Global Transfer Pricing: Principles and Practice

Second Edition

John Henshall

Deloitte.

BLOOMSBURY

Global Transfer Pricing: Principles and Practice

Second edition

by

John Henshall
Deloitte LLP

Bloomsbury Professional

Bloomsbury Professional Ltd
Maxwelton House
41–43 Boltro Road
Haywards Heath
West Sussex
RH16 1BJ

Bloomsbury Professional is an imprint of Bloomsbury Publishing plc

British Library Cataloguing-in-Publication Data
A CIP Catalogue record for this book is available from the British Library.

ISBN: 978 1 84766 396 2

Typeset by Columns Design XML Ltd, Reading, Berkshire
Printed and bound in Great Britain by CPI Group (UK) Ltd, Croydon, CR0 4YY

Global Transfer Pricing: Principles and Practice

Second edition

Preface

WHY ANOTHER BOOK ON TRANSFER PRICING?

Almost ten years ago, my colleagues Chris Adams and Richard Coombes wrote the first edition of this book. As they wrote in their 2003 introduction, some tax professionals viewed transfer pricing as a minor compliance nuisance, but Chris and Richard were much more enthusiastic and their theme for the first edition was to put transfer pricing on the map as 'a fundamental toolset of international tax planning'.

Ten years have passed, and I am writing and editing the second edition. With hindsight, I don't think any of today's readers will doubt that my colleagues were right; transfer pricing is most certainly at the forefront of international tax strategies and compliance. So, you may well be asking yourself: why have they written another book on transfer pricing? And why should I read it?

Over the intervening years transfer pricing planning has become a key feature of tax management for multinationals and tax authorities alike. Attitudinal shifts are never easy as they lead to significant changes in technique and approach; transfer pricing is no different. Transfer-pricing professionals now look at a very different landscape:

- Tax authorities are sophisticated in their selection of transfer pricing audit cases and in the arguments that they employ. The arm's length *behaviour* of the companies involved is as much the focus as the arm's length *pricing* of individual transactions.
- The expansion of transfer-pricing legislation, and penalties for non-compliance, has changed the compliance picture beyond recognition. More countries now specify minimum documentation requirements to evidence compliance with the arm's-length standard and some countries also specify the date by which that material must be available, or how quickly the material must be provided to the tax auditor.
- The guidance to tax authorities and to multinational groups is becoming more detailed and, I believe, more useful. The Organisation for Economic Co-operation and Development (OECD) (through Working Party VI which was set up to address problems in taxation and transfer pricing) has spent a number of years reviewing and overhauling both the Transfer Pricing Guidelines[1] (the Guidelines) and the Report on the Attribution of Profits to Permanent Establishments.[2] Work on the Guidelines is not yet

1 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.
2 OECD 2010 Report on the Attribution of Profits to Permanent Establishments.

complete; the OECD is currently working on the revision of Chapter VI which provides guidance on transfer pricing for intangible property. However, in 2010, the OECD released a new version of the Guidelines which contained substantially revised and rewritten Chapters I–III (dealing with transfer-pricing method selection and comparability issues) and a completely new Chapter IX (dealing with 'business restructurings', of which more later). A further evolving area for the OECD is to make sure that its transfer pricing guidance remains relevant as a global standard, workable for developing as well as developed countries, particularly in terms of helping tax authorities administer transfer-pricing principles in an effective and resource-efficient manner.

- Finally, firms like Deloitte and our competitors have helped businesses to implement transfer pricing models that deal with the business models that have evolved in today's more competitive landscape.

So, to respond to the question, 'Why *should* you read this book?' I would say that, just like the first edition, this book is aimed at readers who understand business and finance, and perhaps tax also, but who are *interested* in transfer pricing rather than being an expert transfer-pricing adviser. If that describes you, then you should read this book to gain an overall understanding of transfer pricing as it is practised today.

John Henshall

Partner, Deloitte

April 2013

Acknowledgements

The Strategy Matrix for Global Transfer Pricing is reproduced with the kind permission of Deloitte Touche Tohmatsu. ©2013 Deloitte Global Services Limited.

The views expressed in this book are those of the author, not necessarily those of Deloitte member firms. Any ideas put forward are illustrative and general; they are not a substitute for professional advice given in particular circumstances and in the light of particular facts.

Contributions to the text of this book were very gratefully received from the following members of Deloitte:

Ian Clarke

Richard Coombes

Roy Donegan

Sarah Morrissy

Ruth Steedman

Thanks also to Alison Lobb and David Cobb, also of Deloitte, who worked tirelessly and dilligently to proofread the drafts and provide suggestions and comments to bring the whole book together.

Table of cases

Table of statutes

Table of other guidance

About the author

John Henshall has been a tax professional for 30 years at the time of writing this book. Training initially with the UK tax authority, he became a Partner at Deloitte in 2001. John is currently global co-lead of the Business Model Optimisation service line and he has a particular interest in the transfer pricing of intangibles. Advising some of the largest multinationals, John's work often leads to Advance Pricing Agreements, tax audit defence work or to Competent Authority claims. John has been consulted by governments concerning the modernisation of their approach to international taxation. He has participated as a delegate to the November 2011 meeting of OECD Working Party 6, considering the update of Chapter VI of the OECD Guidelines for Multinational Enterprises and Tax Administrations. John lectures extensively and he is regularly published.

Deloitte is one of the world's largest providers of transfer-pricing services, with more than 500 transfer-pricing specialists around the world. Deloitte's professionals combine strong international tax and economic expertise with former tax authority experience; they work together in a global practice exclusively dedicated to transfer-pricing solutions and the resolution of transfer-pricing disputes. In addition to its strong international tax and economics base, Deloitte has extensive experience in Advance Pricing Agreement negotiations and Competent Authority claims.

Contents

Chapter 1

Transfer pricing: What is it?

WHAT IS TRANSFER PRICING?

1.1 The term 'transfer pricing' is now embedded in our vocabulary, but what does it really mean? As a transfer-pricing professional, with some 30 years of experience in international taxation, the author considers Winston Churchill's famous statement 'It has been said that democracy is the worst form of government except all the others that have been tried' could be adapted for transfer pricing and the arm's-length principle. Whilst this is not particularly helpful as a definition, it does ensure the right mind-set to learn about transfer pricing.

1.2 Put simply, transfer pricing is the amount that is charged between related parties, when they transact. One way to understand transfer pricing is to think of an organisation's global business profits as a pie which needs to be divided up between different countries who have contributed to its making and that division should be undertaken in a principled and justifiable manner. This exercise must be undertaken because taxation of business profits continues to be based on the national laws of each country, whilst business becomes increasingly global in nature. Whilst the internal objectives of the globalised business might be best served by minimising the importance of corporate and national boundaries, tax law is based on the clear recognition of those same boundaries. Transfer pricing might, therefore, be considered to be the 'oil' that lubricates the coexistence of these opposing starting points.

1.3 To begin, though, it is necessary to review some history.

WHERE DID TRANSFER PRICING COME FROM? THE GROWTH OF WORLD TRADE

1.4 Economic historians cite the fifteenth and sixteenth centuries as the origins of the multinational enterprise (MNE). This period saw the emergence of large companies predominantly based in what were then the superpower countries, trading large amounts of commodities in the colonies of their home countries. Yet it was not until early in the twentieth century that the manufacturing concepts of one country came to be exported to subsidiaries abroad. This growing interest in production accelerated markedly after the Second World War as developed countries began to invest heavily in the rebuilding of their economies. Many historians maintain that it was this period that laid the foundations for the current shape of the global economy.

1.5 *Transfer pricing: What is it?*

1.5 The MNE established itself as a driver of global production and trade in the post-war years but the process has accelerated in more recent years. The most significant growth in the number of enterprises conducting business in more than one country has been seen in the closing years of the twentieth century, years in which the growth in world exports has consistently been greater than the growth in world Gross Domestic Product. Even though the early years of the twenty-first century have been affected by a financial crisis and global slowdown, the importance to business of trading in more than one country has not diminished. There is limited data on trade transactions between related parties (despite growing attention from policymakers), but available evidence suggests that intra-firm trade represents a significant share of world trade.[1]

1.6 There are numerous reasons for the increased growth in world trade over time, ranging from the desire of MNEs to access cheaper labour costs for production, to the increased demands from developing nations for a wider range of goods and services. Yet even at the start of the twentieth century there was little perceived need for the concept of transfer pricing. The reason for this was simply that differences, or potential for differences, between the territorial nature of taxing legislation and the actual behaviour of multinational enterprises remained small. As little as 100 years ago 'international trade' still meant loading things onto a train, wagon or ship to export. As MNEs began to expand their manufacturing abroad they did so by a 'replication' process whereby an individual or management team was identified to run a business overseas which was a standalone copy of the parent's business but which operated in its local market. In this business model, related-party transactions were few in number and low in value, so the potential for local business profits to be affected by related-party transactions was small.

1.7 What changed? In short, the revolution in communications and logistics allowed businesses to become more efficient and consequently more profitable. Reducing the cost of manufacturing, speeding the entry of new products to market, cutting the value of stock held in warehouses and taking a single product to several markets are all steps that increase profitability. Improvements in logistics and information systems allowed product manufacturing to consolidate around single factories, and improved communication allowed management to consolidate around a single location. These step-changes in business efficiency drove up the number and the value of related-party transactions and moved (globalised) business further and further away from mirroring (territorial) taxing legislation. This separation increased the risk that related-party transactions could have a substantial impact on the amount of profit on which an entity was subject to tax in each territory of operation, with a real or perceived preference, from the business point of view, to have the larger share of the profits taxed in the territories with the lowest tax rate. As this risk

---

1 See Lanz, R. and S. Miroudot (2011), 'Intra-Firm Trade: Patterns, Determinants and Policy Implications', *OECD Trade Policy Papers*, No 114, OECD Publishing. Available at: http://dx.doi.org/10.1787/5kg9p39lrwnn-en.