Tricky Tax: Transfer Pricing

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TRANSFER PRICING

Transfer pricing is defined as, "The setting of prices for intra-group or company transfers of goods and services"[1]. In other words it is establishing the price for a transaction taking place between two entities (a company or subsidiary) that are owned by the same person or company. The transfer price is the price at which the goods or services are transferred or 'sold'.

Transfer pricing is inherently problematic. In the absence of two unconnected parties in a transaction it can be difficult to set a fair price. The price of a product or service sold between two unconnected companies is determined by the market. Factors such as supply and demand, tariffs or political conditions can all affect the final sale price. But when a sale takes place between two connected entities, such as two subsidiaries of the same multinational group, many of these factors can be set aside because of the common ownership[2].

The Organisation for Economic Co-operation and Development (OECD) estimates that intra-group transfers constitute more than 60 per cent of all world trade[3] — a fact which puts transfer pricing at the centre of global economic activity. In 1979 the OECD published general guidelines for dealing with transfer pricing, *The Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, which are revised regularly[4]. These guidelines form the basis for the transfer pricing legislation in the UK, ICTA88/SCH28AA[5], which was put in place in 1999.

Transfer pricing in a global context

From a taxation point of view, the global nature of transfer pricing adds a further complication. If both subsidiaries operate in the same country they are likely to be subject to the same tax rules and rates. The effect of setting arbitrary prices for transactions within the group is relatively benign because ultimately they will have little effect on the overall tax bill of the group[6]. If one subsidiary marks up the price of a product it sells to another subsidiary in the group, any gains made by the seller will be offset by the high cost to the buyer. As far as the group is concerned, it is a case of 'robbing Peter to pay Paul' — there are no extra gains for the group.

However, when the two subsidiaries are registered in different countries that have different tax rates and rules, intra-group price setting acquires a new significance. The potential then exists for the group as a whole to exploit the difference in tax rates and increase its overall profits. This is done by manipulating the transfer price to shift profits to the subsidiary which is subject to the lowest tax rate.

For this to occur, the subsidiary paying the higher tax rate needs to purchase from the one subject to the lower tax rate. Raising the transfer price raises the cost to the buyer, which means its profits are reduced and it pays less tax. The losses to the buyer are gains to the seller. These gains are now taxed at a lower tax rate where the selling subsidiary is registered. Although the overall profits before tax (pre-tax profits) for the group do not change, the overall net profits will increase. This is because it is now paying a lower tax rate on a greater portion of its profits.

Using transfer pricing to shift profits

The relationship between transfer pricing and taxation is demonstrated in the following example. The scenario focuses only on the effects of the transfer price and ignores all unrelated factors.

The **Wind Group** is a multinational company manufacturing wind turbines[7] (see ***Figure 1***). It has two subsidiaries: **Dutch Parts** which makes circuit boards for the turbines in The Netherlands and **Turbines UK** which assembles them in the UK. **Dutch Parts** is subject to 20 per cent tax in The Netherlands while **Turbines UK** is subject to 40 per cent tax in the UK. Each year **Dutch Parts** sells 10,000 circuit boards to **Turbines UK**. The sale is made at a transfer price of €100 per board, totalling €1,000,000.

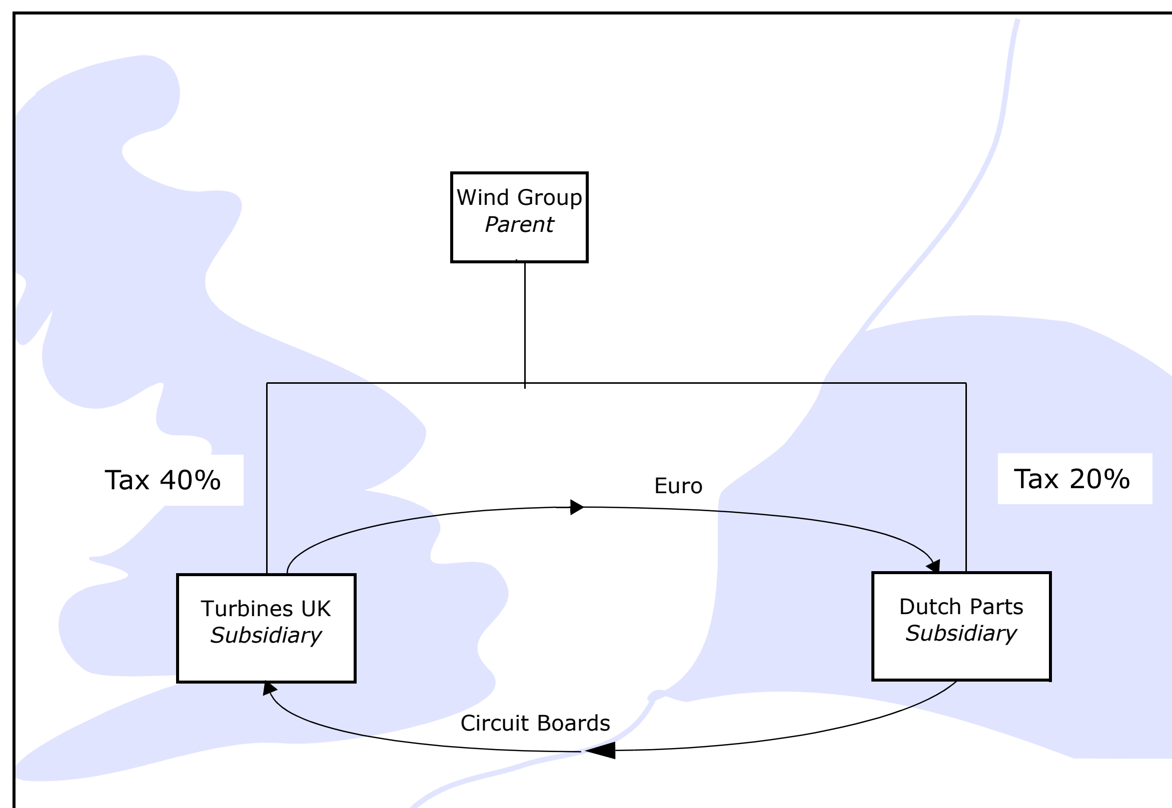
In the first year both subsidiaries make a pre-tax profit of €800,000 each, earning the **Wind Group** a total pre-tax profit of €1.6 million (***Table 1*** on page 4). **Turbines UK** pays €320,000 tax at 40 per cent on its profits, while **Dutch Parts** only pays €160,000 because of the lower tax rate of 20 per cent in The Netherlands. As a result, the total net profit of the **Wind Group** for the year is €1,120,000 and its tax bill is €480,000.

In the second year **Dutch Parts** raises the transfer price to €150 per board increasing the total cost of the sale to €1.5 million. Thus, the profits of **Dutch Parts** rise by €500,000, while those of **Turbines UK** fall by the same amount.

At the end of the second year the balance sheet of **Turbines UK** shows a reduced pre-tax profit of €300,000 (reflecting the increased cost of the boards) while **Dutch Parts** enjoys a rise in pre-tax profits to €1.3 million. Note that the total pre-tax profits of the **Wind Group** remain the same – €1.6 million. However, the tax bill of **Turbines UK** is reduced significantly because of the rise in the cost of the circuit boards, it now pays €200,000 less tax.

Although **Dutch Parts** pays €100,000 more in tax for the year, the overall tax bill for the group is reduced to

Figure 1 **Wind Group company structure**



The **Wind Group** is the parent company of a wind turbine manufacturer. The company has two subsidiaries: **Dutch Parts**, which manufactures circuit boards for the turbines in The Netherlands, and **Turbines UK**, which produces and assembles the turbines. **Turbines UK** purchases the circuit boards from **Dutch Parts** at a transfer price set by the parent company.

€380,000. The group's net profit is €1,220,000 — a €100,000 increase on the previous year.

Table 1 **Wind Group taxes year one**

	Turbines UK	Dutch Parts	Wind Group
Pre-tax Profit	€ 800,000	€ 800,000	€1,600,000
Tax Paid	€ 320,000	€ 160,000	€ 480,000
Net Gains	€ 480,000	€ 640,000	€1,120,000

Group Net Gain: € 1,120,000
Group Tax Rate: 30.00%

Table 2 **Wind Group taxes year two**

	Turbine UK	Dutch Parts	Wind Group
Pre-tax Profit	€ 300,000	€ 1,300,000	€1,600,000
Tax Paid	€ 120,000	€ 260,000	€ 380,000
Net Gains	€ 180,000	€ 1,040,000	€1,220,000

Group Net Gain: € 1,220,000
Group Tax Rate: 23.75%

The increase in the transfer price causes more of the **Wind Group's** profits to be taxed at a lower rate through its **Dutch Parts** subsidiary. This reduces the group's overall tax rate from 30 per cent down to 23.75 per cent.

The arm's length rule

Given the considerable effect a transfer price can have on a company's tax liability, it is subject to much attention from multinational corporations and tax authorities alike. But even companies that have no intention of distorting the transfer price often encounter many objective difficulties when setting it.

Operating complex company structures across a global network can make it difficult to assess global profits. Other factors such as local government restrictions or pressure to deliver high returns to shareholders can all contribute to the distortion of internal price setting[8 9].

Furthermore some products do not have an equivalent in the market, especially when dealing with new types of products, or products like medical patents which are difficult to quantify. Finding a comparable price may then involve collecting pricing information from several companies.

To counter this genuine pricing problem, corporations and tax authorities around the world apply a principle known as the 'arm's length' rule. The rule, discussed at length in the OECD guidelines, states that when pricing the transfer of goods or services between companies with joint ownership, the companies should treat the transaction as if it was taking place between two unconnected parties. In other words, they should try to emulate the market conditions as closely as possible, thereby attaining what would be a fair market price[10]. When setting the price, they should take into consideration all other factors which would affect the price if the transaction occurred between two unconnected entities[11].

The aim of the arm's length approach, according to the OECD guidelines, is to minimise as much as possible the creation of an unfair tax advantage which can be gained by setting prices arbitrarily. By detaching the tax consideration from economic considerations, the arm's length principle aims to promote, "The growth of international trade and investment"[12].

Applying the arm's length rule

The OECD guidelines claim that applying the arm's length rule has been fairly successful and that the rule has been found, "To work effectively in the vast majority of cases" [13].

This claim has been disputed by a number of organisations and tax experts. A report by Global Financial Integrity (GFI) suggests that misuse of the arm's length rule has contributed to the illicit financial flows out of developing countries. According to the report:

> *In 2006, the most recent year of the GFI study, developing countries lost an estimated $858.6 billion – $1.06 trillion in illicit financial outflows.*[14]

Setting a fair arm's length price has been described as more of an art than a science[15].

The arm's length rule is not the only possible approach to dealing with transfer mispricing. One alternative is, 'unitary taxation with formulary apportionment'[16]. This approach allocates the world wide tax liability of a multinational based on its economic links (i.e. sales, payroll etc.) with each tax jurisdiction in which it operates.

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