

# TRANSFER PRICING: CHALLENGES AND SOLUTIONS WITHIN THE ASEAN REGIME

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## Abstract

*Transfer pricing has recently gained a prominent highlight in ASEAN countries. Eventhough transfer pricing policy has already been enacted by most of each ASEAN member states, there still exists loopholes – especially involving the transactions of cross border transfer prices. This research paper will discuss and further scrutinize the legal issues constituted by these loopholes, which affect both member states and Multi National Enterprises (“MNEs”) - particularly those associated with deficit tax revenue suffered by the member states, as a result of transfer pricing manipulations conducted by the MNEs. Transfer pricing concealed in the form of crossborder transactions; including but not limited to acquisitions, joint venture, and supply chains - impedes the movement of trade and capital, even catalyzes a tax distortion. Aside from ASEAN member states, MNEs are also being put at a disadvantage – to be subjected to a much greater burden on paying a higher cost of compliance, due to its responsibility to comply with more than one country’s jurisdiction and to have them imposed towards a susceptible double taxation. The result of this study encourages and essentially demonstrates the necessity of ASEAN to leverage a firm legal framework on transfer pricing that emphasizes on the manifestation of ‘arm’s length principle’ in all ASEAN countries’ jurisdictions.*

**Keywords:** ASEAN, transfer pricing.

## I. INTRODUCTION

The globalized business world has affected the international regime in various aspects, mainly in the field of international trade. Nowadays, had the trade barrier been removed and tarriff been prohibited - the volumes of international global transfer of goods and services, movement of capitals, also intagible assets and services has been increasing tremendously. In order to catch up with the global movement, with the help of rapid and expeditious advances in technology, logistics, and transportation - has given rise to a large number of Multi National Enterprises (MNEs), having them possess the flexibility to expand their business by establishing subsidiaries and branches outside the parent’s company jurisdiction. The existence of such subsidiaries and branches has successfully facilitated the conduct of cross-border intra-group transactions. Those transactions between such related parties, namely

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an associated enterprise – enterprise that directly or indirectly control or being controlled in the management, control or capital,<sup>1</sup> in which one party one-sidedly control the price; either determining the price lower than the market price and thus, shifting the profit gained to a lower tax jurisdiction; has caused a dissentment between both the MNEs and the government's involved between the transaction, mainly its national tax authority.<sup>2</sup> However, such issues should be addressed not only in a 'water edge' isolation<sup>3</sup>, but towards a broad international context as a whole. This matter, thus, has become a prominent highlight and been brought up to be a huge issue to the world of international tax law, namely transfer pricing. These transfer prices play a huge significant role for MNEs and tax authority as they determine the large part in the income and expenses, and thus taxable profits of those associated enterprises, especially in different tax jurisdiction.<sup>4</sup>

This paper helps to underline the underlying issues of transfer pricing, experienced and faced by both MNEs and government on the matter of taxation on the business revenues. First, this paper will discuss about the transfer pricing conduct from MNEs and government's perspective along with the legal loopholes dealt by both MNEs and government. Then, a brief case study along with the concrete examples of transfer pricing in the business world are outlined. Further, the rules applied for transfer pricing, as being practiced by United Nations (UN), Organisation of Economic and Development (OECD) member countries, and also European Union (EU) will also be reviewed. To conclude this paper, an alternate solution for the transfer pricing issues in ASEAN are also being discussed.

The legal loopholes and evasion caused by transfer pricing, also the non-existence of such binding regulations on the transfer pricing has piqued the interest of the author to conduct further research on this matter – also believes this paper would become a legal problem solver to the problems or loopholes which may arise in the near future and may benefit the international community as a whole.

<sup>1</sup> OECD Transfer Pricing Guidelines article 9 subparagraphs 1a and 1b

<sup>2</sup> Lorraine Eden, *Taxes, Transfer Pricing, and MNEs*, Oxford University Press, 2001. P.593; Raymond Vernon, *Multinational Corporations: Political Economy of Foreign Direct Investment*, Lexington Books, 1985.

<sup>3</sup> Eden, p. 614

<sup>4</sup> OECD Transfer Pricing Guidelines, Preface, p. 21

## **II. GROUNDS OF TRANSFER PRICING CONDUCT: IN A NUT-SHELL**

As stated above, while MNEs establish their subsidiaries and branches outside their parents' company jurisdiction, it accommodates their needs to move their assets while also to conduct several transactions, mainly from the MNE's parent company to its subsidiary - so called an intrafirm transaction. Those intrafirm transactions, are charged on whether they are following the market prices, or reaching a price consensus of their own, which are usually cost based - neglecting the market value.<sup>5</sup> In such situation, it becomes necessary for MNEs to determine the price among themselves, so called a 'transfer price'. Transfer prices on such transactions are usually decided from both market and group driven forces which may differ from the open market conditions operating between the independent entities. Therefore, such transactions are not only controlled by market forces, however, also by the driven forces of the common interest of the related parties, such as associated enterprises which form a part of MNE group. To sum up, there are both internal and external grounds and reasons for on the set up of transfer pricing within the intragroup trade in goods, service, and intangibles assets. Followings are the MNEs and tax authority's view on transfer pricing.

## **III. MNEs' MOTIVATIONS FOR TRANSFER PRICING**

First, the nature of MNEs is an integrated business group which consist of associated affiliates in other countries, under common control, with common goals, and sharing a common pool of resources.<sup>6</sup> Theoretically, MNEs are only subjected to domestic law of the different states in which they operate in<sup>7</sup>, but during transactions, MNEs must comply with the different from country to country's laws & regulations and administrative requirements. Many foreign affiliates of MNE are run as the profit centres, which the income of the top strata of the MNEs

<sup>5</sup> United Nations Tax's Committee Working Draft on Transfer Pricing, 6th July 2011; Roger Y. W. Tang 1997, *Intrafirm Trade and Global Transfer Pricing Regulation*, Wesport, Quorum Books.

<sup>6</sup> Eden, *op cit no. 1*, p. 596

<sup>7</sup> M. Sonarajah, *The International Law on Foreign Investment* (Third Edition), 2010

depend on their affiliates' profit.<sup>8</sup> In this case, it is internally driven that the setting of transfer price within the intra-group transactions is to increase the overall efficiency within the firm and monitor the performance of one's entity within the MNEs group, especially on determining the profitability and income of entities involved in the transactions. Externally, MNEs' main purpose on conducting transfer pricing is to optimize the tax arrangement<sup>9</sup> and minimize the taxes paid. By conducting transfer pricing, MNE as a whole, paid a lower tax rate due to the profit shifting in the lower tax jurisdiction and consequently, having the tax liability of the relevant company distorted in consequent.<sup>10</sup> Also, the profit gained by MNE is much higher as the transfer price is depending on the price at which the intrafirm transaction takes place. However, still, they are amounted to double taxation, in which they are obliged to pay corporate income taxes for both domestic and foreign source income as they conduct a transfer pricing on the cross-border transaction.

#### **IV. TAX AUTHORITIES/GOVERNMENT'S VIEW ON TRANSFER PRICING**

Unlike MNEs who view transfer pricing as a media to internally monitor their management, meanwhile paying a reduced tax obligations to the whole of MNEs group, tax authority – in contrast, are only interested in the revenue gained by MNE's local entity. Thus, the tax authority of the involved government has the right to tax the MNE's income within their jurisdiction.<sup>11</sup> However, Tax authority sees transfer pricing to be unpleasant since the government may lose their fair share of tax revenue. This is inevitably due to MNEs are paying less than they should be as their supposedly taxable revenue is being disproportionately allocated to the countries with lower tax jurisdiction – in which at

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<sup>8</sup> Eden, *loc cit* no. 3, p. 597

<sup>9</sup> Ernst & Young Report on Transfer Pricing, 2013

<sup>10</sup> Transfer Pricing and Multinational Enterprises and Tax Administration, 2012, Report of the OECD Committee on Fiscal Affairs, p. 7 ('OECD Transfer Pricing and Multinational Enterprises and Tax Administration')

<sup>11</sup> *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, para 5 □ 12; *Wolfgang Schön*, "International Tax Coordination for a Second □ Best World (Part III)", 2 *World Tax Journal* (2010), p.227 – 261;

the end, MNE as a whole, pay less tax than they are supposed to.

## **V. PROBLEMS GENERATED FROM TRANSFER PRICING MANIPULATION**

The transfer pricing itself, is not illegal and does not bring forth a tax avoidance. Only when the price set is not in accordance with international applicable norms or domestic law – so called a ‘transfer mispricing’, an issue of tax evasion and profit shifting may arise. In narrower aspect of tax administration, the problems on policy and practical level may arise. At the policy level, governments can exercise their rights to tax the profits of taxpayer based upon the income generated within their territory. In practical level, it is difficult for tax administration to obtain the detailed and pertinent data from the transactions conducted by MNEs located outside their jurisdiction.<sup>12</sup>

Although according to the abovementioned explanations transfer pricing seem innocuous, transfer pricing is bound to shape the tax base of the countries involved in the crossborder transaction, involving the MNEs and tax authorities. Transfer pricing is usually conducted and manipulated through moving the deductible expenses to the high taxes jurisdiction and shifting the revenues to the tax haven countries. Hence, without any consistent rules and administration, MNEs might be provided with an incentive to evade taxation through transfer pricing manipulation, which is an over or under-invoicing of related party transactions in order to avoid government regulations<sup>13</sup>; and yet – the world of international tax is left to deal with the upcoming legal loopholes, mainly concerning the jurisdictional matters, custom valuation, and allocation of profit.

### **A. JURISDICTIONAL MATTERS**

Theoretically, MNEs are only subjected to domestic law of the different states in which they operate in<sup>14</sup>, but during transactions, MNEs must comply with the different from country to country’s laws & regu-

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<sup>12</sup> OECD

<sup>13</sup> Lorraine Eden, 594

<sup>14</sup> M. Sonarajah, *The International Law on Foreign Investment* (Third Edition), 2010

lations and administrative requirements. Differing requirements lead to the greater burden on MNE, resulting in higher cost of compliance than for a similar enterprise operating solely within the single tax jurisdictions.<sup>15</sup> On the other hand, as MNEs are exposed to higher cost compliance to comply with more than one tax jurisdiction, the tax authority is also exposed to a similar degree of problem due to the adjustments made to the transfer price in one tax jurisdiction that immediately affect the other corresponding jurisdiction.

## B. DOUBLE TAXATION

Double taxation arises when two enterprises, as residents in different states, are assessed tax on the same profit or income without relief provided by either state for tax imposed by the other. The double taxation may be a result of non-arm's length transactions. The profits of one enterprise are adjusted upwards (mainly due to underpricing of sales and overpricing of transactions), increasing the tax charged on that enterprise in one state - known as a primary transfer pricing adjustment, without a corresponding reduction in tax payable of the associated enterprise in the other state.<sup>16</sup> However, problems arise if the other governments try to reconcile their rights to tax the income within their territory as a result of such cross-border transaction and thus, having one transaction to be taxed by more than one country's jurisdiction. This leaves the question on who has the right to tax the MNEs' income, given both governments have the same rights and which tax court shall continue on with the proceedings in case of dispute. Those issues arise due to MNEs being able to avoid the national reach of government regulations on transfer pricing – engaging in practice and being equipped with tools in order to reduce their overall taxable profit.

## C. ALLOCATION

In most jurisdictions, the tax authority bears the burden of proof – requiring them to establish a prima facie evidence, showing that the MNE's pricing is inconsistent with the arms' length principle. From MNE's perspective, still, these resources shall be allocated where they

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<sup>15</sup> OECD Guidelines 2010, Preface, no. 3

<sup>16</sup> Inland Revenue Department

offer an overall advantage for MNE as a whole, thus having MNEs motivated to shift their profits into countries with lower tax jurisdiction. Those low tax jurisdictions (i.e tax havens) provide an intriguing offer for MNEs meanwhile creating tax competition between the nation states.

However, national trade and tax barriers impede such allocation and also raise the transactional and compliance cost for MNEs. It is also to be noted, even though common resources are a source of competitive advantage for members of the MNE, such resources are interdependent and thus, making it difficult to disentangle the MNE's global income for tax purpose.

#### D. VALUATION (CUSTOM VALUATION)

In practice, MNEs are unconsciously provided with a tool to utilize the intragroup transfer prices for custom purposes. The most significant problems arising from this aspects are having to demonstrate the intercompany transfer prices to be an acceptable custom value and properly account for retroactive transfer pricing adjustment to value for customs purpose.<sup>17</sup> When goods are sold between related parties, the taxable pricing is also used for custom valuation purpose. While transfer pricing is mainly done by underpricing the intra-company sales and overpricing company purchase, the underinvoicing of intragroup sales is the main tool to reduce the tax cost, there cause no definite value of such goods upon the taxable profit.

### **VI. ARMS' LENGTH PRINCIPLE ON TRANSFER PRICING PURPOSE**

Due to the aforementioned problems concerning transfer pricing, government nowadays are facing challenges on protecting their tax jurisdiction while not creating double taxation or uncertainties that would affect their foreign investment and movement of goods and service. Thus, the adoption of transfer pricing framework embodying the arms'

<sup>17</sup> The Intersection of Transfer Pricing and Customs Valuation: Challenges (and opportunities) for Multinational Enterprises, Michael E. Murphy and Holly E, Max Planck Encyclopaedia of Public International Law, 2009, p. 149

length principle will be the solution to achieve such dual objectives.

## A. THE ARMS' LENGTH STANDARD

Where transactions in goods and services move between associated enterprises across country borders it is necessary for companies to establish transfer prices with respect to those transactions. However, to comply with the prevailing transfer pricing regulations, those prices on such transactions must be made on an arms' length basis.

Under Article 9 of the OECD Model Tax Convention, arms' length is defined as a condition made or imposed in the use or transfer of intangibles between two associated enterprises differ from those that would be made between independent enterprises, then any profits that would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly. In practical approach, an entity would only acquire the goods or services from the associated enterprises with the purchase price equal to or below than the ones offered by the unrelated parties/suppliers. Conversely, the selling price to the associated enterprises shall be equal to or higher than the price paid by the unrelated parties/purchasers. Prices on this matter shall gravitate towards the 'arms' length principle' – in which this principle requires two related parties to determine their transfer prices for an intra-group transaction in which two unrelated parties would have agreed with when those unrelated parties engage in similar transaction. It will then, to be generally recognized as prices on which two unrelated parties would agree to a transaction after bargaining in a competitive market.

Such principle set forth within the transfer pricing regulation as in accordance with OECD Transfer Pricing Guidelines might bring forth several tools for the government to face the transfer pricing challenges head on:<sup>18</sup>

1. Set up the boundaries while providing governments with tools they need to fight on the transfer pricing issue conducted by the MNEs

<sup>18</sup> OECD – Centre for Tax Policy and Administration, Transfer Pricing Legislation – A Suggested Approach, June 2011, p. 2



2. Provide MNE with certainty of treatment in such tax jurisdiction
3. Reduce the double taxation
4. Provide a level playing field between the government (as a result of double taxation), thus less likely to hamper the international trade and investment

## B. TRANSFER PRICING OF THE INTANGIBLES

In the practical approach, transfer pricing concealed in the cross-border transactions often constitutes a transfer price on the intangibles. What constitutes as an intangible is something which is not a physical asset or a financial asset, and which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances.<sup>19</sup> Intangibles itself, by OECD, is being limited to commercial intangibles – intangible property associated with commercial activities (e.g production of a good or provision of service, or even a business asset transferred to customers or used within the business operation). The term intangible property encompasses the rights to use industrial assets such as patents, trademarks, designs, or models, even know-how, and trade secrets.<sup>20</sup>

There are two classified types of intangibles:

1. Trade Intangibles (e.g patents, know-how, and technology intangibles created through investments in research and development)
2. Marketing Intangibles (e.g trademark, trade names)

Previously, the arms' length guidance and transfer pricing method shall are generally used to determine the pricing for the tangible property. However, as stipulated in the Guidance on Transfer Pricing Aspects of Intangibles, it might be difficult to apply in the case of transactions involving intangible property due to the complicated search for comparables and the uncertain values at times of transaction.<sup>21</sup> Therefore, in the amendments of the guidance further elaborate that in order to determine the arms' length condition on the transfer of intangibles, it is

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<sup>19</sup> Guidance on Transfer Pricing Aspects of Intangibles, 2014, p. 31

<sup>20</sup> OECD Transfer Pricing Guidelines, p. 191

<sup>21</sup> Ibid, p. 195

important to take these followings into account<sup>22</sup>:

1. Identification of specific intangibles
2. Legal ownership of intangibles Identifying the legal owner of intangibles based on the terms and conditions of legal arrangements: registrations, licence agreements, other relevant agreements. Then, the consistency between the conduct of the parties and the terms of the relevant legal arrangements regarding intangible ownership will be examined with a thorough functional analyses.
3. Contributions MNE group to their development and enhancement Identifying the parties performing functions through assets used and risks assumed related to developing, enhancing, maintaining, protecting, and exploiting the intangibles by means of the functional analyses.
4. Nature of controlled transactions involving such intangibles Identifying the controlled transactions related to the development, enhancement, maintenance, protection, and exploitation of intangibles in light of the legal ownership of the intangibles under relevant registrations and contracts, and the conduct of the parties, including their relevant contributions of functions, assets, risks and other factors.
5. Remuneration value paid between independent parties involving intangibles (optional) The compensation that must be paid to members of the MNE group that contribute to the development, enhancement, maintenance, protection and exploitation of intangibles is generally determined on an *ex ante* basis (anticipated). However, the allocation of *ex post* (actual) remuneration will depend on the facts and circumstances of the case.

a. Who owns the intangibles?

The question on who owns the intangibles has been ringing through the practical approach since the old times. The ownership can be categorized to 2 aspects: legal and economic ownership. The legal ownership is the one that needs to be taken into account, as they can maximize their possession on the ownership to manipulate the transfer between legal entity. Often, the owner splits their economic and legal ownership

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<sup>22</sup> Guidance on Transfer Pricing Aspects of Intangibles, 2014, p. 41

so they can take the benefits on their commercial and tax interest to its maximum.

However, the issues will arise if there are 2 or more different entities owning the legal or economic ownership – how to split profit among those entities claiming on having the legal or economic ownership respectively.

In this case, in accordance with the OECD Guidelines on Transfer Pricing, the legal owner shall take on the profits. If no legal owner of the intangible is identified, the entity – based on facts and circumstances, controls decisions concerning the exploitation of such specific intangible and has the practical capacity to restrict others from using the intangible shall be considered as the legal owner of such intangibles.<sup>23</sup> However, for transfer pricing purposes, for the legal owner to retain the derived returns from intangible exploitation – the owner shall perform their function, use the relevant assets, assumes no relevant risks regarding the development of intangible.

b. Determining the Transfer Prices of Intangibles (Case, Veritas n GE) Identification of legal ownership, combined with the identification and compensation of relevant functions performed, assets used, and risks assumed by all contributing members, provides the analytical framework for identifying arm's length prices and other conditions for transactions involving intangibles. Such analyses shall consider all of the relevant facts and circumstances present in a particular case and price determinations must reflect the realistic alternatives of the relevant group member, including the functions performed, assets used, and assumed risks.

### C. ACCEPTABLE METHOD OF TRANSFER PRICING

For 20s years, there has been a growing uniformity in the acceptable transfer pricing methods applied by the tax authorities in developed and emerging market economy. However, transfer pricing is a matter of facts and status quo, thus, each countries may have different method used by their tax authorities. Followings are the acceptable transfer

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<sup>23</sup> *Op cit*, p. 43

pricing method used and applied by most countries across the globe.

### 1. Transactional Methods

Transaction-based method is used to calculate the transfer prices on the sales of tangible property (goods).

#### a. Product Comparable

Within the product comparable, a Comparable Uncontrolled Price (CUP) is often used. To calculate the transfer prices under the CUP, the price of transaction between MNE and the unrelated parties for the same product under the same circumstances are taken into account. Also, they shall consider the characteristic of the product, market location, trade level of the firms, and risk involved.<sup>24</sup>

#### b. Functional Comparable (Gross-margin Method)

The functional comparable method is an alternate when a product comparable is not available. This method concerns about the one side and narrower approach of the transaction, either the manufacturer or distributor and to calculate the price using functional approach. Followings are the two functional comparable method (and also considered as gross-margin methods) used to determine the transfer prices.

##### i. Resale Price Method (RPM)

Under the RPM, the tax authority's concerns are for the firms at the similar trade levels that perform similar distribution functions, assuming that similar margins on sales are earned for similar function. Given a large number of distributors, to calculate an average over those unrelated firms can be a comparison for the margin that the distribution affiliate will gain in an arms' length transaction (also known as the gross profit margin, since it is derived by the gross margins earned by the comparable distributors engaged in the comparable functions). The formula to determine the transfer price is the overall retail price (price sold to the consumer) subtracted by the abovementioned margins. This method ensures that the buyer receives an arms' length return consistent with those earned by similar firms in a similar transaction.

However, as RPM method is only one-sided, this method cannot

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<sup>24</sup> Eden, p. 605

precisely calculate whether the manufacturer's profit is consistent with the margins earned by the other manufacturers. Under this method, once the distributor's margin has been determined, all the excess profit on the transaction is automatically assigned to the manufacturers. RPM is best used when the distributors add relatively little value to the product, making the value of its function easier to estimate and having intangibles less likely to be undervalued.

ii. Cost + Method

Cost + method calculates that the transfer price can be determined when the gross markup (assuming that the percentage markups over cost that would be earned by other arms' length manufacturers would be roughly the same) charged by the unrelated firms is added to the standard cost of the related party. Thus, this method is also a one-sided method, like RPM. As a one-sided method, C+ only concerns about the profit markup of the seller and insists that the other seller should earn only what arms' length sellers would earn in a similar circumstances. This method immediately allocates the profit to the distributor, implicitly assuming the supplier is the manufacturers and thus, working best when the producer is simple manufacturer without complicated activities, having the cost and return to be more easily estimated.<sup>25</sup>

2. Profit-based method

Previous product comparable methods have proven themselves durable to withstand transfer pricing currents. However, product comparable still could not tackle the remaining problems of the lack of arms' length comparables, making CUP, RPM, and C+ difficult to use in practical approach, especially in the case of intangibles. This is due to the non-existent external market prices. To deal with this problem, transfers of intangibles shall be priced commensurate with those intangibles income (CWI Standard). In this CWI standard, the functional analysis and contemporary documentation of transfer pricing policies are required. Followings are the two profit-based methods added to complement the transaction comparable method.

<sup>25</sup> Eden, p. 607

a. Transactional Net Margin Method (TNMM)

TNMM is the method commonly used for justifying the transfer pricing of the company. TNMM method compares the net profit margin earned by the arms' length party with the non-arms' length ones and use those net margin to go trace back the transfer price. TNMM searches for the comparable transactions and moves up for the other transactions for which data can be found. In addition, a functional analysis of both the associated enterprise and the independent enterprise is required to determine if the transactions are comparable. It might of course be possible to adjust results for minor functional differences, provided that there is sufficient comparability to begin with, The standard of comparability for application of TNMM is no less than that for the application of any other transfer pricing method.<sup>26</sup>

b. Comparable profits method (CPM)

This CPM Method is a profit-based method, where the industry average net profit margin earned by comparable firms is used to back into the transfer price. To perform CPM analysis, the tested party's (party whose operating profit attributable to the transactions require the fewest and more reliable adjustment) results are compared to those of comparable parties (unrelated firms engaged in the same business segment with their balance sheet adjusted for differences).<sup>27</sup>

To determine whether the price falls within the arms' length range, a net profit margin (derived from the profit level indicator – return on assets and sales) of the tested party is to be compared with the interquartile range of the comparable parties, having those margin shall fall inside the interquartile range. If the company's net profit margin falls outside the range, the tax authority will set the margin at the median range and solves backwards to determine the transfer price. The remaining profit of the transaction is then assigned to the comparable parties, making the CPM a one-sided method as it focuses only the net

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<sup>26</sup> [...] Transfer Pricing Methodologies: OCED guidelines: Transactional net margin method available at, <http://www.hmrc.gov.uk/manuals/intmanual/intm421080.htm>, accessed 3 September 2015

<sup>27</sup> Transfer Pricing Rules and Compliance Handbook, 2006, Marc. M Levey, Steven C Wrape, Kluwer Publishers.

margins of the tested company.<sup>28</sup>

## **VII.SOLUTION: CREATING A REGIONAL TRANSFER PRICING REGIME**

Transfer pricing issue on cross-border transaction, especially within the ASEAN Regime, has become difficult to deal with as they involve more than one tax jurisdiction. Consequently, any adjustment to the transfer price in one tax jurisdiction immediately affect the other corresponding jurisdiction. Problems arise if, the corresponding jurisdiction does not agree with such adjustment being made – they will also tax the MNE, thus amounting to a double taxation for a similar transaction. Thus, to overcome the issues of double taxation, a regional transfer pricing regime is required to monitor the flow and tackle upcoming issues of cross-border transaction in ASEAN.

Regional regimes are sets of functional and behavioral relationships among national governments that has been established in response to particular issues that has risen up to outside one country's jurisdiction – in this case, a transfer pricing. For example, in the situations when there are no definite legal framework establishing the transfer pricing policy within such regional, there will be incentives for governments or MNE to behave opportunistically and thus, setting up a regional regime will enhance the global welfare by providing rules of behavior, source of information, legal certainty, and formalizing the dispute settlement mechanisms; as it embodies principles, norms, rules, and procedures. Hence, is needed to manage interdependencies among nations.<sup>29</sup>

### **A. TRANSFER PRICING AS STIPULATED UNDER THE REGIME OF EUROPEAN UNION (EU)**

Generally, the EU could act as a pattern for ASEAN, primarily on the expected ASEAN Economic Community in 2015. While EU countries have already started to have themselves assembled into a regional block with internal market boundary by introducing the freedoms for

<sup>28</sup> Eden, p. 608

<sup>29</sup> Stephen Krasner, *Structural Causes and Regime Consequences: Regimes as Intervening Variables* in Stephen Krasner, Ithaca: Cornell University Press, 1983

goods, service, and capital. These freedoms have impacted the member countries of EU towards a tremendous economic growth in all regions, despite their economic segregation.<sup>30</sup>

### 1. EU Arbitration Convention

In the transfer pricing section, to resolve disputes on transfer pricing which leads to double taxation, in 1990, EU Tax Committee established a legal framework to tackle such upward adjustment of profits of an enterprise of one member states – The EU Arbitration Convention (“Convention”). This Convention possesses a binding nature towards all the contracting states on the goal of eliminating double taxation. As a result, this convention has improved the climate of cross-border transaction within the EU internal market.

EU Arbitration Convention provides that transactions between affiliated companies should be in accordance with the arms’ length standard. Consequently, the tax authorities of the Member States can adjust the profit made from the transactions when it is not at arms’ length. Affiliated companies are to be assumed as if they are wholly independent from each other.

EU Arbitration Convention also offers a solution to eliminate the classical problems of transfer pricing – double taxation problems. According to the EU Arbitration Convention, one of the parties can request a mutual agreement procedure with the tax authorities of the Member States if an upward adjustment of profit is being made by an enterprise of the Member States.<sup>31</sup> Both Member States need to come up with a mutual agreement within two years or else an Advisory Commission will be established, as stipulated under article 11 of the Convention. The Advisory Commission will deliver its opinion within six months. After this the Member States can come to a mutual agreement which is different from the opinion, but they have to do this within six months. If they don’t mutual agree within six months, the opinion of the Advisory Commission is binding. In accordance with the provisions set out in the Convention, double taxation of profits shall be regarded as eliminated if either the profits are included in the computation of taxable profits

<sup>30</sup> Asean Tax Guide, KPMG Asia Pacific Tax Centre, November 2013,

<sup>31</sup> Article 5 of EU Arbitration Convention; Implications of the Arbitration Convention, 2006, Andreas Bernath, Jonkoping University



in one State only or the tax chargeable on those profits in one State is reduced by an amount equal to the tax chargeable on them in the other.<sup>32</sup>

## 2. EU Joint Transfer Pricing Forum

While there is a binding convention, there shall be a jointly authority established in order to execute the provisions set out in the Convention. In 2002, the EU Joint Transfer Pricing Forum (“JTPF”) – comprised of EU member states and business representative (transfer pricing advisors and multinational’s tax expert), was established with the goal of eliminating transfer mispricing throughout the EU.<sup>33</sup>

The JTPF examined procedural issues related to the improvement of the practical functioning of the Convention. This included procedures to be followed during the interim period when not all Member States had ratified the Prolongation Protocol, the starting point of the three year deadline for presentation of a case, the starting point of the two year mutual agreement procedure and proceedings during it, the proceedings during the arbitration phase and the interaction of procedures under the Convention with administrative and judicial appeals. The JTPF concluded that the optimal way to improve the practical functioning of the Convention and to deal with the various issues of it and the recommendations for those issues, was to propose a Code of Conduct with rules for the effective implementation of the Convention.<sup>34</sup>

JTPF also examined existing rules in Member States for suspension of tax collection during administrative and judicial appeals. It came to the conclusion that in almost all countries this is regulated for domestic procedures at legal level. However, for crossborder dispute resolution these regulations only exist in few countries although a significant number of tax administrations could on a discretionary basis suspend the tax collection in order to avoid double payment, even if such specific regulations do not exist. The absence of rules enabling the suspension

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<sup>32</sup> Article 14 of EU Arbitration Convention

<sup>33</sup> [...], Taxation Customs Index, available at, [http://europa.eu.int/comm/taxation\\_customs/taxation/company\\_tax/transfer\\_pricing/forum/index\\_en.htm](http://europa.eu.int/comm/taxation_customs/taxation/company_tax/transfer_pricing/forum/index_en.htm), accessed 5th September 2015

<sup>34</sup> Report of the EU Joint Transfer Pricing Forum, Report on the activities of the EU Joint Transfer Pricing Forum in the field of business taxation October 2002 – December 2003, p. 5-6

of tax collection during cross-border dispute resolution, at least to the same extent as for domestic litigation creates an additional financial burden for the enterprises wishing to apply international double taxation resolution. Therefore, the code provides that Member States are recommended to take all necessary steps to ensure that the suspension of tax collection is obtainable for enterprises during the procedures of the Arbitration Convention in the same way as it would be for domestic appeals

#### B. TRANSFER PRICING: HOW SHOULD IT BE GOVERNED WITHIN THE ASEAN REGIME?

With the implementation of ASEAN Economic Community (AEC) in December 2015, ASEAN is heading down the path to achieve a fully integrated regional regime of economy. AEC provides the opportunity to smoothen business operations to take advantages on the new internal market within the ASEAN members. The opportunities pivot on the actions of the government – ensure the legislation and the general corporate commercial climate is compatible with the expected affluence of investment and trade in ASEAN. The pleasant commercial environment has been catalysed by the decreased corporate tax rates, withholding tax rates, and custom tariffs; to streamline the movement of goods and capital and thus, reducing the tax costs and inputs of taxpayers. Though each member states have reduced their tax costs and inputs of taxpayers, the tax rates between the ASEAN member countries still remain inconsistent – they have not been harmonized. This would become a hindrance in the upcoming 2015 AEC with a more mobile market where it is easier for goods, services, and capital to move across each countries' borders – making a profit shifting by MNEs to the countries with a lower corporate income tax inevitable.

Countries	Transfer Pricing Regime	National Legislation on TP
Brunei Darussalam	Yes.	There is no formal legislation on Transfer Pricing. Any intragroup cross-border transactions between the residents and foreign entities has to be conducted within the arm-length reach.
Cambodia	No. It is only generally accepted that any intragroup cross-border transaction has to be within the arm-length reach.	No specific national legislation on Transfer Pricing. The tax authority has the rights to authorize and re-determine the related party transactions in order to impose pricing that arms' length parties would have contracted for in the transactions.
Indonesia	Yes	Directorate General of Tax Regulation No. 32/PJ/2011 The transfer pricing regime is based on OECD Guidelines. Here, Directorate General of Tax (DGT) has the extended authorization from all domestics to cross-border transaction.
Laos	No	No national legislation concerning Transfer Pricing
Malaysia <sup>1</sup>	Yes	Income Tax (Transfer Pricing) Rules 2012 (P.U. [A] 132) The transfer pricing and advanced pricing agreement rules were issued in May 2012, but have a retroactive effective date of 1 January 2009. The transfer pricing rules make it mandatory for taxpayers to prepare contemporaneous transfer pricing documentation for their related party transactions. The 2012 Malaysian transfer pricing guidelines are largely based on the governing standard for transfer pricing, which is the arm's length principle as established in the OECD Transfer Pricing Guidelines (OECD Guidelines). The IRB accepts CUP, Resale Price, Cost Plus, Profit Split and TNMM. However, the Malaysian transfer pricing rules state that the traditional methods are preferred over the profit methods and advise that the profit methods should only be used when the traditional methods cannot be reliably applied or cannot be applied at all.
Myanmar	No	No formal national legislation concerning Transfer Pricing
Phillippines <sup>2</sup>	Yes	Revenue Regulations 2-2013, dated 23 January 2013 The regulations mainly follow the provisions stipulated under OECD Guidelines. The tax authority has the power to allocate income between the related parties to prevent the tax evasion and transfer mispricing. The tax authority is using the arms'-length principle on evaluating the cross-border transaction. The BIR accepts CUP, Resale Price, Cost Plus, Profit Split and TNMM.

Singapore <sup>3</sup>	Yes	Transfer Pricing Guidelines 2006, dated 23 February 2006 – issued by Inland Revenue Authority of Singapore The legislation strongly follows the OECD Guidelines. Singapore’s tax authority is endorsing the arms’-length principle on conducting the review on transfer pricing. IRAS does not have a specific preference for any of the 5 methods outlined in the OECD guidelines, method that produces the most reliable results shall be selected. However, IRAS tends to endorse comparable uncontrolled price for the loan transactions.
Thailand <sup>4</sup>	Yes	Departmental Instruction no. Paw 113/2545 (DIP 113), dated 16 May 2002 It follows the OECD Guidelines on TP. The Thai Revenue Department (TRD), by default, accepts TNMM, although they would also accept CUP, Resale Price, Cost + and other commercially used methods, such as the Profit Split, as specified in the OECD Guidelines
Vietnam <sup>5</sup>	Yes	General Department of Taxation, Circular 66/2010/TT/BTC jo Decision No. 1250/QD-BTC The tax authorities has the authority to adjust the transfer price with respect to non arms’ length related party transactions and taxpayer to comply with the TP requirement. The regulations are generally based on the OECD Guidelines. Circular 66 permits the use of the following methods: CUP, Resale Price, Cost Plus, TNMM, and Profit Split. Taxpayers must use the most appropriate method under the regulations. There is no hierarchy among the methods, although recent practice shows that the Vietnam tax authority has a growing preference for the CUP method.

## VIII. CONCLUSION

Having seen the varied income tax rates and numerous transfer pricing regulation in each ASEAN Member states in which such situation may offer the increased risk of setting up a non arms’ length transfer price and profit shifting –the author suggests it is advisable to create a regional transfer pricing regime within the ASEAN jurisdiction. In a nutshell, the transfer pricing regulations shall govern the norms, standard, and transfer pricing policies in practical business approach while emphasizing that the transactions between affiliated companies should be in accordance with the arms’ length standard. This regulation may also adopt acceptable transfer pricing methods as set out in OECD

Guidelines on Transfer Pricing, such as methods under transactional cost method and profit-based method on determining the transfer prices. Moreover, deriving from the practice of European Union, an affiliated enterprise shall be considered an independent entity while subsidiaries still being regarded as parts of MNEs as a whole.

Furthermore, this regulation will provide ways to eliminate the most classical issue of transfer pricing – double taxation. This regulation will permit that one of the parties can request a mutual agreement procedure with the tax authorities of the Member States if an upward adjustment of profit is being made by an enterprise of the Member States. Also, double taxation of profits shall be regarded as eliminated if either the profits are included in the computation of taxable profits in one State only or the tax chargeable on those profits in one State is reduced by an amount equal to the tax chargeable on them in the other.

The author believes that by establishing a regional framework on transfer pricing within the ASEAN Regime, the problems arising from transfer pricing will be greatly reduced, as such regional framework will set up the boundaries while providing governments with tools they need to fight on the transfer pricing issue conducted by the MNEs, provide MNE with certainty of treatment in such tax jurisdiction, and more importantly - reduce the double taxation. As double taxation and profit shifting problems will be reduced, the flow of capital, goods, and service will not be anymore hampered by the international tax problems.

(Footnotes)

1 [...] 2013 Transfer Pricing Global reference Guide, available at, <http://www.ey.com/GL/en/Services/Tax/International-Tax/Transfer-Pricing-and-Tax-Effective-Supply-Chain-Management/2013-Transfer-pricing-global-reference-guide---Malaysia>, accessed 5th September 2015

2 [...] Philippines Issue Transfer Pricing Regulations, available at: <http://www.ey.com/GL/en/Services/Tax/International-Tax/Alert--Philippines-issues-Transfer-Pricing-Regulations>, accessed 6th September 2015

3 [...] Singapore Issue transfer Pricing Regulations, available at: <http://www.ey.com/GL/en/Services/Tax/International-Tax/Alert--Singapore-issues-Transfer-Pricing-Regulations>, accessed 6th September 2015

4 [...] Transfer Pricing and Tax Effective Supply Chain Management, available at: <http://www.ey.com/GL/en/Services/Tax/International-Tax/Transfer-Pricing-and-Tax-Effective-Supply-Chain-Management/2013-Transfer-pricing-global-reference-guide>

--Thailand , accessed 6th September 2015

5 [...] Vietnam Issue Transfer Pricing Regulations, available at: <http://www.hvglaw.nl/GL/en/Services/Tax/International-Tax/Transfer-Pricing-and-Tax-Effective-Supply-Chain-Management/2013-Transfer-pricing-global-reference-guide---Vietnam>, accessed 6th September 2015.