

# *INTERNATIONAL TRANSFER PRICING RESTRICTIONS: IMPACT ON CORPORATE FINANCIAL POLICY*

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**RESUMO:** Precificação de transferência é um tema muito difundido e que apresenta significativos potenciais de economias de impostos, sobretudo no que se refere a empresas internacionais. Em artigo anterior, os autores abordaram os incentivos das empresas para melhor administrar os preços de transferência. Em resposta a esses incentivos, os governos têm, cada vez mais, aprovado e imposto restrições internas aos preços de transferência. Neste artigo, as atuais normas que restringem a precificação de transferência são analisadas. Os modelos de precificação dos EUA e OECD são avaliados e as recentes aplicações desses métodos no Brasil são consideradas. Os métodos de precificação são descritos e a sua eficácia é apresentada. Concluímos por meio da descrição das políticas de precificação de transferência entre empresas que têm por finalidade facilitar o gerenciamento interno e minimizar a ameaça das taxações externas.

**ABSTRACT:** *Transfer pricing is a pervasive issue that presents significant tax savings potential concerning international enterprises. The authors discuss company incentives to manage transfer prices in an article appearing in the preceding issue of this journal. In response to these incentives, governments have increasingly enacted and enforced domestic restrictions on transfer prices. In this article, contemporary norms restricting transfer pricing are analyzed. The OECD and US pricing standards are assessed and Brazil's recent application of these standards is considered. Transfer pricing methods are described and evidence of their use is presented. We conclude by describing an intercompany transfer pricing policy intended to facilitate internal financial management and minimize external tax threats.*

**PALAVRAS-CHAVE:** políticas financeiras, impostos internacionais, preços de transferência, restrições.

**KEY WORDS:** financial policy, international tax, transfer pricing, restrictions.

The possibility of minimizing global taxes provides a powerful incentive for multinational enterprises to manipulate transfer prices among related entities as discussed in Limberg, Robinson, and Christians.<sup>1</sup> As a result, governments are increasingly challenging companies' practices. Challenges are based on country-specific restrictions that tend to share common characteristics. The purpose of this article is to analyze the general form of these restrictions, and to identify the basic components of an intercompany transfer pricing policy that facilitate internal financial management and minimize successful government tax challenges. Special attention is given to Brazil's new transfer pricing provisions.

***The critical concept  
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length standard.***

The following analysis is relevant to companies with interests in foreign jurisdictions that have established transfer pricing rules. It also provides insights into how countries might interpret existing standards and develop future standards. We focus on transfer pricing concepts and rely on the most recent comprehensive document, namely the Organization for Economic Co-Operation and Development (OECD) *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD Guidelines) issued in July 1995.<sup>2</sup> Brazil recently passed transfer pricing provisions<sup>3</sup> with the expressed intention of conforming to the rules of other OECD countries.<sup>4</sup> We assess the extent to which this intention is realized. Reference is also made to the OECD's influential predecessor, the *US Treasury Department Regulations on Transfer Pricing* (US Regulations) issued in July 1994.<sup>5</sup>

We first analyze the arm's length standard which represents the fundamental principle underlying contemporary transfer pricing restrictions. Next, the common methods for

determining transfer prices under the arm's length standard are assessed. Thereafter, formulary apportionment, a non-arm's length standard, is considered. We summarize a study on transfer pricing methods used in the US. Next, administrative issues important to companies' transfer pricing strategies are presented. Last, we recommend that companies adopt a consistent transfer pricing policy and describe the basic features of such policy.

### **Arm's length standard**

The critical concept underlying contemporary transfer pricing guidelines is the so-called arm's length standard. Under this standard, transfer prices between related parties are based on prices between independent parties and comparable transactions under comparable circumstances. This standard assumes that market forces determine fair prices in transactions between independent parties. Therefore, these prices should be applied to comparable transactions between related parties. Accordingly, comparability becomes a central feature in interpreting the arm's length standard.

Some characteristics of the new Brazilian law adopt the arm's length standard, while others deviate from it. In contrast, the OECD Guidelines and US Regulations uniformly apply the arm's length standard. They provide substantial guidance concerning the determinants of comparability, as well as other factors for consideration. At this writing, similar elaboration has not yet occurred under the Brazilian law, in part, because of its recent enactment. Hence, OECD and US factors may be relevant for applying Brazilian law, as well as a preview of potential future Brazilian guidance.

### **Comparability factors**

Comparability considers the economically relevant aspects of transactions. If comparable aspects are inexact, adjustments for differences may be necessary. The OECD Guidelines specify five factors for determining the comparability of controlled and uncontrolled transactions. These same factors are directly or indirectly prescribed under the US Regulations.

1. LIMBERG, S.T., ROBINSON, J.R. AND CHRISTIANS, R.L.M. International transfer pricing strategies for minimizing global income taxes. In: *Revista de Administração de Empresas*, v. 37, n. 2, 1997.

2. ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT. *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*. OECD publication service, July 1995.

3. Law 9430 (December 27, 1996). Articles 18-24.

4. Exposição de Motivos (E.M.) Nº / MF Brasília, de outubro de 1996. Paragraph 12.

5. THE UNITED STATES TREASURY DEPARTMENT. US Regulation Section 1.482.

First, the *characteristics of the property* transferred should be comparable. For example, tangible property should have comparable features, quality, reliability and volume. Intangible property should be comparable regarding transaction form (for example, leases are distinguished from sales); type (for example, patents are distinguished from copyrights); duration and degree of protection; and the anticipated use of the property. Services should be comparable in nature and extent.

Second, a *functional analysis* determines the comparability of the economic activities and responsibilities of controlled and independent enterprises. For example, functional analysis might identify and compare activities regarding design, manufacturing, assembly, research and development (R&D), service, purchasing, distribution, marketing, advertising, transporting, financing, and management. Transfer pricing adjustments should be made to the extent these functions materially differ between controlled and independent enterprises. Adjustments might also arise as a result of comparing the operating assets used by the controlled and independent entities. Moreover, consideration of various forms of risk is critical in the comparability of independent and controlled transactions. Risk analysis might include a comparison of the parties assuming market risk, investment risk, R&D risk, financial risk such as currency exchange risk — and credit risk, to name a few. The US Regulations indicate that risks specified by contractual agreement will be respected if they have economic substance.<sup>6</sup>

Third, *contractual terms* often indicate how responsibilities, risks and benefits are to be shared, hence they are considered when determining the comparability between a controlled and independent transaction. Actual conduct, in addition to written contract terms, should also be examined since, compared to independent parties, related parties may be submitted to less pressure to comply with contractual terms. The US Regulations elaborate by listing the types of contractual terms requiring comparison.<sup>7</sup>

Fourth, disparate *economic circumstances* may affect the comparability of transactions, and hence prices. For example, prices may be affected by geographic location; the size

and extent of competition; the relative competitive positions of buyers and sellers; the availability of substitute goods; the levels of overall and regional supply; consumer purchasing power; government regulation of the market; the costs of production including labor, land, and capital; transportation costs; the level of the market, for example retail or wholesale; and the date and time of transactions, among other factors. US Regulations also indicate that consideration should be given to the relative size of and economic development in each market, as well as the economic condition of the particular industry in each market.

Fifth, a comparison of *business strategies* may be relevant to the comparability of controlled and independent prices. For example, prices might reasonably be expected to differ if there are distinctions among companies' innovations, new product development and diversification, risk aversion, assessments of political changes and labor laws. Also, market penetration and expansion strategies based on short term losses might confound the analysis. Evaluation of such strategies considers their common characteristics, such as low prices and intensive advertising, and whether for a comparable independent enterprise these strategies are plausible at inception and whether they are undertaken by related parties beyond an expected and reasonable period.<sup>8</sup>

**Other factors**

In addition to comparability, the OECD Guidelines and the US Regulations present the following other factors for consideration regarding the applying of the arm's length standard. Determination of transfer prices is almost always based on the actual transaction undertaken. Rare exceptions include, for example, when interest on debt is recharacterized as dividends on shares of stock, and when a sale of intellectual property rights is recharacterized as a lease. Because controlled enterprises can engage in more contracts than independent enterprises and modify, extend and suspend them more readily, the underlying economic reality must be considered in establishing transfer prices.

While it is preferable that transactions be treated separately, this is sometimes

6. See US Regulation Section 1.482-1(c)(iii) that elaborates on the relevant factors in determining the economic substance of a transaction which include the assumption of risk by the controlled taxpayer as reflected in its: (a) Pattern of conduct, (b) financial capacity, and (c) managerial and operational control. See US Regulation Section 1.482-1(c)(iii)(C) examples (1) and (2) for illustrations.

7. See US Regulation Section 1.482-1(c).

8. A reduced price is allowed under US Regulation Section 1.482-1(c) only if there is documentation that substantiates: (a) The controlled party bears the cost of the strategy and is likely to benefit, (b) the reasonableness of the strategy's time period, and (c) the strategy and its terms are established before the strategy was implemented.

impossible and multiple contracts are bundled together. When using a single method or more than one method for establishing an arms length price, sometimes a range of tenable comparables emerges.<sup>9</sup> There is no general rule for selecting a price within the range: merely, good judgment should be exercised. Multiple year data may be useful because it might disclose intertemporal facts that affect transfer prices, and it may reveal relevant aspects of a business cycle. Losses are possible but should not persist beyond those that are logical for an independent comparable. In other words, while consideration should be given to the fact that different loss strategies may exist, losses should be expected for a limited time only.

A company's transfer prices might be affected by government policies, such as controls over prices, interest rates, payments for services and management fees, royalty payments, and currency exchange rates and amounts; subsidies to particular sectors; and anti-dumping provisions. Pricing — when government policies intercede — is still based on comparable uncontrolled transactions. For example, if a controlled supplier is subject to government costs, the ability of an independent supplier to pass on these costs to the customer is of relevance in establishing a comparable transfer price. Blocking is a special problem in which governments prevent (or block) transactions, such as the payment of interest. In these situations, independent comparables subject to similar blocking are still used to determine a transfer price. Comparables may not be available if independent companies will not engage in the government affected transaction. Solutions to the absence of comparables are, for example, to consider the other means by which independent parties would likely arrange payment in light of government restricted payments. US Regulations provide specific criteria that must be met before foreign legal restrictions will be considered.<sup>10</sup>

Exchanging goods among controlled enterprises is also observed among independent enterprises. Therefore, the market price of goods exchanged between independent companies is used to determine the transfer price for goods exchanged in comparable transactions between related companies. Customs valuations are

considered, but not determinative, in establishing transfer prices. The relevance of customs valuations in determining transfer prices considers that customs valuations occur at the time of import, whereas pricing occurs when contracts are concluded. Moreover, companies may have conflicting preferences for low customs values to minimize duties and high transfer pricing values that minimize income taxes.

Under the arm's length standard, transfer prices are determined on a case-by-case basis. Analysis using only one transfer pricing method may be sufficient. Multiple methods may also be used if they provide better evidence.

***A company's transfer prices might be affected by government policies, such as controls over prices, interest rates, payments for services and management fees, royalty payments, and currency exchange rates and amounts; subsidies to particular sectors; and anti-dumping provisions.***

### Transfer pricing methods

Based on the arm's length standard, both the OECD Guidelines and US Regulations describe methods for determining transfer prices. Because of their intertwined histories, it is no surprise that these methods bear a striking resemblance. While Brazil also enacted provisions that fit into this framework, there are important distinctions. In this section, OECD, US and Brazilian transfer pricing methods are discussed separately for tangible property, intangible property and some special cases.

### Tangible property

The OECD categorizes a transfer pricing method as either a traditional method or profit method as shown in column (a) of Exhibit 1,

9. Details for determining a price range are limited under the OECD guidelines. In contrast, US Regulation Section 1.482-1(e) is more detailed and indicates, in part, that in determining an arm's length range only one (i.e., the best) pricing method is to be used. As will be discussed in the next section, numerous methods for determining an arm's length price are possible. Therefore, an arm's length range is not determined by applying two or more pricing methods to one controlled transaction.

10. See US Regulation Section 1.482-1(g).



that summarizes the transfer pricing methods for tangible property sanctioned by the OECD, US and Brazil.

Exhibit 1 TRANSFER PRICING METHODS FOR TANGIBLE PROPERTY			
(a) Categories <sup>1</sup>	(b) OECD	(c) US	(d) Brazil
Traditional Methods <sup>3</sup>	CUP	CUP	CUP <sup>2</sup>
	RPM	RPM	RPM <sup>4</sup>
	CPM	CPM	CPM <sup>5</sup>
		Other	
Profit Methods <sup>6</sup>	PSM	PSM	
	TNPM	TNPM <sup>7</sup>	

**CUP = Comparable Uncontrolled Price Method**  
**RPM = Retail Price Method**  
**CPM = Cost Plus Method**  
**PSM = Profit Split Method**  
**TNPM = Transaction Net Profit Method**  
**Within the dotted boxes, methods are virtually identical**

<sup>1</sup> These categories derive from the OECD Guidelines.  
<sup>2</sup> Brazil's CUP analog for imports is called "Método dos Preços Independentes Comparados" (PIC), Law 9430 (December 27, 1996), Article 18.I. Brazil's CUP analog for exports is called "Método do Preço de Venda nas Exportações" (PVEx), Law 9430 (December 27, 1996), Article 19, Section 3.I.  
<sup>3</sup> More specifically, the OECD refers to "Traditional Methods" as "Traditional Transaction Methods."  
<sup>4</sup> Brazil's RPM analog for imports is called "Método do Preço de Revenda menos Lucro" (PRL), Law 9430 (December 27, 1996), Article 18.II. Brazil's RPM analog for wholesale exports is called "Método do Preço de Venda por Atacado no País de Destino, Diminuído do Lucro" (PVA), Law 9430 (December 27, 1996), Article 19, Section 3.II. Brazil's RPM analog for retail exports is called "Método do Preço de Venda a Varejo no País de Destino, Diminuído do Lucro" (PVV), Law 9430 (December 27, 1996), Article 19, Section 3.III.  
<sup>5</sup> Brazil's CPM analog for imports is called "Método do Custo de Produção mais Lucro" (CPL), Law 9430 (December 27, 1996), Article 18.III. Brazil's CPM analog for exports is called "Método do Custo de Aquisição o de Produção mais Tributos e Lucro" (CAP), Law 9430 (December 27, 1996), Article 19, Section 3.IV.  
<sup>6</sup> More specifically, the OECD refers to "Profit Methods" as "Transactional Profit Methods."  
<sup>7</sup> The US analog to the OECD's TNPM is called the "Comparable Profit Method."

11. The sale of inventory is the predominant transaction to which these methods are applied because inventory is the most prevalent type of intercompany transfer. See, for example, US INTERNAL REVENUE SERVICE, Controlled foreign corporations, 1984: An industry focus. *Statistics of Income Bulletin*, p. 31-52, Fall 1989.

12. Law 9430 (December 27, 1996). Article 19, Section 3.I.

13. The distributor's gross profit may be, in some cases, based on an arm's length brokerage fee, such as a percentage of sales. Product differences are less significant than with CUP because the focus is on comparable gross profits, not products. For example, many home electronic devices, such as toasters and blenders, may have similar mark-ups, thus the nature of the product is not as critical as under CUP.

14. In this context, the term "unconditional discounts allowed" means discounts that are consistent for all customers.

*Traditional methods.* The dotted boxes in Exhibit 1 indicate traditional methods that are virtually identical. As these boxes show, CUP is universally applied, yet Brazil deviates from OECD and US norms in determining RPM and CPM. Exhibit 2 illustrates the basic concept underlying traditional methods. For simplicity, it assumes a multinational enterprise is involved in a two-stage process using a supply company and a distribution company.<sup>11</sup>

Under CUP, an arm's length transfer price derives directly from comparable uncontrolled sales, adjusted if necessary. Although Brazil addresses imports and exports separately, its analog to CUP bears a strong resemblance in spirit and form to the OECD and US versions of this method.<sup>12</sup>

Exhibit 2 THE RELATIONSHIP AMONG THE THREE TRADITIONAL TRANSACTION METHODS A TWO-STAGE PROCESS EXAMPLE	
Supplier	$\begin{aligned} & \text{Cost} \\ & \left\{ + \text{Gross profit, i.e., mark-up} \right\} \text{ CPM} \\ & = \text{Arm's length transfer price} \dots \text{CUP} \end{aligned}$
Distributor	$\begin{aligned} & \left\{ + \text{Gross profit, i.e., mark-up} \right\} \text{ CPM} \\ & = \text{Sale price} \end{aligned}$

Under RPM, an arm's length transfer price is estimated indirectly by working backwards using the formula in Exhibit 2. Namely, the following calculation applies.

$$\begin{aligned} & \text{Sale price} \\ & - \text{Gross profit, i.e., mark-up} \\ & = \text{Arm's length transfer price} \end{aligned}$$

This approach is tenable because the distributor's sale price derives from independent market forces and, under the OECD and US models, the distributor's gross profit is based on independent (arm's length) comparable transactions which are adjusted if necessary.<sup>13</sup>

While consistent in form, Brazil's implementation of this method deviates significantly from the fundamentals underlying the OECD and US approaches. For imports, the average gross sales price (i.e., the sale price) is reduced by unconditional allowed discounts,<sup>14</sup> sales related taxes, sales commissions, and a defined gross margin of

20 percent.<sup>15</sup> For exports, the average gross sales price is reduced by foreign sales related taxes, and a gross margin of 15 percent if the foreign affiliate is a wholesaler and 30 percent if it is a retailer.<sup>16</sup> A taxpayer is safe from challenge, if the transfer price determined for exports is no less than 90 percent of the price for the same or similar products sold in Brazil<sup>17</sup> (hereafter called the 90 percent rule) calculated according to the lowest of any of the methods described above. This is advantageous to taxpayers because it enables a transfer price variance of plus or minus ten percent.

Specification of a gross margin and other deductions directly contradicts the concept of a case-by-case arm's length standard as envisioned by the OECD and US. Brazil recaptures, in part, the spirit of the arm's length standard by allowing alternative gross margin percentages if they are supported by the taxpayer, based on research using internationally adopted methods of evaluation (hereafter called the arm's length option).<sup>18</sup> In essence, when this arm's length option is exercised, it conforms the Brazilian system to international norms as reflected in the OECD Guidelines and the US Regulations.

An arm's length transfer price under CPM is also indirectly determined based on the formula in Exhibit 2. Namely, the transfer price is determined as follows.

$$\begin{aligned} & \text{Cost} \\ & + \text{Gross profit, i.e., mark-up} \\ & = \text{Arm's length transfer price} \end{aligned}$$

This approach is defensible because the supplier's cost derives from independent market forces and, under the OECD and US models, the supplier's gross profit is, as under RPM, based on independent (arm's length) comparable transactions which are adjusted if necessary.<sup>19</sup>

As with RPM, Brazil's application of CPM deviates in significant ways from the fundamentals underlying OECD and US norms. Namely, the arm's length principle is modified by application of explicit supplier costs and mark-ups. More specifically, for imports, the foreign supplier's average cost of production (i.e., the cost) is increased by related taxes paid in the supplier's country and a mark-up of 20 percent on calculated costs.<sup>20</sup> For exports, the Brazilian supplier's average cost of production is increased by related

Brazilian taxes and a mark-up of 15 percent on these total costs.<sup>21</sup> Deviation from market gross profit norms is moderated by the availability of an arm's length option.

As shown in Exhibit 1, other (unspecified) methods are also allowed under the US Regulations with no OECD or Brazilian analog. Under these regulations, methods unique to tangible property other than CUP, RPM and CPM may be used to determine the price in the case of controlled transactions. When using an unspecified method a company still must apply the principles underlying the arm's length standard.

*Profit methods.* The OECD describes two profit methods that can be used to calculate transfer prices, namely PSM and TNPM, although it makes clear that other methods may be employed. The US also describes PSM and a counterpart to TNPM which is called the "comparable profit method." The Brazilian law is silent on the application of profit methods.

Under PSM, the arm's length profit of two related parties is estimated by comparing the relative economic contribution that the two parties make to the success of the common venture. Therefore, not unlike a partnership, the total profit to be split between the two related companies is identified and profit is split based on the contribution of each enterprise as determined using functional analysis. In general, all the comparability factors must be considered in implementing PSM.<sup>22</sup> The profit split should be based on expected profits. It is most easily implemented if profit splits are actually used by the affiliated group. However, because this is rare, the OECD describes two profit split approaches while acknowledging that others are possible.<sup>23</sup>

Under TNPM, net margin (NM) ratios of controlled enterprises are determined based on those of comparable independent enterprises. Net margin equals revenues minus direct, indirect, and operating costs. Appropriate ratio denominators include, for example, costs, sales, and assets. Thus, controlled company ratios such as NM/costs, NM/sales, or NM/assets are equated to those of independent companies.<sup>24</sup>

The comparability standard, with necessary adjustments, is applied when TNPM is used. Operating profits, hence net

15. Law 9430 (December 27, 1996). Article 18.II.

16. Law 9430 (December 27, 1996). Article 19, Sections 3.II and III.

17. Law 9430 (December 27, 1996). Article 19.

18. Law 9430 (December 27, 1996). Article 21, Section 2.

19. The OECD Guidelines indicate that the cost plus mark-up of the supplier ideally should be established by reference to the cost plus mark-up that the same supplier earns in comparable uncontrolled transactions. The cost plus mark-up that would have been earned in comparable transactions by an independent enterprise may also serve as a guide. The US Regulations indicate that the appropriate gross profit is computed by multiplying the supplier's cost of producing the transferred property by the gross margin earned in comparable uncontrolled transactions.

20. Law 9430 (December 27, 1996). Article 18.III.

21. Law 9430 (December 27, 1996). Article 19, Section 3.IV.

22. Comparability under PSM is especially dependent on the factors under TNPM as described in footnote 25. In addition, comparability depends particularly on the degree of similarity in the contractual terms of the controlled and independent companies.

23. So-called contribution analysis uses the relative value of the functions performed by each associated enterprise to split operating profits or gross profit (with deductions specifically identified by entity). So-called residual analysis allocates a normal profit to each party based on independent market returns from data used in traditional methods, then any residual gain or loss is allocated based on the facts and circumstances. Other approaches suggested by the OECD include setting prices so multinational enterprises earn equivalent rates of return on capital, which assumes equal risk, and splitting multinational profits based on comparable independent transactions. However, it is unlikely to find comparable independent transactions in cases where traditional transaction methods would not be used.

24. Under the US Regulations, specified ratios called profit level indicators include, but are not limited to, rate of return on capital, operating profit to sales, and gross profit to operating expenses (the so-called Berry Ratio). The US Regulations elaborate by indicating that the facts and circumstances include consideration of the relevant lines of business, the product or service markets involved, the asset composition employed (including the nature and quantity of tangible assets, intangible assets and working capital), the size and scope of operations, and the stage in a business or product cycle. While the Regulations reiterate that all of the general comparability factors must be considered, the comparability of a controlled and independent company under this approach is particularly dependent on a comparison of the: (1) Resources employed, (2) risks assumed, and (3) functions performed (where it is noted that the degree of functional comparability required to obtain a reliable result is generally less than that required under RPM and CPM). Other comparability considerations are also noted.



margins, can be significantly influenced by a number of factors in addition to product comparability which is so critical to CUP, and comparable functions that are critical to RPM and CPM mark-up determinations.<sup>25</sup> Because there are more potential factors, TNPM net margins may be more volatile (even if consistently measured) than values originated under traditional methods. In traditional methods, pricing variation among comparables may be eliminated by insisting on greater product and functional similarity.

The OECD prefers traditional methods over other pricing methods because they are the most direct means of determining price. In exceptional circumstances where data is inadequate or nonexistent, other methods may be considered. However, these methods are a last resort and their use is discouraged because the OECD believes they inadequately consider companies' differences and countries' lack of experience in their application. The so-called "best methods rule" under the US Regulations appears to be less judgmental by stipulating that there is no hierarchy of methods. In other words, the method to be used should simply be the best method, although no objective rules are provided for implementing this rule. However, the US Regulations also indicate that TNPM is a method of last resort given adequate data under other methods. This puts in question the full force of the "best methods rule" and whether it is, in practice, distinct from the OECD Guidelines. Brazilian law does not specify any profit methods. However, it does create priorities among the traditional methods by indicating that the method that results in the highest transfer price for imports and the lowest transfer price for exports should be used.<sup>26</sup> For imports and exports, allowable prices are limited by the actual contract price.<sup>27</sup>

**Intangible assets**

Exhibit 3 summarizes OECD, US and Brazilian transfer pricing guidance for intangible property.

As Exhibit 3 indicates, OECD guidelines for pricing the transfer (or use) of intangible assets are pending. Brazilian transfer pricing law specifies that domestic deductions related

Exhibit 3 TRANSFER PRICING METHODS FOR INTANGIBLE PROPERTY		
(a) OECD	(b) US	(c) Brazil
Pending	CUT Other  PSM TNPM	Reference to prior law and CUP and CPM

CUT = Comparable Uncontrolled Transaction Method  
 PSM = Profit Split Method  
 TNPM = Transaction Net Profit Method  
 CUP = Comparable Uncontrolled Price Method  
 CPM = Cost Plus Method

to royalties are subject to laws that predate the new transfer pricing provisions.<sup>28</sup> At the same time, the new transfer pricing law indicates that CUP and CPM pricing methods apply to imported rights. When pre-transfer pricing law versus CUP and CPM methods are applied is not clarified. In contrast, rules pertaining to intangible assets are extensive under the US Regulations. While there is no assurance that the US rules will be adopted by the OECD or Brazil, they are briefly reviewed below because they may be instructive, for example, for companies with US interests, in establishing or defending a position in a country without intangible property rules, and as a possible reflection of guidelines the OECD and nonUS countries may adopt.

The US rules require that transfer prices for intangibles be commensurate with the income attributable to the intangibles.<sup>29</sup> To meet this so-called commensuration with income requirement, transfer prices must reflect the actual profit realized subsequently to an intercompany sale or license.<sup>30</sup> Adjustments must therefore be made in the original sales price or royalty rate to reflect unanticipated changes in the income generated by the intangible.<sup>31</sup> When nonUS governments will not, or cannot, make a corresponding adjustment significant issues of double taxation may arise.

In effect, the commensuration with income standard requires that sales and licensing arrangements between related

25. Other factors influencing TNPM net margins include, for example, the threat of new entrants, competitive position, management efficiency, individual strategies, threat of substitute products, varying cost structures and business experience. Moreover, it is necessary to consider the accuracy of asset valuation in the calculation, and whether specific costs should be passed through, marked-up, or excluded entirely to arrive at net margin.

26. Law 9430 (December 27, 1996). For imports see Article 18, Section 4. For exports see Article 19, Section 5.

27. Law 9430 (December 27, 1996). For imports see Article 18, Section 5. For exports see Article 19, Section 6.

28. Law 9430 (December 27, 1996), Article 18, Paragraph 9.

29. The US Regulations define intangible property as any commercially transferable interest included in the following six classes of items, provided that it has substantial value independent of the services of an individual: (1) Patents, inventions, formulas, processes designs, patterns, or know-how, (2) copyrights and literary, musical, or artistic compositions, (3) trademarks, trade names, or brand names, (4) franchises, licenses, or contracts, (5) methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data, and (6) other similar items.

30. Very narrow exceptions to this rule are available. However, due to the numerous requirements, the utility of these exceptions is limited.

31. STAFF OF THE US JOINT COMMITTEE ON TAXATION, *General Explanation of the Tax Reform Act of 1986*, 99th Congress, 2nd Session, p. 1016, 1986.

parties be treated as if they are periodically renegotiated. For example, if a new patent leads to a product that turns out to be far more successful than expected at the time the patent was licensed, the affiliates are required to increase the royalty payments as if the success could have been fully anticipated. This requirement also applies to intangibles that are sold to an affiliate for a lump-sum sales price. In such cases, the commensuration with income standard may require a recasting of the transaction to include future contingent royalties or payments of sales price. The need to make periodic adjustments has led some to call these deemed payments super royalties.<sup>32</sup>

Exhibit 3 indicates that, together with the commensuration with income rule, the US Regulations prescribe a specific pricing method, CUT (comparable uncontrolled transaction method), and also permit other (unspecified) methods for determining the arm's length transfer price of intangible property. In addition, PSM and TNPM already discussed under tangible property, can be applied to intangible property.

Under CUT, arm's length consideration is determined by reference to a comparable uncontrolled transaction. Similar to CUP, the "best method rule" applies and CUT is considered to provide the most direct and reliable measure of an arm's length price when there are only minor differences between the controlled and independent transactions. In order to consider intangibles comparable they must be products or processes within the same general industry or market, and have similar profit potential. The profit potential of an intangible is measured by the net present value of the future profit or cost savings to be realized through the use or subsequent transfer of the intangibles, taking into consideration the capital investment and start-up expenses required, the risks to be assumed, and other relevant considerations. The contractual terms and economic conditions in which the controlled and uncontrolled transactions take place must be similar.<sup>33</sup> These comparability requirements may be particularly difficult to satisfy, specially considering the unique nature of many intangible assets.

## Special cases

Exhibit 4 identifies special cases for determining transfer prices under OECD, US and Brazilian norms.

Exhibit 4 TRANSFER PRICING METHODS — SPECIAL CASES		
(a) OECD	(b) US	(c) Brazil
Not specified	Interest Services fees Rents	Interest Services fees

The OECD Guidelines do not specify any special cases. Therefore, the general principles of the arm's length standard presumably apply under the OECD Guidelines until further notice. In contrast, under the US Regulations special pricing applies to interest on intercompany loans, fees for intercompany services, and rents on intercompany contracts regarding tangible property. Brazilian law also views interest as a special case and singles out technical, scientific, administrative, or similar assistance, for special treatment and deductions.<sup>34</sup>

Each US and Brazilian special case is discussed below because they are relevant to companies from, or operating in these countries. Moreover, the discussion may be a useful reference in establishing or defending a transfer pricing position in countries already using US or OECD-type norms, and a preview of future OECD guidelines.

**Interest.** Under the US Regulations, charges for interest generally are consistent with the arm's length standard. All relevant factors must be considered in determining the arm's length rate, including the amount and duration of loans, security involved, credit standing of the borrower, and interest rate prevailing at the locations of the lender and borrower. One exception among several allows zero interest on incurred intercompany debt that is on trade receivables.<sup>35</sup> Determining the appropriate arm's length interest rate may be difficult unless one of the affiliates is a commercial lender and therefore has expertise in the area. US Regulations provide a safe harbor rule to address this problem.<sup>36</sup> A safe

32. US DEPARTMENT OF TREASURY. *A study of intercompany pricing*. US printing office, p. 479, October 1988. In adopting the commensurate with income standard, the US deviated from the premise that the arm's length standard depends solely on the facts existing at the time a transaction is entered into (see, for example, the US court case *R. T. French*, 60 TC 836, 1973). Nevertheless, the US does not consider the periodic adjustment requirement to be a deviation from the arm's length standard because unrelated persons rarely make long-term licenses with no provisions for future adjustments, particularly for intangibles with high profit potential. Consistent with this view, periodic adjustments need not be made if a company can establish that an uncontrolled license agreement would not have included an adjustment clause and any post-agreement increases in the profitability of the intangible are attributable to unanticipated events occurring after the license was made (US DEPARTMENT OF TREASURY. *A study of intercompany pricing*. US printing office, p. 477-478, October 1988).

33. In addition to applying these comparability standards and the general principles discussed under the arm's length standard, in determining comparability the US Regulations set forth the following eight specific factors that may be particularly relevant in comparing controlled and uncontrolled transactions under the CUT pricing method: (1) The terms of the transfer, (2) the stage of development of the intangible, (3) rights to receive updates, revisions, or modifications of the intangible, (4) the uniqueness of the property and the period for which it remains unique, (5) the duration of the license, contract, or other agreement, and any termination or renegotiation rights, (6) economic and product liability risks assumed by the transferee, (7) the existence and extent of any collateral transactions or ongoing business relationships between the transferor and the transferee, and (8) the functions to be performed by the transferor and the transferee.

34. Law 9430 (December 27, 1996). Article 22 pertains to interest and Article 18, Paragraph 9 pertains to technical, scientific, administrative, and similar assistance.

35. Under this exception, trade receivables are defined as debt incurred in the ordinary course of business from sales, leases, and services, so long as the debt is not evidenced by a written agreement requiring the payment of interest. This exception reflects the common business practice of not charging interest on these so-called trade receivables, and serves as an important rule of administrative ease given the large number of these transactions. The interest-free period for intercompany trade receivables is generally limited to between three and six months.

36. Under this safe harbor, the interest rate on an intercompany loan is deemed equal to the arm's length rate if it is between 100 and 130 percent of the so-called applicable federal rate. The applicable federal rate is the average interest rate (redetermined monthly) on obligations of the US federal government that have maturity dates similar to those of the intercompany loan. For a discussion of the three situations in which a company cannot rely upon the safe harbor rule see US Regulation Section 1.482-2(a).<sup>37</sup> Law 9430 (December 27, 1996). Article 22.





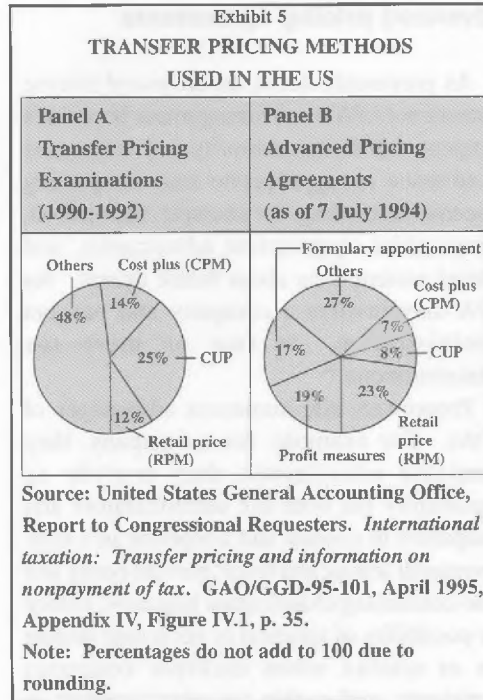
multinational company with gross sales of \$40 million in country A and \$60 million in country B. If the multinational's worldwide taxable income is \$20 million, it could be divided between country A and B based on relative gross sales, resulting in taxable income of \$8<sup>44</sup> million allocated to country A and \$12<sup>45</sup> million allocated to country B. Other factors, such as the location of operating assets and compensation, could also be used as weighted variables in the formula.

Advocates assert that this method is convenient, certain, consistent with economic reality, and reduces compliance costs. The OECD opposes formulary apportionment because it only works if adopted in every jurisdiction; different countries are likely to use different apportionment factors; transition from the existing system would be difficult; formulas are arbitrary; exchange rate movements are not accommodated; compliance costs are higher than proponents advocate, including information gathering costs and standardization for all multinational units worldwide; accounting norms would need to be standardized worldwide; there is no consideration of important geographic differences, regional efficiency differences, and other factors specific to separate companies; disregarding specific intra-group transactions complicates the implementation of withholding taxes and a number of bilateral treaty provisions; some rules still require arm's length prices, such as customs duties; and, although every member of the multinational is included, separate entity records are still necessary for non-multinational transactions.

### Evidence of methods used in the US

Publicly available evidence of transfer pricing methods used by companies is limited. The most recent study by the US General Accounting Office provides some insights about US practices as shown in Exhibit 5.

Exhibit 5, Panel A, reports the transfer pricing methods in 430 cases examined by the US between 1990 and 1992. Traditional methods, namely CUP, RPM and CPM, were used in only 51 percent of the cases. Panel B reflects an even less use of traditional methods. In 75 advanced pricing agreements



as of July 1994, 63 percent of the methods used were not one of the three traditional methods, but were methods based on formulary apportionment (17 percent), other approaches (27 percent), or profit measures (19 percent). As it will be discussed in the next section, an advanced pricing agreement is an arrangement between a company and tax authority that determines in advance an acceptable transfer pricing procedure.

### Administrative issues

Governments face a wide range of issues in administering transfer pricing restrictions. These issues may be relevant in forming and implementing a company's international transfer pricing strategy. While administrative issues are not yet addressed under Brazilian law, the US Regulations and OECD Guidelines discuss various administrative issues including advanced pricing agreements, which we discuss first because of their potential impact on a companies' transfer pricing strategies. Next, we discuss other administrative issues including mutual agreement procedures, corresponding and secondary adjustments, simultaneous examinations, and safe harbor rules. These issues are addressed below by reference to the OECD Guidelines, which closely parallel the US Regulations.

44. \$8 million = (\$40 million of gross sales in A)/(\$100 million of worldwide gross sales) \* \$20 million of worldwide taxable income.

45. \$12 million = (\$60 million of gross sales in B)/(\$100 million of worldwide gross sales) \* \$20 million of worldwide taxable income.

**Advanced pricing agreements**

As previously noted, an advanced pricing agreement (APA) is an arrangement between a company and the tax authority that determines in advance an appropriate transfer pricing procedure including, for example, the method, comparables, appropriate adjustments, and critical assumptions about future events. An APA may involve a company and one tax administration, or two or more tax administrations.<sup>46</sup>

Proponents cite numerous advantages of APAs. For example, for a company, they eliminate uncertainty; they provide an opportunity for both tax administrators and companies to consult and cooperate in a non-adversarial setting and spirit, prevent costly and time-consuming examination litigation, reduce the possibility of juridical or economic double tax or nontax when multiple countries participate, and enable tax administrators to gain insight into complex multinational transactions.

At the same time, a number of APA disadvantages have been cited. For example, if APAs are only unilateral, other tax jurisdictions may not agree with APA judgments thereby increasing uncertainty and placing in question corresponding adjustments. Moreover, an APA may pertain to a number of future years, therefore if predictions of changing market conditions are unreliable the APA must be flexible. APAs may strain the audit resources of tax administrations and divert these resources from other important functions. A tendency may exist to use past APAs as the basis for prices in future APAs. Improperly administered, APA programs might seek more detail and allow the tax administration to make a closer study of the transactions than in a

regular transfer pricing examination, and confidential information might be misused. Last, because the APA process can be expensive and time consuming it may not be usable by some businesses.

In general, the OECD believes it is too early to make recommendations concerning APAs because experience is limited to a few countries. One of the countries that might provide future information about the viability of APAs is the US which has a growing APA program.

**Other administrative issues**

Mutual agreement procedures between governments to resolve disputes are encouraged by the OECD Guidelines and are a standard feature of the OECD Model Tax Convention on Income and Capital (hereafter called the OECD Model Tax Convention).<sup>47</sup> Such procedures may provide a mechanism for corresponding adjustments which denote a transfer pricing adjustment made by one country that corresponds to the primary adjustment made by another country.<sup>48</sup> This, in turn, may justify a secondary adjustment which is encouraged under the OECD Guidelines in a way that minimizes double taxation.

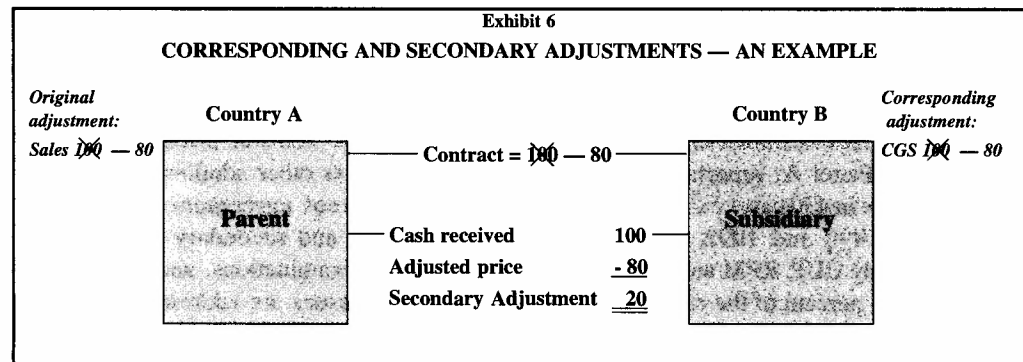
For example, assume that a \$100 transfer price and payment is made for inventory sold by a parent company in country A to a subsidiary in country B. As shown in Exhibit 6, if country A adjusts the transfer price to \$80, purchases of the subsidiary in country B should correspondingly be adjusted to \$80.

This corresponding adjustment may also cause a secondary adjustment. The secondary adjustment in Exhibit 6 arises

46. The OECD Model Tax Convention, Article 25(3), indirectly provides for APAs through competent authorities who are directed to endeavor to resolve difficulties by mutual agreement. Lacking a domestic law authorizing APAs, a clause such as Article 25(3) in a country's treaties may provide authority for APAs.

47. OECD COMMITTEE ON FISCAL AFFAIRS. *Model tax convention on income and capital*. Article 9(1). OECD publication service, March 1994, Article 25.

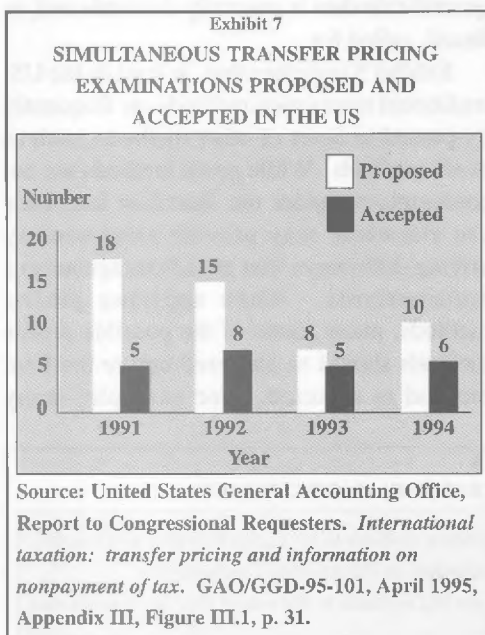
48. Corresponding adjustments are authorized under Article 9(2) of the OECD Model Tax Convention.





because when the \$100 transfer price is adjusted to \$80, \$20 of the \$100 payment to the parent should now be recharacterized from sales receipts to something else. It could be deemed a dividend, payment for services, interest on debt, or any other item depending on the facts and circumstances.

Simultaneous examinations by countries are also encouraged by the OECD Guidelines and authorized under the OECD Model Tax Convention (Article 26). Simultaneous examinations refer to the examination of a company's transfer prices by two or more governments at the same time. While they are intended to promote cross-country transfer pricing coordination and identify potential disputes at an early stage, they have seen limited use, at least in the US, as indicated in Exhibit 7.



It appears that there has been little change in the number of simultaneous examinations accepted in US cases between 1991 and 1994. Overall the number is small, between five (1991 and 1993) and eight (1992), despite the active role played by the US in transfer pricing challenges. This is unfortunate for companies if the absence of a simultaneous examination inhibits a favorable corresponding adjustment. Of course, conversely it plays to a company's advantage to the extent unfavorable corresponding adjustments are inhibited.

As already indicated, safe harbors are objective rules under which transfer prices are automatically accepted by national tax authorities. There are already some safe harbors applicable to specific items under the US Regulations, such as previously discussed interest on intercompany loans. By prescribing specific interest rates on loans and mark-ups under RPM and CPM, Brazil also has employed objective norms, although they appear more as general rules than safe harbors. The OECD Guidelines do not recommend the adoption of safe harbors because difficulties may arise across jurisdictions if safe harbors are not universally adopted and they are viewed as artificial rules that present opportunities for tax avoidance. Indeed, this is precisely the situation that could be faced by multinational companies concerning for example, Brazilian inventory transactions priced under fixed mark-up RPM or CPM methods.

### Toward a company transfer pricing policy

There is no international law prescribing transfer pricing restrictions. There are only domestic laws with which a company must deal. Therefore, a multinational company may encounter as many different rules as countries in which it is transacting. At the same time, many countries such as Brazil have developed, or are developing, transfer pricing rules based, in part, on principles underlying the OECD Guidelines and US Regulations. Not only do these models reflect the most developed thinking and experience in the area, but without cross country harmony, asymmetrical treatment may arise hence threatening international double taxation. Therefore, a country that is out of step with international norms is potentially less attractive to companies, thus at a comparative disadvantage in international trade.

Current trends suggest that governments will increasingly monitor companies' transfer pricing practices. Regular tax liabilities that result from unexpected transfer pricing adjustments are, at best, an unexpected cost that disrupts or might even undermine a business. In addition, such adjustments are potentially accompanied by significant tax penalties and interest.

Moreover, even if a company successfully defends its transfer pricing practices, the defense process can be extremely costly.

Potential conformity in cross boarder transfer pricing norms, increased monitoring by governments, and the high defense costs associated with a government challenge suggest the need for multinationals to develop an intercompany transfer pricing policy. Not only does such a policy hold potential for minimizing long term tax costs, but the presence of a consistent, rather than *ad hoc*, pricing policy is a financial management attribute that is important for current operations and effective strategic planning. The major components of a consistent intercompany transfer pricing policy are summarized in Exhibit 8 and discussed below.

**Selecting a pricing method**

In general, a company's assessment of transfer pricing methods should consider the full complement of available methods. Brazilian multinationals that wish to develop a global transfer pricing policy that is consistent with US and OECD norms, can use CUP (or CUT), or exercise their RPM or CPM arm's length options under Brazilian law. However, before doing so, they should assess using prescribed RPM or CPM mark-ups that may create advantageous pricing discrepancies across Brazilian and

nonBrazilian companies.

In applying the arm's length standard, transactions should be evaluated considering the list of OECD and US comparability factors. In addition, the OECD and US lists of other factors should be reviewed, along with any other factors a company finds relevant. These comparability and other factors also provide potential guidance for companies with Brazilian activities since Brazil has not yet developed detailed guidelines. Identical or similar transactions between a multinational company and an independent party, if available, are a good starting point for establishing prices between the multinational and an affiliate and, indeed, are required for exports under the Brazilian 90 percent rule. Bearing this, a company is left to compare its controlled sales with the sales of unrelated companies in comparable transactions. Independent quantifiable data is generally desirable and, in Brazil, called for.

Exhibit 5 indicates that, at least in the US, traditional transaction methods are frequently by-passed in favor of other methods, such as profit methods. While profit methods are not contemplated under the Brazilian law, their use elsewhere may provide cross-country pricing differences that are advantageous to a multinational. When applying profits methods, many forms of the possible profits methods should be analyzed before the final method is selected. For example, many

Exhibit 8

**COMPONENTS OF A COMPANY TRANSFER PRICING POLICY**

Selecting a pricing method	<ul style="list-style-type: none"> <li>· Use preferred traditional pricing methods to the extent they give best results.</li> <li>· Refer to OECD and US guidelines in determining comparability.</li> <li>· Consider non-traditional pricing methods to the extent they are tenable and advantageous.</li> </ul>
Documentation	<ul style="list-style-type: none"> <li>· Keep thorough records of the pricing method selection process.</li> <li>· Maintain documentation of the systematic procedures for the pricing method selected.</li> </ul>
Implementation	<ul style="list-style-type: none"> <li>· Seek input from the full range of affected company personnel in selecting a pricing method.</li> <li>· Training sessions facilitate the acceptance and effective use of a transfer pricing mechanism.</li> </ul>
Developed history	<ul style="list-style-type: none"> <li>· Develop a history of consistent use of the transfer pricing policy.</li> <li>· Maintain clear evidence supporting this history.</li> </ul>

different types of net margin ratios under TNPM should be considered. As with traditional methods, comparability analysis and the availability of quantifiable independent data is relevant to profit methods. For example, only comparable companies should be considered when determining comparable net margin ratios under TNPM. Access to companies' financial report data, independently classified by industry, facilitates this process. Often such data is available in electronic form as, for example, financial reports of companies organized by standard industrial classification (SIC) offered by Compustat in the US.

### Documentation

Relevant documentation includes a record of the transfer pricing method selection process and, for the selected method, the systematic procedures to be consistently undertaken in determining transfer prices. First, evidence of the method selection process should reflect the comparability and other factors assessed, including an assessment of the data sources that led to conclusions about the best method. Such a record is a useful internal document for reassessing transfer pricing policies in the future, as well as for initial transfer pricing assessments for new products or product entry into new regions. It is also a valuable external document for defending tax authority challenges to transfer pricing policies.

Second, documenting the procedures under the selected method also has internal and external importance. Internally, it is a valuable management tool for systematically determining transfer pricings and facilitating strategic planning, especially to the extent transfer pricing variables can be reasonably predicted. The rationale for, and quantification of, adjustments made to comparables is a relevant part of the record. The transfer pricing method selected should be dynamic in the sense that a company's transfer prices react to changes in the comparability variables within the model. For example, if a company's market share decreases relatively to that of an independent comparable, then transfer prices might change accordingly to reflect greater competition, relative to the preceding year.

Externally, documentation of selected method procedures is important for supporting transfer prices before tax authorities.

### Implementation

Transfer pricing is central to an organization's decision process and typically impacts nonfinancial, as well as financial personnel. Because of its pervasive role and priority, it is useful to involve all affected personnel in the method selection and procedures process. The involvement of marketing, operations, and other nonfinancial personnel may provide valuable input. Broad involvement through input and short awareness sessions facilitates the internal acceptance and functioning of transfer pricing mechanisms. Moreover, broad and well documented involvement in the process provides evidence to tax authorities of the selected method's viability. Management approval of the process and selected method further authenticates the outcome to internal and external constituents. In the extreme, this suggests a board of directors approval or an executive officer authorization.

### Developed history

The systematic use of the selected method builds a history that is important for continuity and internal planning, and demonstrates consistency to outside authorities. Over time, documented periodic reviews contribute to the validity of the process.

### CONCLUSION

Clearly, transfer pricing requires extensive exercise of judgment in which reasonable minds might differ. Because of its subjective nature, the process of developing an intercompany transfer pricing policy might be considered as much art as science. Accordingly, there are no guarantees of trouble free transfer pricing practices. At the same time, well informed decisions and attention to the considerations in Exhibit 8 stand to facilitate internal processes and minimize external hazards. □