DETERMINATION OF TRANSFER PRICING

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ABSTRACT: *The phenomenon of transfer pricing has emerged as common practice among highly diversified companies. It can be qualified as "prices with related parties" including specifically transfer of goods, providing of services, transfers and other transactions concerning intangibles, cost contribution, arrangements and business restructurings. In a context of growing globalization and in view of the importance that multinational companies are assuming in the economic world, the regulation of transfer pricing represents an issue of significant importance, both for taxpayers and financial administrations, as it allows the determination of companies' taxable income operating inside tax jurisdictions.*

KEY WORDS: *Transfer pricing; globalization; international tax regulations.*
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1. INTRODUCTIVE CONSIDERATIONS

Transfer pricing[1] or transfer price is defined as a set of the ways in which companies, which develop in multinational contexts, resident in different states and characterized by control and/or connection relationships, define internally the prices of intra-group commercial transactions relating to the exchange of services or goods. This is a complex phenomenon, which derives from the analysis of the economic relations between companies resident in different States belonging to the same Group (international transfer pricing) and between companies resident in the same country (domestic transfer pricing). Indeed, in recent decades, transfer pricing in transactions between associated companies has become the main subject of taxation (Lang M., Strock A., Petruzzi R., Risse R., 2019). This phenomenon originates and is based primarily on business needs, which are underpinned by economic and business requirements, consisting of skills and economic development, monetary transactions that occur daily between companies belonging to international groups. To better understand the phenomenon of transfer pricing it is

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[1] About the concept of Transfer Pricing see Lang M., Strock A., Petruzzi R., Risse R., in *Transfer Pricing and Intangibles: Current Developments, Relevant Issues and Possible Solutions*, 2019, Vienna, pp. 30ff. The authors also analyse intangible asset transfer prices.

necessary to start from the fact that each company of a multinational group is subject to the tax rates of its tax jurisdiction of residence[2].

Because of this, it is immediately clear that achieving income in one country rather than in another can have a strong impact on the tax burden and therefore on the productivity of a group (Levey M. M., Wrappe S. C., Chung K., 2006). In this context it can be said that the goal of multinational companies is to study and plan the operations to be carried out within the group in order to achieve the results of maximizing group profit and optimising the tax burden[3]. It can be argued that the problem of the transfer price involves different disciplines[4], from the fiscal/corporate/civil law to the business economy and therefore is under the magnifying glass of many subjects (companies at the base of the Groups; tax authorities passing through international bodies). (Bakker A., Levey M. M., 2012)

2. OECD GUIDELINES: DEFINITION AND MAIN FEATURES

Certainly, the guidelines are instructions which governments, belonging to the OECD, in close contact with and with a view to international cooperation, direct to multinational companies, communicating principles and practical rules appropriate to the applicable laws. The OECD is aimed at companies or other entities established in more than one country and connected with each other by forms of operation variously coordinated. If there is certainly that one or more of these entities may be able to significantly influence the activities of the others, from the other their level of autonomy within the group can change significantly from one multinational to another[5] (Silverztein C., 2009).

The capital of these companies does not necessarily have to be private, but at least a partial participation of the State is allowed. These provisions are addressed in an indistinct way to all entities forming part of the multinational enterprise (parent company and/or local entities) and pay attention to the real distribution of responsibilities between them. They don't spread different treatments between multinational companies and other companies, but reveal, in the intentions of the OECD member countries, reliable behaviors and practices for all types of companies. In view of this, national and multinational entities should behave in the same way in all cases where the Guidelines are applicable to both categories. The governments of the acceding countries have the right to regulate the operating conditions of multinational companies within their own jurisdictions in accordance with the provisions of international law[6] (OECD Publishing, 2011). The entities of a multinational company are therefore subject to the laws

[2] See Levey M. M., Wrappe S. C., Chung K., in *Transfer Pricing Rules and Compliance Handbook*, 2006, Chicago, pp. 5ff.

[3] Bakker A., Levey M. M., in *Transfer Pricing and Intra-group Financing: The Entangled Worlds of Financial Markets and Transfer Pricing*, 2012, Amsterdam, pp. 7ff.

[4] For details and more examples, see: https://static1.squarespace.com/static/55a50b8ee4b00f4e23b93618/t/59cbb19bb7411c70275cad8d/1506521503109/2017_27-09_FISCOM_ADR_FV_Dal+principio+del+valore+normale+al+concetto+di+libera+concorrenza.pdf

[5] Silverztein C., "Transfer pricing: a challenge for developing countries", OECD Observer, in *Gale Academic Onefile*, (December 2009), pp. 29ff.

[6] "OECD Guidelines for Multinational Enterprises", (2011), OECD Publishing, p. 54ff., available on: https://www.oecd.org/daf/inv/mne/MNEguidelinesITALIANO.pdf

applicable in the countries in which they carry out business activities. The guidelines also focus on corporate information and its dissemination, with the aim of providing third parties with reliable and transparent information on the structure, activity and financial situation. This information should be provided for the enterprise as a whole and, where appropriate, for each business sector or geographical area. The information disseminated by undertakings should correspond to the nature, extent and location of the undertaking, taking into account costs, privacy requirements and other competitive considerations[7] (OECD, 2017). Undertakings with regard to the publication of information, the keeping of accounts and the necessary audits should apply certain rules.

These entities are also obliged to implement certain rules for non-financial information. It is essential that companies disclose information on:

- The financial and economic results achieved;
- The objectives pursued;
- The main shareholders and voting rights;
- The members of the Board of Directors and the main management and their remuneration;
- Foreseeable management risk factors;
- Important 'issues' relating to employees and other stakeholders in the life of the enterprise;
- Corporate governance structures and policies[8] (Plesner Rossing C., 2017).

3. TRANSFER PRICING METHODS

At the end of the 1970s, the OECD, in drawing up the new guidelines, was at the same time concerned with defining the basic methods for determining the value of the free market price in intra-group transactions[9] (Feinschreiber R., 2004). What was at the basis was to respect the arm's lenght principle. Within the Guidelines five methods were inserted and planned, divided into two different categories:

a) Traditional methods
   - Comparable Uncontrolled Price Method
   - Resale Price Method
   - Cost Plus Method

b) Alternative methods
   - Transactional Profit Split Method
   - Transactional Net Marginal Method[10].

[7] OECD (2017), "OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations", OECD Publishing, Paris, p. 30ff, available on: http://www.mef.gov.it/documenti-allegati/2018/xAllegato_3x_Linee_Guida_OCSE_sui_prezzi_di_trasferimento_per_imprese_multinazionali_e_amministrazioni_fiscali.pdf

[8] Plesner Rossing C., "International transfer pricing in multinational enterprises", in *Journal of Accounting Education*, (June 2017), Volume 39, pp. 55-60.

[9] Feinschreiber R., (2004), *Transfer Pricing Methods: An Applications Guide*, John Wiley & Sons, Inc., Hoboken, New Jersey, pp. 212ff.

[10] *Ibidem.*

Until 2010, the OECD provided that in choosing transfer pricing methods it was essential to follow a rigid pattern. In short, the comparable free market price method was to be used predominantly. The remaining methods, however, played a secondary role. Under the new guidelines (2010), it was planned that each firm could use the method most suited to each situation, leaving a predisposition to use mainly the CUP method, if it proved reliable and the remaining traditional methods, considered more efficient in the identification of prices in line with what is expected in the 'arm's length principle.

The use of alternative methods was preferable in those cases where an associated company was offered a contribution that was not comparable with other types of transactions, or where it made an exclusive contribution. The OECD Guidelines also allow the use of methodologies not listed therein, provided that the undertaking in question is able to demonstrate that these methods comply with the arm's length principle[11] (OECD Transfer Pricing Methods, 2010).

Concerning the methods defined as "traditional" the free-market comparable price method essentially provides for a comparison between the transfer price of goods or services applied to a transaction between undertakings belonging to the same group and the price which is charged in transactions concerning independent undertakings under similar conditions. If the transactions audited were found to be inconsistent with the arm's-length principle, the intra-group transfer price would be different from the price charged in market transactions.

A comparison of these prices can be made in two ways:

a) An internal comparison, where it is allowed to compare the price applied in an intercompany transaction and that practiced by a group enterprise in transactions with third parties;

b) An external comparison, where in the case in which it is difficult to identify such transaction internally, it is decided to opt for the comparison of the transfer price with that practiced in comparable transactions between independent parties[12].

The use of an internal comparison is preferable by the tax authorities, as there is a higher possibility of identifying easily comparable situations. The possibility of using the external comparison is closely linked to the presence in the market of transactions relating to homogeneous goods or services. In the event that the differences between prices can be calculated precisely, for reasons linked to duties or certain transport conditions, the price of the independent transaction should be corrected, thus identifying the appropriate differential value. The differential value represents the price of the goods, excluding costs not related to the marketing and disposal of the goods themselves, although influential in its quantification. If in a specific case the intra-group price is found not to coincide with the differential value, the transfer price must be changed to that of the sample price. This method (CUP) is now regarded as the most compliant by the OECD. In its application, however, it is possible to identify concrete limits, as it is considered functional only in transactions involving raw materials and fungible goods[13].

[11] OECD, Transfer Pricing Methods, (2010), OECD Publishing, pp. 2ff., available on: https://www.oecd.org/ctp/transfer-pricing/45765701.pdf

[12] KPMG, (2016), Transfer Pricing Methods, Capitolo 6, paragrafo 6.2, pp. 196ff., available on: https://assets.kpmg/content/dam/kpmg/ua/pdf/2016/12/UN_Manual_TransferPricing%20(6).pdf

[13] *Ibidem.*

In cases where the CUP is not successful, the resale price method is normally used. This method aims, like the previous one, to respect the principle of free competition by paying attention to the price at which the asset, purchased by one of the companies belonging to the group, is resold to an independent undertaking. Once the price has been determined, there is a decrease in the price corresponding to the resale price margin. The gross margin shall indicate the compensation by which the seller intends to cover his selling and operating expenses and shall make a profit thereon. What results as the difference between the purchase price within the company and the resale price margin can reasonably be defined as the arm's-length price used in transactions involving independent parties. What appears to be a key point of this methodology is the recognition of the resale price margin. This can be quantified by taking into account the margin obtained in other transactions involving similar sales between the firm and an independent firm.

This methodology is suitable for use in the following cases:

a) the retailer only carries out marketing activities without implementing any change to the good itself that may increase the value of the good;

b) The reseller does not participate in the maintenance of intangible assets related to the goods sold;

c) The time elapsed between the purchase transaction and the disposal transaction is minimal. In this way, they will not affect elements that could inevitably alter the price (e.g. exchange rates);

d) An accounting comparison may be made[14] (Feinschreiber R., 2004).

The number of assets put in place by the seller affects the value of the resale price margin. The greater the number of such activities, the greater the margin. Through the increased cost method it is possible to assess the transfer price, identifying all the costs incurred for the realization of the good or service by the manufacturer to which a mark-up will be added (percentage of mark-up including risks, market situation and activities. The mark-up can be obtained from the ratio of gross margin to costs incurred. In this method, as in the resale price method, there is an internal or external comparison between the gross profit margin of the reference transaction and a transaction of a homogeneous nature. This method is normally used where a related undertaking acquires semi-finished products or when services are provided to undertakings belonging to the same group. It is essential for proper use to be made of this methodology:

1) Define a cost base (sum of direct and indirect costs of production);

2) Identify a mark-up;

3) Understanding the fundamental characteristics of the asset for taxation purposes.

The third point is significant in that two different contexts may arise:

a) The asset has different characteristics or technical peculiarities that make it exclusive or different from other assets. In order to be able to identify the mark-up it is necessary (in this case) to pay more attention to comparability factors;

[14] Feinschreiber R., (2004), *Transfer Pricing Methods: An Applications Guide*, John Wiley & Sons, Inc., Hoboken, New Jersey, pp. 226ff.

b) The asset shows significant differences compared to the rest of the assets. In this situation, changes should be made to take account of the differences identified in relation to similar transactions[15] (A. Riedl, T. Steinbach, 2017).

The study of the relevant functions supported by the manufacturer and the identification of the reference market are extremely important. If there are explicit differences on the margins, it will be essential to correct them; if these discrepancies are due to inefficiencies or efficiencies, no corrections will be made. Within Ministerial Circular 32 of 1980 there are clear operating directives to the Financial Administration for the measurement of the basic cost, which can decide whether to use the cost accounting system used by the company, make changes to it or use another system.

In addition to these directives, there are also systems for determining costs:

1) The standard cost system, which provides for an estimate of the costs incurred;

2) The system of marginal costs, which relates to the change in total costs by reference to the increase in production by a single unit;

3) The system of full production cost, within which direct costs and indirect costs are included.

The most commonly used system is that of the full cost of production since it allows to refrain from the analysis of fixed costs and variable costs of the reference asset, revealing at the same time more efficient in identifying the level of coverage of costs, It is essential not to be considered outside the market. Direct and indirect costs should normally be taken into account for the calculation of the cost base, but expenditure relating to the financial year, which is not directly chargeable should be excluded, including general and administrative costs. A competitively definable price can be obtained from the sum of direct costs, indirect costs and mark-up. In view of the above, given the characteristics of this method, it is feasible in situations relating to the sale of semi-finished products, which are subject to future transformations; the provision of services or in other situations where there is a long-term supply contract[16] (Della Rovere A., Schipani P., Valente P., 2013).

On the other hand, alternative methods, also referred to as income methods, focus their attention on the profit that comes from transactions between associated enterprises. According to the OECD, the individual methodologies which take account of the arm's length principle are the profit-sharing method and the net margin method of the transaction. The use of these methods requires, from a functional point of view, a modest level of comparability and information that is easy to trace.

The profit allocation method has as its objective to obtain the overall profit of the transaction. This amount is expected to be allocated at a later date between the parties within the transaction (individual operating units belonging to the group) in relation to the allocation criteria. The division of profits is expected to take place in a similar way as is normally the case in transactions between independent entities. The economic result in its entirety, subsequently divided between them, must necessarily precede a functional analysis, which should show the situation the standard situation that would have been

[15] A. Riedl, T. Steinbach, *Transfer Pricing Documentation Requirements*, in *International Transfer Pricing Journal*, may-june 2017, pp. 171ff.

[16] Della Rovere A., Schipani P., Valente P., (2013), *Analisi di comparabilità nel Transfer Pricing: Metodologie applicative*, Milanofiori, Assago: IPSOA.

expected in the free market[17]. When transactions are correlated in such a way that they are not considered independently, it is essential that the parties concerned draw up contracts to share any profits. It should be borne in mind for any undertaking wishing to share profits:

1) The functions performed;
2) The risks assumed;
3) Assets used and other market benchmarks.

The OECD predicts that profit-sharing may involve two processes: contribution analysis or residual analysis. In the contributory analysis, the profit as a whole is divided among the affiliated undertakings, referring to how the profit division takes place in similar transactions between independent undertakings. This breakdown normally takes place on comparable data, but where it is impossible to find, the breakdown takes place by giving a percentage of profit to the functions carried out and the risks associated with each associated enterprise[18] (Righini A., 2010). The residual analysis provides instead that the profit is divided into two phases. In the first, the profit is divided between the companies involved in the controlled transaction using traditional methods or the net margin method. In a second step, the residual profits are allocated by reference to the criterion that independent undertakings would have used in the same transaction. The net transaction margin method is a methodology for examining the net margin on a basis appropriate to the resources employed, the costs and related sales that a company makes in a controlled transaction. The difference between the gross profit and the operating expenses allows to determine a net profit. In this case, the net margin in the calculation shall take account of the margin that the same undertaking would have achieved by completing homogeneous transactions in the free market or of the net margin that an independent company would have realised in similar transactions.

For this method, too, a careful analysis of the functions is necessary and if differences in the comparability analysis are identified, corrections should be made in order to obtain reliable results. In order for changes to be made to allow for a fair comparison and to make transactions as close as possible, it is useful to consider certain factors:

a) The position in the competitive environment;
b) The strategy adopted;
c) The optimal management;
d) The threat of new competitors;
e) The maturity of the enterprise[19] (Martone A., 2013).

4. CONCLUSIONS

With the globalization of the markets, the great success of the Multinational companies, makes mandatory a correction of the international legislation in order to

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[17] *Ibidem.*

[18] Righini A., (2010), *Il Transfer Pricing alla luce dei recenti provvedimenti attuativi: i metodi di calcolo e l'analisi di comparabilità*, Verona, Commissione di Diritto Societario, available on: http://www.studiorighini.it/public/file/pubbl481312.pdf

[19] Martone A., "La determinazione dei prezzi di trasferimento *intercompany* normative e metodologie applicabili", in II Fisco, No. 11/2013.

exclude possible transfers of the taxable matter in tax havens. It is therefore essential, to prevent damage to the economy, to identify the set of tax planning strategies that have the unitary purpose of achieving an undue tax advantage. In general, the discipline of transfer pricing applies subjectively to commercial transactions that take place between a resident company and non-resident companies. While from an objective point of view, transactions which are important for the application of transfer pricing rules concern those which have a value for income and can be divided into: the supply of tangible or intangible goods in, or the licensing of, intercompany transactions; financing and intercompany service activities.

Multinational companies that can produce income in more than one country are therefore often forced to choose those with less burdensome tax systems. In order to exploit the tax systems of the various countries to obtain the greatest possible tax savings, they use transfer price practices. This system takes place through intra-group transactions that are more or less charged than those that would be set by independent undertakings. The attention of the financial administrations is placed in the last years more to determine if they are placed in existence from the practical enterprises of Transfer Price aimed to erode the tax base.

The transfer of profits (profit shifting) from high-taxation countries to zero or reduced-taxation countries is, in fact, itself a strategy leading to the erosion of the tax base.

Such practices are allowed by: aggressive fiscal strategies in contexts with a high rate of innovation, digitalization and globalization; by the rigidity of tax systems in the face of an extreme "flexibility of corporate incomes"; by the possibility of separating the taxation of sources of income from the economic activities that generate them; by the lack of coordination and asymmetries between different national tax regimes, for example in terms of different treatment (for tax purposes) of the components of the company's balance sheet (e.g. interest, dividends, etc.) and an uneven valuation of income items associated with intra-group and non-group transactions.

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