985, has been empowered to retaliate if a British company is taxed on unitary basis.47 Thirdly, a single apportionment formula covering all the industries and sources of income may be difficult to devise.48 Fourthly, a precise definition of the unitary business and the parameters for inclusion of business entities in it have not been agreed upon so far. Fifthly, there will be exchange rate problems for taxpayers as well as tax collectors.49 Sixthly, it may create conceptual confusions like abandoning the well-established separate entity and limited liability doctrines. Seventhly, the measurement and valuation of the apportionment factors like property (tangible and intangible), sales etc., may pose various problems. Finally, it will be difficult to collect the informations and books of accounts necessary to compute taxable income from foreign affiliates because of low competence to enforce compliance and lack of jurisdiction.

6. Anti-Transfer Pricing Strategies In Practice

Transfer Pricing Adjustments on the Basis of the Arm’s Length Price

The main objective in determining the arm’s length price through various methods previously seen is to make a transfer pricing adjustment in order to bridge the difference between the transfer price and the arm's length price. Therefore, tax authorities make appropriate

49 Ibid, Page 261
adjustments (called transfer pricing or primary adjustments) to the transactions and profits based on difference between the arm's length price and the transfer price, as provided in the domestic legislation of the country. There are currently two approaches for the determination of the arm's length price

- negotiated approach as adopted by UK tax authorities
- strict rules and regulations in determination of the transfer prices, as followed by US.

The transfer pricing (or primary) adjustment based on the arm's length principle can result in a number of further problems like disagreement by the MNE on the arm's length price determined by the tax authorities, leading to litigation and refusal of another country to make correlative or secondary adjustments leading to double taxation.

Advance Pricing Agreement (APA)

The unilateral determination of the arm’s length price by tax authorities is frequently disputed and litigated by the taxpayers, besides creating uncertainty in taxation. Some countries have tried to resolve these problems by negotiating agreements with the taxpayers on the methodologies to determine transfer prices before any dispute arises. Such an agreement, called an advance pricing agreement or arrangement, is binding on all parties. It may be unilateral (between taxpayer and one tax authority), bilateral or multilateral (involving more than one tax authorities). The APA procedure was first introduced in the US in 1991 and followed by other countries. It has various advantages like the removal of elements of uncertainty, the reduction of compliance costs, the fostering amicable milieu between taxpayers and tax collector, the avoidance of time and money consuming litigation and reduction of economic double taxation (bi- or multilateral APAs). However, it has certain drawbacks arising from unpredictable change in market conditions, disagreements on APA’s conclusions on various transactions, lack of corresponding adjustment by tax authorities of other countries and misrepresentation or fraud in concluding APAs.

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**Reporting and Record Keeping Requirements**

The requirement of reporting and disclosure vary from country to country. However, each country prescribes minimum criteria of transactions to be reported to tax authorities for records and books of accounts to be maintained.\(^{53}\)

**Penalty Provisions**

Penalties are instruments of compliance and deterrence to the delinquents. These penalties are either flat-rate penalties (for various defaults like non-filing of returns or any documents) or the percentage penalties (for various defaults like underreporting or concealment of income) which are calculated as the percentage of tax sought to be avoided.\(^{54}\)

**Exchange of Information**

The article 26 of OECD MC and UN MC provides for exchange of information in tax matters between tax authorities. The majority of the bilateral avoidance of double taxation treaties has similar provisions. Such exchange is very helpful in undoing tax effects of inappropriate tax prices.\(^{55}\)

**Imposition of Anti-Dumping Duty (ADD)**

In all WTO signatory countries, if an entity sells a product in a country other than the country of origin at less than its normal value (less than the sale price in the exporting country or less than the cost of production), the importing country can impose antidumping duty (ADD) not exceeding the amount of margin of dumping, as per provisions of Article VI of the General Agreement on Tariff and Trade (GATT).\(^{56}\)


\(^{54}\) Ibid, Pages 70-71


7. Transfer Pricing And Shareholders’ Value

Transfer pricing, currently, is recognized as the most important international tax issue by both MNEs and tax authorities around the world (Ernst & Young 2006 via Sikka & Willmott 2010). The recent research by United Nations (2013:1) has found that related-parties transactions are accounted for about thirty percent of international trade. From this research, it can be noticed that transfer pricing is increasing its importance in today’s world trade. Since MNEs operate its businesses in several jurisdictions where tax rate may be differed, it is possible that such MNEs will take the advantage of such tax difference through transfer pricing to reduce its global tax expenses. Baker states that by mispricing the related-parties transactions the MNEs can facilitate tax avoidance and capital flight from developing countries to developed countries, thus deteriorating the social welfare57. He also shows that more than sixty percent of illicit flow of capital around the world are accounted for tax evasion through transfer pricing, which is two times more than criminal activities, bribery and theft. As the result of the loss of tax revenue from the aggressive transfer pricing by MNEs together with the budget deficit, tax authorities around the world have come up with several methods to protect their tax bases and meanwhile increasing their tax revenue. They are increasing their scrutiny in tax audit by tightening up the transfer pricing regulation and legislation, training more tax officials in transfer pricing area, enforcing a high documentation requirement and imposing high financial penalties. There are evidences shown that by increasing their scrutiny in tax audit, especially in the area of transfer pricing, the governments can collect additional tax payment from millions of dollars to billions of dollars each year58. MNEs will notice that different countries may adopt and apply their transfer pricing laws and regulations differently; and by not complying with countries’ legislations, it can put the MNEs at risk of additional income tax adjustment, penalties and even double taxation59. As the result of such undesirable consequences which can eventually increase the effective tax rate and thus hurt the shareholders’ value, several transfer pricing experts have suggested that transfer pricing should be taken into the risk management issue; the board of directors and top management will be aware of their corporate transfer pricing practice and take it into consideration when making a strategic planning that can affect their tax structure

57 Morais 2009
58 Cools 2005, Sikka & Willmott 2010
59 Sanschagrin & Isensee 2013
and their tax position\textsuperscript{60}. According to Kobel (2009), there are several risk factors that MNEs will consider when setting their transfer pricing strategy:

\begin{itemize}
  \item tax audit risk (so called cashflow risk);
  \item accounting risk;
  \item reputation risk;
  \item and regime risk.
\end{itemize}

Tax audit risk is the risk of being audited by one or more tax authorities which can end up with the unexpected cash outflow relating to previous accounting period as the result of tax incompliance. Accounting risk is the risk associated with the unexpected change in the company’s financial position as the result of unexpected accounting adjustments. Reputation risk is the risk that company will lose its reputation from having negative headline news. Regime risk is the risk of unexpected change of future cash flow due to the change in governmental legislations. These risk factors can significantly affect shareholders’ value, and that can be seen from several cases; the most recent and famous cases are Starbucks, Amazon and Google operating its businesses in United Kingdom. These MNEs have been challenged by Her Majesty’s Revenue & Customs (HMRC) for not paying taxes or less taxes than their competitors through the use of transfer pricing strategy\textsuperscript{61}. We will see the example of Starbucks as a demonstration on how such risks can affect the shareholders’ value. We all know that businesses have the obligation to maximize its shareholders’ value. However, as the corporate governance is increasing its importance in today’s business world, businesses need to take other stakeholders’ interest, especially tax authorities, into account when doing their businesses\textsuperscript{62}. According to Cadbury (Cools 2005), good corporate governance will provide the transparency and accountability of the fair income distribution between shareholders and society and thus, between tax jurisdictions. Starbucks, through the use of transfer pricing, has paid its corporate income tax to HMRC only once, just about £8.6 million over the past fifteen years during its operation in United Kingdom; it avoided its tax payment over the past three years by making payments to its related-party in Netherlands and Switzerland for its royalty fee and coffee bean respectively. Since Reuters has exposed its complex tax arrangement, the UK public has demanded Starbucks to make tax payment to

\textsuperscript{60} Kobel 2009, Loh 2013, PricewaterhouseCoopers 2010
\textsuperscript{61} British Broadcasting Corporation 2013, Neville & Treanor 2012
\textsuperscript{62} PricewaterhouseCoopers 2010, Sikka & Willmott 2010
HMRC. Likewise, some of coffee drinkers have boycotted Starbucks and shifted their preference to Costa coffee. According to the preference survey by YouGov, they find that Starbucks coffee drinkers have dropped from 22.7% to 15.4% after its tax arrangement has been exposed, while the Costa coffee drinkers have risen from 31.8% to 39.4%. To protect its reputation, Starbucks has announced that it will claim no tax deduction on related-parties transactions fee in 2013 and 2014. Furthermore, it will voluntarily pay £10 million in corporate income tax each year in 2013 and 2014, which amount is two times more than taxes been paid to HMRC over fifteen years of its operation in UK. From the Starbucks case, we can see that the associated cost of transfer pricing will be considered as the tax expenses, which will eventually reflect in the global effective tax rate of the MNEs. Kobel (2009) has demonstrated how effective tax rate can have the impact on shareholders’ value by simply computing economic value added (EVA) of the MNEs. EVA is the tool used to evaluate whether the management has created or destroyed the shareholders’ value by evaluating the true business profit after accounting for the cost of capital.

Economic Value Added (EVA) is calculated as:

\[
EVA = (ROIC - WACC) \times Invested\ Capital
\] (1)

or

\[
EVA = \frac{NOPAT - (WACC \times Invested\ Capital)}{NOPAT}
\times \frac{Invested\ Capital}{NOPAT}
\] (2)

because ROIC in equation (1) can simply computed as:

\[
ROIC = \frac{NOPBT}{Sales} \times \frac{Sales}{Invested\ Capital}
\] (3)

Furthermore, the ROIC can be calculated as:

\[
ROIC = \left( \frac{\text{Total tax expenses}}{NOPBT} \right) \times (1 - ETR)
\] (4)

where

\[63\] British Broadcasting Corporation 2012, Bowers 2013, Neville & Treanor 2012
\[ ETR = \]

where \( \text{ROIC} \) = Return on invested capital  
\( \text{WACC} \) = Weighted average cost of capital  
\( \text{Invested Capital} \) = Total cash invested in firm, net of depreciation  
\( \text{NOPAT} \) = Net operating profit after taxes  
\( \text{NOPBT} \) = Net operating profit before taxes  
\( ETR \) = Effective tax rate

From the above formula, it can be advised that MNEs can simply create the shareholders’ value by following: (1) minimizing the effective tax rate of the enterprise, (2) increasing its efficiency in generating revenue from invested capital (or capital turnover), and (3) increasing profitability by reducing costs and improving its production efficiency (or operating profit margin) (Kobel 2009). Since transfer pricing is considered as one of the potential way to minimize MNEs’ global effective tax rate and vice versa, it is essential for top management and even board of directors to involve transfer pricing issue into risk management. As Angeline Ziouslas (via Financial Post 2013), a transfer pricing expert, claims that transfer pricing is the art not the science, the MNEs can be put at risk when implementing transfer pricing as it is in the grey area of the interpretation of fair share of taxes between tax jurisdictions. Therefore, to prevent tax dispute with tax authorities, several researchers and transfer pricing experts have suggested MNEs to use the proactive approach to minimize risks associated with transfer pricing practice. The approach includes the establishment of transfer pricing policy, improvement of tax department efficiency, acquiring the experts or their advice in setting their transfer pricing strategy and entering into advanced price agreement (APA) (Financial Post 2013, Sikka & Willmott 2010). According to Kobel (2009), Ziouslas (via Financial Post 2013), Sanschangrin and Isensee (2013), they find that such proactive approach can improve the shareholders’ value as a good proactive approach will provide the MNEs with spare time, effort and money necessary for managing its businesses.

\(^{64}\) Loh 2013, PricewaterhouseCoopers 2010
Chapter 3

1. Transfer pricing in Italy

In the last few years in Italy, a lot of attention has been given to transfer pricing. Until 2010 this was related to a delocalization process since we were experiencing companies that were relocating their manufacturing activities out of Italy into countries with low production costs, developed infrastructure, tax incentives and a skilled labor force aiming at a long-term strategic response to the increasingly challenging business environment. Furthermore, highly centralized business model structures resulting from supply chain restructuring became the norm within multinational enterprises with a concentration of high-value intangibles and entrepreneurial functions and risks in tax-advantaged jurisdictions. In 2010, Italy established the penalty protection documentation rules together with the early recognition of the 2010 OECD Guidelines. In the annual tax return now, Italy also requires the reporting of the totals of inter-company transactions. These changes have significantly intensified the importance of transfer pricing with a much broader level of awareness and general interest. Transfer pricing has also become one of the key audit and tax adjustment areas in the past year from the perspective of the Italian tax authorities.

Statutory rules

The Italian Income Tax Code sets the Statutory rules on transfer pricing in Article 9 and Article 110. Article 110, paragraph 7, states that components of the income statement of an enterprise derived from operations with non-resident corporations that directly or indirectly control the enterprise, are controlled by the enterprise or by the same corporation that itself controls the enterprise should be valued on the basis of the normal value of the goods transferred, services rendered and services and goods received, if an increase in taxable income would arise thereby. Because of the normal value rule, possible reductions in taxable income are allowed only based on mutual agreement procedures or on the European Union (EU) Arbitration Convention. Article 9, paragraph 3, affirms that ‘normal value’ means the average price or consideration paid for goods and services of the same or similar type, carried at market conditions and at the same level of business, at the time and place in which the goods were purchased or the services were performed. To determine the normal value, reference should be made to the extent possible to the price list of the provider of goods or
services. In the absence of the provider’s price list, reference should be made to the price lists issued by the Chamber of Commerce and to professional tariffs, considering usual discounts.

The translation of the above statutory rules into operating guidelines was effected through the Ministry of Finance instructions in Circular Letter No. 32/9/2267, dated 22 September 1980. The Circular Letter imparts principles and methods to be utilized in determining normal value. Its current status is now unclear, as it is based on the 1979 OECD Transfer Pricing Report, and the transfer pricing documentation provisions introduced by Law Decree 78 of 31 May 2010 make clear reference to the 2010 Organization for Economic Co-operation and Development (OECD) Guidelines. Tax auditors have applied the Circular Letter for many years and may continue, even though the International Office of the Italian Tax Authority discourages this. In some situations, local practice in the field continues to deviate from the most updated OECD position. Transfer pricing documentation provisions have been included in Law Decree 78 of 31 May 2010, which was converted into law on 30 July 2010. For enterprises that comply with the documentation requirements it provides a penalty protection regime, including the detailed format as set out in a Regulation dated 29 September 2010 and that notifies possession of documentation when they file their tax returns. The provision of compliant documentation relieves taxpayers from the normal regime of tax geared penalties on adjustments since the adjustment relates to a transfer pricing matter.

Burden of proof

The burden of proof lying with the ITA is the general principle; however, in the event of an assessment by the tax authorities, the taxpayer has to demonstrate the fairness of its inter-company transactions. Particular rules apply to cross-border transactions involving counterparties (including third parties) resident in tax havens. The Italian taxpayer must provide evidence that the foreign party is a genuine commercial undertaking, that the transactions were effected in connection with a real economic interest and that the relevant transactions actually took place in order to deduct the relevant costs; they must be disclosed in the company’s tax return otherwise penalties will apply. The rules relating to such costs are independent from Italian transfer pricing rules.

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65 Italian tax authorities
Tax audit procedures - Selection of companies for audit

The ITA focuses on major taxpayers therefore on multinationals. From 2002, at least once every two years taxpayers with turnover above 26 million euro are expected to be systematically audited; moreover, at least once every four years, taxpayers with turnover exceeding EUR 5.2 million will be audited. These audits can be complete and extensive or focus just on specific items such as transfer pricing. They are considered as a general guideline for tax audits even if these parameters, introduced by Article 42 of Law 388/2000, are not consistently met, as stated by Revenue Office Circular (hereinafter Circular) 6/E, dated 25 January 2008. Provisions concerning ‘large taxpayers’ were introduced by Law Decree n. 185/2008. The decree provides that companies with turnover exceeding EUR 100 million will be audited by dedicated tax offices. Also as confirmed by Circular Letter 21/E of 18 May 2011, ITA should focus attention on large taxpayers. It is also increasing the level of exchange of information with foreign tax authorities. Law Decree 78 of 31 May 2010 included the provision of information and duty of the taxpayer to cooperate with the tax authorities Transfer pricing documentation provisions. The Regulation of 29 September 2010 contains detailed specification about the form and content of this documentation.

The Regulation is based on the EU Code of Conduct for Transfer Pricing Documentation and follows the concept of master file and country file.

The Master File will contain information about the group and will be structured as follows:

- General description of the Multinational Group
- Group structure
- General strategies pursued by the Group and any changes of strategy compared to the prior financial year
- Flow chart of the intercompany transactions
- Intercompany transactions
- Functions, assets and risks
- Intangible assets
- Transfer pricing policy
- APAs and rulings concerning transfer pricing with the tax authorities of EU Member States.

66 the so-called anti-crisis decree
It is possible to deliver more than one Master File if the MNE operates in different sectors, each of them being governed by specific transfer pricing policies.

The National File will contain information about the company and will be divided as follows:

- General description of the company
- Sectors in which the company operates
- Operational structure of the company
- General strategies pursued by the company and any changes of strategy compared to the prior financial year
- Intercompany transactions
- Cost Contribution Arrangements.

The Master File as well as the National File are required to be presented by the Holding companies or permanent establishments of holding companies. Sub-holding companies and permanent establishments of sub-Holding companies are required as well to present them. A sub-holding company can present together with the National File, the Master File prepared by its non-resident holding company. Controlled companies and permanent establishments of controlled companies are only required to present the National File. The records must be kept for at least 10 years. Italian-based groups, which include non-Italian subsidiaries, must produce both a master file and a country file; Italian subsidiaries need to produce only a country file. An Italian sub-holding company with at least one non-Italian subsidiary must produce a sub-holding master file as well as a country file, although it can choose to produce the group master file if compliant as to form and content. This requirement of a sub group master file also applies to an Italian branch of a company that has non Italian subsidiaries regardless of whether the investments are held by the Italian branch. Both documents must be prepared in Italian, but an Italian sub-holding company can produce a master file in English provided the file is for the entire EU-based group. Annexes can be in English. The documentation is not required but the regulation states that whether or not a company has communicated its existence, it will influence the tax authorities in their risk assessment as an indication of taxpayer transparency and willingness to cooperate. The documentation that is considered to meet the requirements of the regulation will protect taxpayers from tax-gereared penalties on any transfer pricing adjustments. The format is mandatory and prescribed in detail. If the taxpayer has notified possession of such documentation by 28 December 2010 or
at any point thereafter until a tax authority audit or visit take place, the penalty protection is also applicable to past open years. However, once an audit begins, the opportunity is not available anymore. On tax auditor request, the documentation must be produced within 10 days. If requested, taxpayers have a further seven days to produce additional supplementary information. The penalty protection is lost if the taxpayer is unable to meet these deadlines. The transfer pricing documentation must be produced annually. Small and medium companies\(^6\) need to perform the method selection and economic analysis part of the documentation only every three years, provided there has been no significant change in the business and that the economic analysis is based on public available databases. The company’s legal representative must sign on each page and the documentation must be submitted electronically. The regulation does not impose specific methodologies but refers in general to the 2010 OECD Guidelines emphasizing the preference for traditional transaction-based methods. General rules on tax documentation also continue to apply to inter-company transactions. In accordance, the company should be able to substantiate all income and expense items. During an audit, the ITA may require taxpayers to produce documents or other information (also in the form of answers to questionnaires). In this case, taxpayers must comply with the requests. An assessment may be made based on the tax authority’s assumptions if a taxpayer fails to submit the documentation within the time frame provided in the tax authorities’ request.

**The audit procedure**

Tax audits in Italy are normally based on the taxpayer’s premises; the duration of an on-site tax audit may not exceed 60 days of presence at the taxpayer premises; at the end, the authorities release a report with findings and proposed adjustments. Within 60 days the company may file a defense brief or rebuttal against the tax audit report with the relevant tax office. The tax office may not issue a tax assessment until the 60 days have elapsed. Tax authorities will not necessarily issue an assessment immediately after the 60 days expire, and the formal assessment may not appear for some time. Tax issues, including transfer pricing, may be settled with the tax authorities without litigation. The relevant procedure was introduced by Decree 218/1997 and is termed *accertamento con adesione*. If an agreement is reached, an official report is produced showing the amount of taxes, interest and penalties due. In the event a settlement is reached, penalties are reduced to 33% of the total amount

\(^6\) defined as those with a turnover of less than EUR 50 million
due. Once litigation begins, the company and the tax authorities may still settle the dispute out of court. They are required to take into consideration this option if they have not already done so. The procedure, introduced by Article 48 of the Decree 546/1992, is called the judicial settlement procedure. In the case a settlement is reached during the judicial settlement procedure, penalties are reduced to 40% of the total amount due. If the dispute is decided in court against the taxpayer, the penalties are applied in full. There are three stages before a final judgment is reached with no further prospect of appeal: First Instance (provincial), Second Instance (regional) and Supreme Court or Corte di Cassazione. Unless a suspension is obtained while the dispute is pending, the tax authorities are allowed to collect 50%\(^\text{68}\) of the tax assessed before the first instance decision is given; two-thirds of the tax (and penalties) due, following the first-degree judgment; and the total taxes (and penalties) due, following the second-degree judgment.

**Resources available to the tax authorities**

There are units dedicated to transfer pricing, and the number of audits has increased in recent years. There are more qualified personnel performing audits, and staff members in local offices have also received transfer pricing training. The Italian administrations have created specific task forces to monitor larger companies on all their tax issues, with particular emphasis on transfer pricing and permanent establishments.

**Use and availability of comparable information**

A taxpayer’s documentation is expected to include a benchmark analysis showing that the results earned by the company are within the arm’s length range of results realized by comparable companies to support their transfer pricing policy. Under the penalty protection rules, the Italian tax authorities have indicated that, except for small and medium sized enterprises\(^\text{69}\), they expect to see a new benchmark (including new company selection) each year. Italian companies are required by law to file their financial statements with the local Chamber of Commerce. Hence, it is possible to obtain detailed data on the results of other companies, including extensive notes in many cases. These can be accessed online by taxpayers and tax authorities. There are databases allowing research of comparable companies at the European and Italian levels. The Italian tax authorities have access to these.

\(^{68}\text{reduced to 33\% by Law Decree 70/2011}\)

\(^{69}\text{turnover less than 532 International Transfer Pricing 2013/14 Italy EURO 50 million}\)
Risk transactions or industries

In 2008, the Italian tax authorities\(^\text{70}\) issued Circular Letter n. 6/E, dated 25 January 2008. It highlights for consideration international transfer pricing as well as inter-company transactions between resident Italian companies when an internal transfer pricing issue could occur because of the presence of a favorable tax regime. The focus on transfer pricing was confirmed by Circular Letter n. 13/E of 9 April 2009 and Circular Letter n. 20/E of 16 April 2010. The Italian Tax Police\(^\text{71}\) issued Circular Letter n. 1/2008 containing guidelines to be followed by its officers when performing tax audits. Chapter 6, titled ‘International Tax and Tax Audits Methodologies’, provides operative guidelines for tax officers when they assess companies on transfer pricing and permanent establishment issues. The circular provides specific criteria for officers to identify Italian companies whose inter-company transactions attract particular attention.

- Transactions with foreign-related companies in jurisdictions where they benefit from favorable tax regimes.
- Transactions concerning intangible assets (such as royalties) and services (management fees).
- Transactions where the Italian company acts as a mere intermediary (commissionaire, agent) and receives a commission-based remuneration.
- The sale of high-value intangible properties by the Italian company to foreign entities.

Limitation of double taxation and competent authority proceedings

Italy has begun to use the EU Arbitration Convention and has given a boost to mutual agreement procedures for intra-EU issues. The use of the competent authority process to obtain correlative adjustments has not been common in Italy in other circumstances to date. Some aspects of the mutual agreement procedure have been clarified by the Italian Tax Authority in Circular No. 21/E of 5 June 2012. Some key points of the Circular are:

- It is not possible for an agreement under MAP or the Arbitration Convention to override an Italian court judgment or any negotiated settlement between www.pwc.com/internationaltp 533 I the Italian tax authorities and an Italian taxpayer.

\(^{70}\) Agenzia delle Entrate
\(^{71}\) Guardia di Finanza
Hence, a court judgment or an out of court settlement will preclude any alternative outcome in Italy at competent authority.

- An Italian taxpayer must appeal the tax assessment in order to apply for MAP under a bilateral tax treaty. For an Arbitration Convention procedure to go ahead, however, the taxpayer must be prepared to withdraw from the tax appeals procedure.
- It is possible to continue with appeals on other matters not covered by MAP or the Arbitration Convention at the same time as embarking on the mutual agreement procedure for transfer pricing issues.
- The process for requesting that the collection of tax assessed in Italy be suspended varies between MAP and the Arbitration Convention. However the implication is that suspension should be granted in both cases.
- Concerns that the automatic referral in Italy of a tax adjustment above a certain (low) threshold for consideration in the criminal courts constitutes a ‘serious penalty’ and hence prevents access to the Arbitration Convention are confirmed to be groundless. This should be evaluated on a case by case basis.
- If an agreement under MAP is successfully concluded and the circumstances have not changed, the Circular recognizes the possibility of also applying the terms for the years immediately subsequent to those of the MAP.

Advance pricing agreements (APAs)

On 23 July 2004, an official procedure was published for a so-called ‘International Ruling’, which had been introduced by Article 8 of Law Decree No. 269 of 30 September 2003. This advance ruling is unilateral, although it is possible to achieve a bilateral effect by using two unilateral agreements. From the last part of 2010, the ITA particularly has increased the number of instances where a bilateral process with other countries is followed. The procedure involves companies engaged in ‘international activity’ and may cover transfer pricing, dividends, royalties and interests. The following may apply:

- Italian resident enterprises that have transactions that fall under the Italian transfer pricing rules and/or entities that are owned by non-resident shareholders or themselves own non-resident entities and/or enterprises that receive or pay dividends interest or royalties to or from non-Italian persons.
Any non-resident company carrying on activity in Italy through a permanent establishment.

The ruling application must be submitted to one of the competent offices (i.e. Milan or Rome office, on the basis of a company or permanent establishment tax residence, although any application interested in invoking a bilateral approach needs to be made in Rome). The information to be included in the ruling application under penalty of non acceptance is:

- General information concerning the company, such as the name, its registered office, its tax and VAT identification number, and so on.
- Documentation that proves the eligibility requirements.
- Scope of the application and the purpose of the ruling request.
- The signatures of the legal representatives.

The relevant rulings office may inform the taxpayer to appear to verify the accuracy of the information provided and to define terms and conditions for the subsequent negotiations within 30 days from the receipt of the application or from the completion of any inquiry activity. The full procedure should be completed within 180 days from the filing of the request, but the parties may agree to extend the deadline. In practice, the APA negotiation procedure is generally a long process. Once an agreement has been reached, it remains in force for three years (the year in which the agreement is signed and the two following years). There is no formal rollback provision either for years before the application was made or for years subsequent to the application but before the agreement was signed. The taxpayer may ask for a renewal within 90 days before the expiry of an existing APA agreement. The Revenue Office must approve or decline a renewal at least 15 days before the agreement expires. In 2010, the ITA issued a report of the number of APAs achieved and in process as at 31 December 2009, with some analysis of time taken, methods used etc. The number of applications has increased significantly since that date.

**Anticipated developments in law and practice**

Under the relevant tax treaties the ITA has indicated on more than one occasion that it hopes to establish a framework for bilateral APAs. As indicated above, it appears that the ITA is
now doing this on a wider basis even though there has been no formal announcement of change.

**OECD issues**

Italy is a member of the OECD and uses the OECD Guidelines in bilateral dealings with other tax authorities. Reference has been often made to the 1995 OECD Guidelines by taxpayers in the absence of detailed and up-to-date local regulations, but the 1980 Ministerial Circular still tends to be a tax auditor’s first point of reference until the law changes. The Italian courts have recognized the 1995 Guidelines as persuasive. It is also important to note that in relation to other OECD material (e.g. the OECD Model Treaty Commentary), the Supreme Court limited the role of the OECD Commentary in three identical decisions relating to a permanent establishment case, all in 2006. This was held not to have legislative value, but to represent a recommendation that may not override local law. The 29 September 2010 regulation on transfer pricing documentation explicitly refers to the 2010 OECD Guidelines, to the EU Code of Conduct as the basis underlying Italian documentation and to the transfer pricing methodologies of the OECD Guidelines.

In joint investigations on 1 May 2006, Italy became the 12th party to the joint OECD Council of Europe/ OECD Convention on Mutual Assistance in Tax Matters. As a party to the convention, Italy enhances its ability to combat tax evasion and avoidance through exchange of information on a wide range of taxes. The other parties to the convention are Azerbaijan, Belgium, Denmark, Finland, France, Iceland, the Netherlands, Norway, Poland, Sweden and the United States. A key feature of the convention is the ability to take part in simultaneous multilateral examinations. Some joint investigations occurred.

**Deductibility of interest payable**

The 2008 Finance Act (24 December 2007 Law no. 244) replaced the previous limitations on interest deduction (i.e. thin capitalisation and pro rata rules). The new rule states that payable interests and similar charges are fully deductible in each fiscal year, to the extent of receivable interest and similar income. In addition, any excess of payable interest over receivable interest is deductible up to 30% of EBITDA. The non-deductible amount may be carried forward without any time limit. The new interest deduction limitation does not apply to certain taxpayers, including individual entrepreneurs, partnerships, banks, financial entities, insurance
companies and their holdings. It does apply, however, to holdings of industrial and commercial groups. The rule applies to interest due, both to related parties and to third parties.

2. Law Cases examples

In the last few years, there have been a number of court decisions relating to transfer pricing. The most important cases are summarized below; they provide general principles on various points (i.e. concept of free competition, arm’s-length definition, burden of proof and necessary documentation for deducting inter-company service charges). Decisions from the Supreme Court represent the final judgment in an Italian tax case. Provincial and regional tax court decisions represent first and second instances.

The Judgment No. 13233 of the Supreme Court, fiscal division (October 2001), deals with the concept of ‘free competition’. An Italian company subject to assessment (ITCO) purchases goods from its foreign parent. The Italian tax authorities (ITA) adjusts the purchase price on the grounds that it is not at arm’s length. The ITCO appeals to the court and claims that transfer pricing provisions are not applicable in this case due to the absence of free competition in this sector in Italy; only one other Italian company produces the same product, and it is under the license from its foreign parent. The court determines that in order to speak of ‘free competition’, it is enough that a similar product is sold in Italy without any legal restriction on pricing. There is no need to have ‘ideal’ free competition. For this reason, the court rejects the appeal.

The Judgment No. 130 of the Tax Court of Tuscany (January 2002) concerns the definition of ‘arm’s-length value’. The tax court states that normal value can be determined by reference to average data from the sector in particular, data provided by the trade association to which the Italian resident company belongs, or data confirmed by financial statements from Italian companies in the same sector.

The Judgment No. 253 of the Tax Court of Ravenna (November 2002) concerns a non-interest-bearing loan made to a controlled non-resident company. An ITCO grants a non-interest-bearing loan to a controlled company resident in Luxembourg. The ITA assesses interest income at the ‘normal value’ based on the Italian Bankers Association (ABI) prime rate. The ITCO is not able to justify the reasons for having granted a significant non-interest-
bearing loan to its foreign affiliate when the ITCO bore interest costs on its own external debt. The tax court recognizes that the inter-company loan should have generated interest receivable for the Italian company as argued by the ITA.

The Judgment No. 1070 of the Tax Court of Vicenza (February 2003) concerns inter-company sales made without mark-up. An ITCO sells raw materials to a German related company at a price equal to the purchase price without any mark up. Based on data in the company’s financial statements, the ITA derives an average mark-up on costs released by the ITCO in its other operations (38%) and applies this mark-up to the sale of the raw materials. The tax court determines that the assessment should be cancelled for the following reasons:

- The operation under review is of negligible value compared with the volume of purchases and sales made by the ITCO as a whole.
- The operation is not comparable with the company’s usual inter-company transactions (ITCO’s business activity consists of sales of finished products).
- The operation is undertaken for the purpose of allowing the German company to produce a particular product to sale to an important Italian client. The aim was a significant increase of the ITCO’s overall business.

The Judgment No. 13398 of the Supreme Court, fiscal division (September 2003) concerns the burden of proof. An ITCO (in a tax loss position) applies to sales made to its French parent company at a 6% rebate once a certain sales threshold is reached. The ITA considers that the rebate is not justified by reference to costs and risks deriving by the French company and subsequently determines an adjustment on the ITCO, arguing that the company should have demonstrated that the rebate was justified by reference to distribution costs and risks derived by the parent company and consequent savings for the ITCO. A matching of savings and rebates is considered necessary to show that the prices applied are in line with those applied to the third parties. The court decided that in the absence of the required benefits demonstration, the ITA adjustment was correct.

The Judgment No. 158 of the Tax Court of Milan (June 2005) concerns the documentation necessary to support the deductibility of inter-company services charges. An ITCO receives charges from its foreign parent company under a multilateral service agreement. The ITA due to alleged lack of documentation considers these charges non-deductible. The Milan Tax Court decides in favor of the ITCO, judging that it has presented sufficient documentation to
show the certainty of the costs sustained and that the costs were related to the ITCO’s business, including:

- Written agreement describing the services provided.
- Comfort letter issued by a major audit firm attesting that the cost allocation have been correctly performed and that the attribution of costs to the various group entities have been made on the basis of the benefits they received.
- Invoices containing a detailed description of the services performed.
- Demonstration that the costs borne, with reference to the services received, were correctly recorded in the accounting records and included in the financial statement of the Italian company.
- Documentation describing, for each type of service, the nature of the activity performed and the advantage received by the Italian company.

The Judgment No. 22023 of the Supreme Court, fiscal division (October 2006) sets the important principle that the inappropriateness of a company’s transfer pricing must be proved by the ITA, which bears the burden of proof that the company does not comply with the arm’s-length principle. An ITCO purchases cars from foreign related companies and bears repair and maintenance costs on new cars without adequate remuneration. The ITA argues that this causes a reduction in the Italian tax base and an increase of profit for related companies resident in low-tax jurisdictions but does not provide any real evidence of this. The court decides in favor of the ITCO because the ITA do not demonstrate that the group’s transfer pricing is unfair. The court refers to the OECD Guidelines, which expressly state that if the local jurisdiction provides that the tax authorities should set the reasons for any adjustment, the taxpayer is not obliged to prove the correctness of its transfer prices unless the tax authorities have first demonstrated that the arm’s-length principle has not been observed.

The Judgment No. 52 of the Tax Court of Pisa (February 2007) concerns the applicability of the CUP methodology. The ITA issues a notice of assessment on an ITCO, a company operating in the garden pumps market, to cover revenue resulting from the sale of products to a French related party at a price lower than the normal value. The ITA compares the sale prices applied to third parties with those applied to the French related company, observes that the intercompany prices are lower by about 10%, and assesses the difference. However, the court agrees with the arguments of the taxpayer, which demonstrates that the transactions taken by the ITA are not comparable as regards to the stage of commercialization, the
volumes involved, and the number of shipments. These differences would be sufficient to justify a 10% difference in the sale price. The court states that the ITA should at least carry an analysis of the tax rates in force in the two countries and the comparable transactions.

The Judgment No. 9497 of the Supreme Court, fiscal division (April 2008) concerns the power of the ITA to verify the appropriateness of compensation agreed between Italian resident companies. An ITCO have an existing contract with its directly controlled Italian refinery for the receipt of certain refinery oil services. The refinery compensation is guaranteed to cover all the plant’s fixed costs and variable costs and provide a fair profit margin. Both the ITA and the provincial tax court disallow the profit margin paid by ITCO to the refinery. However, the regional tax court decides that the service received by ITCO is definitely related to its own operations, and any requirements in transfer pricing and anti-avoidance provisions that would allow the ITA to disregard the agreement between the parties are not met. The Supreme Court revokes this judgment, determining that the ITA may verify the amount of costs and profit in financial statements or tax returns and make relative adjustments where there are no accounting irregularities or errors in legal documents. The ITA may deny deductibility, in fully or in part, where a cost is considered to be without foundation or is disproportionate. Therefore, the ITA is not bound to the values or the compensation arrived at in company decisions or contracts.

The Judgment No. 20 of the Regional Tax Court of Bologna (April 2008) concerns the deductibility of management costs derived from a written contract between the parties prior to the cost recharge and the use of a percentage of turnover mechanism. An ITCO is charged certain management costs by its parent based on a lump sum linked to estimated turnover. The ITA disallows the deductibility of these costs as there are no analysis of their nature and, therefore, it might be assumed some are not relevant to the ITCO’s business. The ITCO argues that although it is part of a group, it is not fully controlled, as there is a 35% minority interest. The services are agreed and performed on the basis of a written agreement signed before the fiscal year in question. The contract states remuneration for these services (equal to 2.86% of turnover), which should be considered arm’s length. The regional tax court agrees with the taxpayer arguments taking into account the fact that the ITA’s case is based on mere assumption. The ITA does not prove the absence of services or that the services have no bearing on ITCO’s business.
The Judgment No. 87 of the Regional Tax Court of Milan (March 2009) concerns the application of the arm’s-length principle to intercompany sales in a multinational group. The ITA issues a notice of assessment on an ITCO (a contract manufacturer) for fiscal year 2003, on the basis that the ITCO have sold finished goods to a Swiss related company at a price lower than the arm’s-length price in order to transfer income to Switzerland. The ITA’s challenge is based on the fact that the Swiss company sold the same products to an Italian reseller in the group at a higher price. The ITCO claims the higher price charged by the Swiss company to the Italian reseller is justified for the following reasons:

- The Swiss company owns the trademarks and patents; performs research and development; and bears the foreign exchange, credit, and inventory risks.
- The ITCO performs manufacturing for the Swiss company and does not bear any inventory risk as a contract manufacturer.
- The Italian reseller performs finishing activities based on local market preferences and manages the sales network.

The court cancels the assessment, as it does not consider the ITA have discharged the burden of proof to show the prices to be non-arm’s-length. Moreover, the court considers that the sales prices from ITCO to the Swiss company are in line with those applied by the Swiss company.

The Judgment No. 5926 of Supreme Court, fiscal division (March 2009) concerns the deductibility of inter-company costs charged by a non-resident entity to its permanent establishment in Italy. The case deals with the determination of certain overhead costs (administrative expenses, flight operations, and maintenance of the fleet) related to the international airline business and paid by a company resident outside of Italy also for its permanent establishment in Italy. The ITA issues a notice of assessment on the ITCO for 1998, disallowing costs that it considers undocumented. The provincial tax court confirms the ITA’s position. ITCO appeals to the Supreme Court, claiming that it was not possible to make a detailed individual analysis of costs as they were incurred by the overseas company and charged pro rata to the branches based on the latter’s sales. The financial statements and the auditor’s report are appropriate to support the non-resident company costs charged to Italy, unless the tax office could show errors committed by the auditor. The Supreme Court agrees with the taxpayer and confirms that the auditor’s report on the financial statements is sufficient to support the costs registered in the annual financial statements.
The Judgment No. 396 of the Provincial Tax Court of Milan (January 2010) concerns the transfer of functions and risks from an Italian company to another firm of the group for registration tax purposes. The case deals with the conversion of an Italian entity operating as a fully fledged manufacturer into a toll manufacturer with the relocation of certain functions and risks to a Swiss related company. The ITA argues that this operation represented a transfer of a going concern, subject to registration tax. The ITA issues a notice of assessment, which is challenged by the ITCO. The Provincial Tax Court of Milan determines that the mere transfer of risks and functions does not represent a business transfer and therefore no registration tax is due.

The Judgment No. 7343 of the Supreme Court, fiscal division (March 2011) concerns the application of rebates on inter-company sales. The case regards the application of discounts granted by an ITCO on sales to intercompany entities. The ITA makes a transfer pricing adjustment disallowing the discounts on the grounds that no discount is granted on sales to third parties. The ITCO argues that the transactions are not comparable since the goods sold to related parties are at a different stage in the production/distribution chain. The Supreme Court confirms the ITA view, rejecting the ITCO’s arguments by a lack of comparability.

The Judgment No. 134 of the Provincial Tax Court of Reggio Emilia (March 2011) concerns the possibility that the taxpayer is exempted from the burden of proof. The court states that the burden of proof in transfer pricing cases is on the ITA, which has to demonstrate that the inter-company transactions, as implemented by an ITCO, are not at arm’s length. The ITA has to determine the ‘normal value’ of the transactions and demonstrate that a tax advantage is achieved by the ITCO (i.e. taxation in the counterparty’s country was lower than in Italy).

The Judgment No. 580 of the Tax Court of Lazio (September 2011) concerns the application of a different transfer pricing method by the ITA compared to the method selected by ITCOs for its intercompany transactions. The taxpayer calculates its inter-company prices based on the return on capital employed (ROCE). The ITA argues that the ROCE is not the appropriate ratio and makes a transfer pricing adjustment based on what is described as TNMM but without further reference to the ratio. The Tax Court of Lazio rejects the ITA’s challenge based on the following reasons: the ITA should have demonstrated both the lack of economic reasons underlying the ROCE and that the ITCO was pursuing a tax avoidance strategy. The Court states that since the ITA did not provide the above evidences and ROCE is an indicator provided by OECD, the application of an alternative method compared to the one chosen by
the taxpayer is not legitimate. The Tax Court also comments on the benchmark analysis performed by the ITA recognizing the lack of comparability of some comparable found by the Office.

The Judgment No. 129/19/2011 of the Tax Court of Lombardia (October 2011) concerns the burden of proof in relation to transfer pricing disputes. This case concerns the prices applied by an Italian manufacturer to the Group Swiss Principal. In particular, the ITA compares these prices with the prices at which the principal sold the same goods to an Italian related distributor. This approach results in an adjustment since the prices between the principal and the distributor are higher than those applied by the manufacturer to the principal. The Tax Court rejects the ITA’s adjustment for the following reasons: the prices between the principal and the distributor, as inter-company prices, do not represent a market comparable; the company demonstrates the business reasons of the principal structure; the ITA does not challenge any violation of tax law in Switzerland or Italy; the fact that both the manufacturer and the distributor are resident in Italy and their premises are close to each other is not relevant since the whole business model underlying the transactions needs to be considered.

The Judgment No. 80/27/12 of the Tax Court of Lombardia (June 2012) concerns the deductibility of inter-company services charged. The case relates to a challenge by the ITA to the deduction of costs charged by its French parent to an ITCO for administrative, legal, accounting and fiscal services and the costs related to the implementation and maintenance of the operating software. In particular, the ITA challenges that these costs are not deductible because the taxpayer did not demonstrate that these were relevant to its business activity (art. 109, par. 5 Italian Tax Code). The ITCO, in order to prove the deductibility of the costs, produces: the inter-company contract signed before the services was provided, describing the nature of services provided; the monthly reports summarizing the activities performed by the service provider; spreadsheet showing the costs incurred by the service provider and the allocation of these costs to the Group recipients. The Regional Tax Court states that the evaluation of the deductibility of service costs should be made applying the transfer pricing principles stated by the OECD, particularly regarding the analysis of the benefit provided to the recipient. According to the Tax Court, the existence of the above mentioned documentation and, in particular, the consistency between the contractual provision and the services actually supplied, is sufficient to demonstrate the actual provision of the services and
the benefit for the recipient. Therefore, the Tax Court acknowledges the deductibility of the service costs.

The Judgment No. 11949 of the Supreme Court, fiscal division (July 2012) concerns the burden of proof in cases of adjustment of costs. An ITCO is an Italian distributor of software purchased from a UK related party. Close to the year-end, the ITCO received a transfer pricing adjustment from the UK entity increasing the transfer prices of the goods supplied during the year. The ITA challenges the deduction of this year-end adjustment. It is worth mentioning that the Regional Tax Court denies the ITA challenge. The Supreme Court acknowledges that the arm’s-length principle (Art. 110, paragraph 7 of the Italian Income tax code) is an anti-avoidance provision and, accordingly, the burden of the proof of the taxpayer’s avoidance aims lies with the tax authorities. However, since the challenge considered here, related to inter-company costs incurred by the Italian taxpayer, the latter has to demonstrate that the costs are necessary for its business activity and resulted in a benefit for the Italian taxpayer. The Supreme Court states that the ITCO did not provide evidence of the benefit deriving from the costs challenged particularly regarding the year-end adjustment; the transfer pricing study prepared by the company to support its transfer pricing is not considered sufficient.

3. Case companies – Volvo and Innovo Ltd.

Volvo

Volvo was incorporated in 1915 as a subsidiary of AB SKF, the Swedish ball bearing manufacturer. In 1924, the two founders decided to start the construction of a Swedish car and three years later, it left the factory in Gothenburg. This was the birth of Volvo. A year later, they sold their first manufactured truck, which was an immediate success, and during the 1930s, they started to produce buses. Since then their range of products has been increased with aircraft engines, terrain vehicles, marine engines etc. Volvo cars were though sold out to Ford Motor Company in 1999. Today Volvo Group includes 20 different companies with sales activities in more than 180 countries and production facilities in 19 countries, which one of them is in China. (AB Volvo Group) At Volvo Ida Hjertberg & Sanna Pettersson (2010) interviewed Mr. Lars-Eric Ericson whose current position is responsible for international
taxation and transfer pricing. Mr. Ericson has been employed at Volvo since 1996 but his experience on transfer pricing goes back to the middle of the 1980’s by several different positions at the Swedish authorities and companies.

**Strategy at Volvos**

As we have seen in the previous pages, theory provides a variety of models for calculating transfer prices and each model has its advantages as well as disadvantages. The choice of the model depends on the company structure, on organization goal and on the product or service sold. Within each and every model, different methods and approaches can be used, and that can result in as many different transfer pricing strategies as there are MNEs. Volvo operates in the manufacturing industry and has chosen a centralized model where the decisions on transfer pricing are taken from the management and local companies have limited opportunities to make decisions. Inside Volvo’s company, there is a department that is responsible and ensures that the different companies inside the group follows transfer pricing policies. This is to avoid not being in compliance with the law and directives. Hjertberg & Sanna Pettersson (2010) state that Mr. Ericsson at Volvo is sure that transfer prices should be separated from the operational activities.

“For Volvo it is not the tax optimization that is most important, it is the fact that the group can use their resources all over the world without any tax obstacles.”

In the Hjertberg & Sanna Pettersson (2010) paper, they explain that for Mr. Ericsson it needs to be possible to move know-how or technology from one country to another without any major tax concerns. That is why Volvo has chosen a business model where all intellectual property is owned from Sweden with the Swedish companies representing all the risks, while other companies are guaranteed a fixed result for their services. Mr. Ericson added that Volvo has divided their companies into two different types, Entrepreneurs and Service Providers. Entrepreneurs within Volvo group are situated in Sweden; all other companies are Service Providers. The Entrepreneurs are risk takers and the Service Providers perform defined services to the entrepreneurs. These services can be within research & development (R&D), production and distribution etc. The Service Providers are guaranteed a specific result for their services hence the entrepreneurs are the ones taking all the risks. In good times, the

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72 Mr. Lars-Eric Ericsson – Volvo
73 for example Volvo Trucks, Buses, Penta or Aero
entrepreneurs are the ones making high profits while in bad times they take all the losses. The Service Providers are not affected by the external market to the same extent, as their result of a business always is secured in advance. The guaranteed result is decided by Corp Tax and based on comparable transactions. The group companies involved are then responsible for setting prices to meet the guaranteed result. As a general rule, Volvo always tries to use the described result model based on comparable transactions, but depending on the service, other methods can occur. For example, the method of return on capital employed can be used within production, cost plus method within R&D and other services.

**Picture 3 - Volvo’s Strategy**

The result based business model with one company taking all the risks makes it possible to develop and produce products in any country but pay the research and development from Sweden with a mark-up for the subsidiary’s costs. This allows the product to be sold to any country within the company group without any occurring transactions between the producing country and the buying country. All transactions are gathered in Sweden, which is favorable, as Volvo often has quite complex transactions with several countries involved. Parts of one engine can be produced in several different countries and then sold to yet another; if there was not one single owner and risk taker it would have been almost impossible to sort out the proportion of the profit for each participating unit. By coordinating the transactions, it facilitates to sort them out and makes it possible to move technology and production between countries.

*Innovo Ltd.*
Established in 2012, Innovo Engineering & Construction Ltd. is an independent manufacturing and engineering company based in Aberdeen (UK). It is devoted in providing high value professional services and high technology equipment for subsea telecommunication, offshore renewables, Oil & Gas and marine business scenarios. It designs and manufactures dedicated machinery utilized for various scenarios: from cables and flexible laying, riser recovery, wellhead installation, pipeline repair, deep-water oil & chemical agent recovery up to subsea well inspection and maintenance working at both high environment pressure and high temperature. In 2014, INNOVO pushed technology beyond its limits, delivering the largest capacity and operationally proven Powered Reel Drive System available in the Offshore Oil & Gas and Renewable Industry, the INNODRIVE-600. One year later, the company already obtained the appraisal for the INNODRIVE-800, reaching new heights in terms of product capacity. In September 2015, INNOVO also obtained the European Patent for the MODULAR INNODRIVE technology, an innovative jacking system purposely designed to guarantee safer operations, reduced environmental impact and significantly increased time and cost effectiveness. Innovo also has another product in its portfolio. The Jack-up that this year has been supplied to the Italian Research Center in Naples. On this product, Innovo has another Patent. This shows how Innovo is a Company that dedicates itself in research and Development and in innovative products focusing on intellectual property of their own developments. STEA s.r.l is the Italian branch of INNOVO and is 100% owned by INNOVO.
Based in Padova, it provides engineering services and personnel highly skilled and qualified for any operation that Innovo sub contracts, or any other job that is obtained in the Mediterranean area. Localization is in fact strategic for the group as a whole. Innovo ltd. covers the North Sea area and Stea covers all the Mediterranean area. This guarantees the company a big flexibility and the ability to cover the main areas for the Oil&Gas sector. As the relationship between Stea s.r.l and Innovo is quite tight and transactions between the parent company and the subsidiary ones are very common, it’s not rare that Innovo Ltd., due to its high volume of work, from time to time has to subcontract to Stea engineering works, expedition activities or other services such as trademark licensing or certifications, in order to fulfill all the requests it receives. This has given rise to the transfer pricing problem. In order to avoid going against the law and being eligible for future fines by the ITA, Innovo has decided to develop its own manual on transfer pricing thus showing their own will on being transparent and in compliance with EU directives and OECD guidelines on transfer pricing.
Strategy at Innovo

As said before, there are various models that companies may use. Innovo is actually using the cost plus method, as we saw in Chapter 2. It is more suitable in respect of transfer of semi-finished goods, rendering of services and long-term buy and sell arrangements. In order to explain better how the application of this method is done by Innovo, we can see the following example. Let’s say that Innovo has to subcontract to Stea a repair service that has to be carried out by Stea personnel. Things will go as follow. Stea will study the requested service, analyze and forecast the costs that it will incur in carrying out the work and decide a lump sum that would include all costs. Once the costs are analyzed, Stea will apply the usual mark-up that is used when providing these kind of services, securing the company a profit. Innovo will then issue the purchase order, and once the job is done, or at certain stages of the work, invoices will be done by stea and paid by INNOVO. In this way we are certain that the transfer price is in compliance with the arm’s length principle and the price respects comparable transaction, since the final price is only based on the cost plus a mark-up as if the service or good was sold to a third party.

Picture 5 - Innovo's Strategy
Conclusion

“Because transfer pricing is not an exact science, there will also be many occasions when the application of the most appropriate method or methods produce a range of figures all of which are relatively equally reliable.”

As we can deduct from the above statement, transfer pricing is not made of a single rule which brings only a specific result. We saw that there are multiples models and techniques that can be used in order to derive the correct transfer price in compliance with the arm’s length principle. When a strategy is established there are numerous of internal and external factors to take into consideration and, at a first glance, it may seem dissuasive. At one hand, the strategy will be aligned with internal goals and, at the other one, with external factors such as duty tariffs, competition and legal compliance. Enterprises have to ask themselves what they want to achieve with their transfer pricing strategy. The answer can vary between regulatory compliance to tax optimization or competitiveness. When the aim is set there are other internal and external factors to take into consideration. The internal ones can also vary widely between enterprises while the external have a more unified appearance. Results may defer in relation to the model selected, and still the transfer price might be correct. It remains important that companies develop their own manual on transfer pricing, that they select the method that they are willing to use and that they communicate this method to the authorities. In such way, companies are more transparent and they are capable of showing how they are not using transfer pricing as a vehicle to shift profits from a country to another. It still remains hard because when there aren’t transactions that are comparable to other ones, or when the transaction is referred to intangible assets, the price chosen for the transaction might be difficult to assess. For example, if we are transferring the use of a license, or a trademark, the transfer price could be 100€ or could be 100’000 €. It then depends on the correct analysis of the underlying good or service that is being transferred and future earnings that might derive from it. Therefore, transfer pricing could be very challenging when comparable transaction do not exist, both for who sets the price and for who controls that the price set is correct. OECD guidelines have given multiple choices and many countries are following them in order to be on the same level, and in order to facilitate international transfer between multinationals. There have been enormous efforts in order to rule transfer pricing and the result reached in

74 OECD Guidelines
this moment is quite satisfying but not optimal, because the multiple choice rules and methods increase the ambiguity of the system. In my opinion, transfer pricing rules should only focus on a singular method or on multiple ones that give the same output price independently from what methods are used, even though this remain very difficult because of the numerous types of transactions available in the market. To conclude, transfer pricing has to take into account a variety of variables that have to be analyzed in accordance with companies aims in order to select the correct model and the correct transfer pricing strategy.
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