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Guide to International Transfer Pricing

— Best Practices and the OECD Guidelines

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Preface

In 2006, the US Internal Revenue Service reached a USD 3.4 billion settlement with GlaxoSmithKline over transfer pricing adjustments, representing the single largest settlement in the history of the IRS. While this example demonstrates the impact that transfer pricing can have on a multinational, there are many other less sensational reasons why transfer pricing is important and is gaining increasing attention within an organisation.

Countries around the globe are increasingly scrutinising the intercompany pricing practices of taxpayers and enacting rules and regulations to ensure an appropriate allocation of income among the various tax jurisdictions in which a multinational operates. In addition, a growing number of tax authorities have established documentation requirements to demonstrate appropriate transfer pricing policies, with penalty provisions for non-compliance. Not only must a multinational understand the different nuances in the transfer pricing laws and in their practical interpretation in each local country, but it must also appreciate that by operating in jurisdictions with varying tax rates, transactional structures or intercompany pricing policies can impact the multinational's global effective tax rate. It is this same labyrinth of differing local country laws and tax rates, however, that can also increase the potential for double taxation. Maintaining legal compliance with local country tax laws while reducing tax burdens via effective transfer pricing structures is an imperative challenge facing today's multinational enterprises.

This primary objective of this book is to create a comprehensive guide that would arm the various constituents impacted by transfer pricing – from tax directors, legal counsel, accounting and operations personnel to CFOs and outside advisors – with the knowledge base and resources needed for effective transfer pricing decision-making. **Guide to International Transfer Pricing — *Best practices and the OECD Guidelines*** presents an overview of the fundamental concepts applied in transfer pricing. A particular focus is on practical guidance and implementation, enabling the reader to execute a coordinated, cost-effective approach to global policies and documentation needs. It is hoped that this book will shed light on how some of the complexities raised by transfer pricing – from planning to compliance to controversy – can be effectively managed.

This book is adaptation of Chapters 1 and 2 of Kluwer Law International's *Guide to International Transfer Pricing: Law, Tax Planning and Compliance Strategies*.

CCH Tax Editors

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Introduction

Transfer pricing is the most challenging international tax issue facing Multinational Enterprises ('MNE') today. Essentially, transfer prices refer to the prices at which enterprises transact with associated enterprises for the transfer of physical goods, intangible property or the provision of services.

The altering of this transfer price will influence the allocation of profits between the buyer and the seller. A high transfer price results in the profits shifting to the seller whilst a low transfer price shifts profits to the buyer. How MNEs fix prices for transactions between associated enterprises operating in different countries have given rise to significant tax disputes with tax authorities.

The situation in Malaysia is no different. Transfer pricing guidelines were first introduced by the Malaysian tax authorities in 2003. These guidelines are fundamentally based on the governing standard for transfer pricing as set out under the Organisation for Economic Co-operation and Development ('OECD') Transfer Pricing Guidelines.

Since then, Malaysia has introduced specific transfer pricing legislation in the form of Section 140A of the Malaysian *Income Tax Act* which took effect on 1 January 2009. Pursuant to this section, where a person enters into a transaction with an associated person for the acquisition or supply of property or services, that person shall determine and apply the arm's length price for such acquisition or supply.

On the other hand, Singapore does not have specific transfer pricing legislation. General provisions cover transfer pricing, namely Section 53(2A) and Section 33 of the *Income Tax Act*. Section 53(2A) concerns related-party business dealings between a non-resident and a resident, while Section 33 is a general anti-avoidance provision. The Inland Revenue Authority of Singapore ('IRAS') issued Transfer Pricing Guidelines in February 2006, which are consistent with the OECD Transfer Pricing Guidelines. The IRAS does not specify preference for any of the prescribed methods outlined in the OECD guidelines.

This book is intended to provide an in-depth understanding of the fundamental principles surrounding transfer pricing as set out in the OECD Transfer Pricing Guidelines. This book highlights key transfer pricing concepts and best practices in managing transfer pricing risks, developing group transfer pricing policy as well as handling transfer pricing audits and disputes. This book also delves into the arm's length standard and discusses the transfer pricing methods as set out under the OECD Transfer Pricing Guidelines. The book further examines the special considerations for intellectual property, intra-group services, cost contribution arrangements and business restructurings.

This book is useful for tax professionals and practitioners as well as corporations involved in cross border transactions with associated enterprises. It is also intended for the educated laymen wishing to understand transfer pricing concepts and practices.

Transfer pricing is subjective – it is often quoted that '*transfer pricing is an art not a science*'. Hence, this book should not be taken as authoritative interpretation or application of the law. Expert advice should be sought before a particular course of action is adopted.

CHAPTER 1

Overview/Best Practices

Mark Bronson

Mark Bronson has nearly fifteen years of experience addressing transfer pricing issues. Bronson's recent experience includes two years with the Advanced Pricing Agreement (APA) program, where he was the lead economist for the cost-sharing industry specialty group and where he served on a small team of individuals from the IRS and treasury that were working to resolve valuation issues in the proposed cost-sharing regulations. In addition to cost-sharing, Bronson has extensive experience addressing complex intangible and tangible transfer pricing issues in tax planning, compliance, and controversy resolution contexts. Bronson has helped numerous clients resolve disputes through audit, appeals, competent authority and APA venues. Bronson has a wide variety of industry experience, but has been especially focused on pharmaceutical, biomedical device, and other technology-driven industries. Prior to joining Ceteris, Bronson was a Vice President at one of the largest international economic consulting firms. Bronson holds an MBA with accounting and finance concentrations from the University of Chicago Graduate School of Business, and a BA from the University of Rochester in economics and statistics.

Michelle Johnson

Michelle Johnson is a Director with Ceteris and has significant experience advising clients on transfer pricing and valuation matters, including FIN 48 recognition and measurement analyses, inter-company services analyses, transfer pricing implementation strategies, audit defence, Advanced Pricing Agreements, global studies, cost sharing analyses, buy-in valuations, and tangible and intangible transfer pricing documentation. Michelle leads Ceteris' FIN 48 service line development and thought leadership and was commissioned to co-author the BNA Portfolio on FIN 48 and Transfer Pricing. She is an award winning speaker and presents frequently at industry associations such as Council for International Tax Education (CITE) and Tax Executives Institute (TEI). In addition, she has been selected for multiple BNA audiocast panels involving transfer pricing. Michelle works with Fortune 500 and Fortune 100 firms in a wide range of industries and has notable experience with financial services firms and technology companies. Michelle obtained her Masters degree in Economics fromNewYork University and a BS in Economics and French from the University of Illinois.

Kate Sullivan

Kate Sullivan is a Director in Ceteris' Boston office and has over ten years of transfer pricing experience. She has assisted clients with international and state and local transfer pricing documentation studies, APAs, global tax planning, cost sharing, and audit defence in transfer pricing-related tax controversies. In addition, Kate has assisted clients with meeting FIN 48 and section 404 compliance requirements. She has worked with clients in a wide variety of industries including medical products, agricultural machinery, financial services, industrial equipment, information technology, software, and commodities. Prior to joining Ceteris, Kate spent six years working in the transfer pricing groups at Arthur Andersen and Deloitte & Touche and three years at one of the largest international economic consulting firms. Kate has an MBA from Boston University and a BA from Trinity College in Hartford, CT.

Ceteris

Ceteris provides Transfer Pricing and Business Valuation services to many of the largest multinational companies, top-ranked law and accounting firms and leading government agencies around the world. As an independent firm, Ceteris' advisors are able to seamlessly collaborate with accounting, tax, legal and finance groups while providing objective viewpoints that are unequivocally free from regulatory conflict and independence concerns set forth by the SEC, PCAOB and other governing bodies. Ceteris' experts have considerable experience as both external and in-house advisors, providing clients with technical expertise coupled with well-defined practical solutions incorporating industry best practices with an unrelenting sense of urgency. In 2008 and 2009, Ceteris has been ranked in Inc. Magazine's '500|5000 Fastest Growing Private Companies in America'.

With a global group of advisors spanning the Americas, Europe and Asia, and with offices in the major metropolitan areas of Atlanta, Boston, Calgary, Chicago, Dallas, Los Angeles, Mexico City, New York, Salt Lake City, San Jose, Toronto, and Washington, D.C., and Auckland, New Zealand, Ceteris' extensive network allow for teaming and the provision of tailored services and analyses to comply with all tax jurisdictions.

NOTE:
This chapter is written prior to the issuance of the 2010 Revised OECD Guidelines.

1 WHAT IS TRANSFER PRICING AND WHY DOES IT EXIST?

In a rapidly globalising economy, multinational enterprises (MNEs) are expanding their operations into an increasing number of countries around the world. This expansion has resulted in a growing number of intercompany transfers of tangible goods, intangible property, services, and financial instruments across international borders. The price at which these transfers occur has an effect on the taxable income reported by the legal entities involved in the transaction and the overall effective tax rate of the consolidated organisation. These internal prices are called 'transfer prices'.

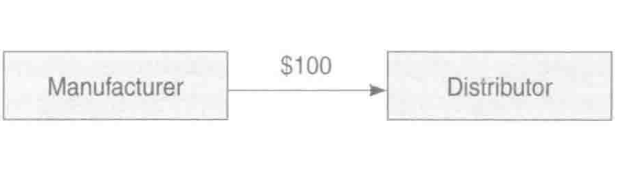
Transfer pricing regimes (e.g., the arm's length standard discussed later in this chapter) provide the conceptual framework for pricing intercompany transactions and ensuring an appropriate allocation of income between the various tax jurisdictions in which a multinational company operates. Transfer pricing for tax purposes is governed by local country tax authorities, many of which have issued formal rules regulating transfer pricing practices. In most instances, the regulations are accompanied by documentation requirements and penalty provisions for non-compliance.

1.1 Transfer Pricing Example

The impact of transfer pricing on taxable income can be seen in the following examples. Consider the case of a manufacturer that sells all of its product to a related-party distributor located in another tax jurisdiction. Assume that the distributor does not sell any third-party manufactured products, and that it sells everything it buys from the manufacturer instantly, so that its cost of goods sold (COGS) entirely consists of the purchases from its related-party manufacturer during the relevant period. See Figure 1.1 (the related-party transactions in the following are shown with arrows and, for purposes of this example, all figures are in US dollars).

In Scenario 1, the manufacturer charges the distributor $100 for the goods. If the manufacturer has total costs of $85 (COGS of $75 and operating expenses of $10), it will have $15 of taxable income. The tax rate in the country in which the manufacturer is incorporated is 10%, resulting in $1.5 in taxes paid.

Figure 1.1: Scenario 1 – Tangible Transaction

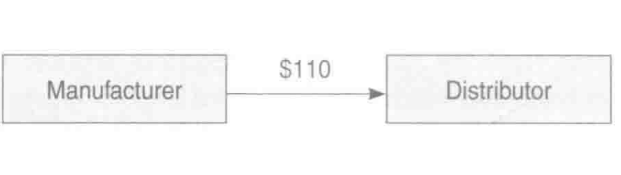


Revenues	$100	$120	$120
COGS	75	100	75
Operating Expenses	10	5	15
Taxable Income	$15	$15	$30
Tax Rate	*10%*	*40%*	
Taxes Paid	$1.5	$ 6	$ 7.5 (25% ETR)

The distributor's profit and loss statement is made up of $120 in third-party revenue, $100 in related-party COGS, and an additional $5 in operating expenses. In total, the distributor earns $15 of profit. After applying the 40% tax rate, the distributor pays $6 in taxes.

In Scenario 1, the consolidated group pays a total of $7.5 in taxes. Since the total taxable income of the group is $30, this represents an effective tax rate of 25%. Now consider Scenario 2, shown in Figure 1.2.

Figure 1.2: Scenario 2 – Tangible Transaction



Revenues	$110	$120	$120
COGS	75	110	75
Operating Expenses	10	5	15
Taxable Income	$25	$ 5	$30
Tax Rate	*10%*	*40%*	
Taxes Paid	$2.5	$ 2	$ 4.5 (15% ETR)

In Scenario 2, the manufacturer charges the distributor $110 for the goods rather than the $100 charged in Scenario 1. The change in price has a significant impact on total taxes paid because of the varying tax rates in the two jurisdictions. Specifically, because the manufacturer now receives $110 in revenue rather than the $100 it earned in Scenario 1, its taxable income increases by $10, to $25. Applying the 10% tax rate results in $2.5 in taxes paid. On the other side of the transaction, the distributor's taxable income has decreased by $10 as a result of the increase in its COGS. This results in taxable income of $5, which, after applying the 40%tax rate, results in $2 in taxes paid by the distributor.

On a consolidated basis, the company's revenues, COGS, operating expenses, and taxable income remain identical to the corresponding amounts in Scenario 1. However, because profit has been shifted from the higher tax jurisdiction into the lower tax jurisdiction, the company has saved $3 in taxes ($7.5 less $4.5), and the company's overall effective tax rate has been reduced from 25% to 15%.

This simple example illustrates how taxpayers with material intercompany transactions can manipulate their financial results to reduce their overall effective tax rates. It also shows how the amounts collected by individual tax authorities are affected by transfer pricing practices. Not surprisingly, tax authorities around the world have adopted formal rules and regulations that limit taxpayers' ability to either understate or overstate their transfer prices, and the rules grant the tax authority the right to adjust the taxable income of a taxpayer that is not in compliance with the country's transfer pricing laws.

1.2 Arm's Length Standard

The fundamental concept behind pricing intercompany transactions is the arm's length standard. The arm's length standard has become the basis for evaluating transactions between members of a controlled group in virtually all tax jurisdictions. The concept was first introduced in the United States, was subsequently adopted by the Organisation for Economic Co-operation and Development (OECD),[1] and has since been adopted by virtually all tax

1 The OECD is comprised of thirty member companies that work together, in part, to coordinate domestic and international policies. The OECD has issued specific guidelines on transfer pricing which are discussed in detail in Chapter 2.

authorities in major market countries. To understand its status as the global standard for transfer pricing matters, it is helpful to examine its origins.

The first regulatory initiative addressing transfer pricing was made just four years later in the War Revenue Act of 1917, which required corporations to file consolidated returns where necessary to 'equitably determine the invested capital or taxable income'.[2] This brief mention of transfer pricing was expanded in the Revenue Act of 1921, in which Congress declared:

> In any case of two or more related trades or businesses ... owned or controlled directly or indirectly by the same interests, the commissioner may consolidate the accounts of such related trades and businesses, in any proper case, for the purpose of making an accurate distribution or apportionment of gains, profits, income, deductions, or capital between or among such related trades or businesses.[3]

Subsequent to the Revenue Act of 1921, numerous laws were passed which expanded the ability of the Commissioner to reallocate gross income or deductions in order to 'clearly reflect the income' or prevent the 'milking' of profits of US-based entities. However, the definition of the proper or 'accurate' allocation of income remained quite vague until the promulgation of the Revenue Act of 1934. In section 45 of the Revenue Act of 1934, the arm's length standard as it is known today became explicit:

> The purpose of section 45 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true net income from the property and business of a controlled taxpayer ... The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.[4]

Since the passage of the Revenue Act of 1934, subsequent legislation has adhered to and advanced the arm's length principle, solidifying it as the basis for testing intercompany transactions in the United States. Although the arm's length principle first emerged as a formal concept in the United States, it has since spread to countries throughout the world. The principle was included in the OECD's *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD Guidelines) in 1979. As a result,

2 War Revenue Act of 1917, §1331(a).
3 Revenue Act of 1921, §240(d).
4 Revenue Act of 1934, §45.