# *ARTICLES*

# *Not* at Arm's Length: A Guide to Transfer Pricing Resources

Lorraine Eden
Rebecca A. Smith

**ABSTRACT.** Transfer pricing is the setting of prices for transactions inside multinational enterprises. Because transfer prices can be manipulated to avoid paying taxes, governments insist that these prices must be set as if the firms were at arm's length. Complex regulations, particularly in the United States, have made transfer pricing the top international tax issue for multinational firms. As a result, most legal, accounting and consulting firms offer transfer price services and advertise them on the Internet. This article explains why transfer pricing is so controversial, gives an overview of US and OECD regulations and methods, and provides an annotated list of transfer price resources available both on-line and off-line to researchers and information specialists. 

Lorraine Eden is Associate Professor of Management, Lowry Mays College & Graduate School of Business, Texas A&M University, College Station, TX 77843-4221 (E-mail: leden@tamu.edu).

Rebecca A. Smith is Assistant Professor and Coordinator of Reference Services, West Campus Library, Texas A&M University, College Station, TX 77843-5001 (E-mail: rebecca-smith@tamu.edu).

Address correspondence to Rebecca A. Smith.

Journal of Business & Finance Librarianship, Vol. 6(4) 2001

**KEYWORDS.** Transfer pricing, multinational enterprises, international taxation, international accounting, bibliography, case studies

## *INTRODUCTION*

What if someone in your organization said, "Please help me find information about Section 482. I need materials on CUP, RPM, CPM and TNMM. I'd like the latest information on APAs and contemporaneous documentation, and a copy of the 1995 OECD guidelines." A transfer pricing expert would know exactly what the individual was asking for, but for most information specialists the request might as well be in a foreign language. While many information professionals have heard of transfer pricing, they may not know *quite* what it means. Information specialists need to understand transfer price terms and regulations in order to assist professionals who specialize in this area. This article provides a guide to understanding such requests, and to finding transfer price resources on the Internet and in print.

## *WHAT IS TRANSFER PRICING?*

A *transfer price* is the price charged in transactions between firms that are related, for example, trade between a parent company and its foreign subsidiary or between two foreign affiliates. Multinational Enterprises (MNEs) normally set their transfer prices based on either production costs or market prices; surveys suggest that about two-thirds of transfer prices are cost based.

There are both internal and external motivations for the MNE to establish transfer prices for intrafirm trade in goods, business services and/or intangibles. Internally, many foreign affiliates are run as profit centers and their managers are rewarded depending on their subsidiary's profits. Transfer pricing can therefore be a way to motivate managers and monitor subsidiary performance. Externally, MNEs have to pay corporate income taxes on their domestic and foreign source income, necessitating they set transfer prices for cross-border trade flows. Similarly, intrafirm imports of parts, components and finished goods may face customs duties or have to meet NAFTA rules of origin requirements.

*Transfer price manipulation*–as distinct from transfer pricing–is the over or under invoicing of transfer prices in order to avoid or evade government regulations and policies, such as taxes or tariffs. That is, transfer price manipulation is the deliberate setting of transfer prices either too high or too low in order to avoid government regulations. Table 1 below illustrates some of the regulations that might induce MNEs to manipulate transfer prices.

TABLE 1. External Motivations for Manipulating Transfer Prices

| Regulation | Motivation for Transfer Price Manipulation |
|---|---|
| Ad valorem (% of value) tariffs on imported goods | Through underinvoicing, the MNE can avoid paying customs duties. |
| Differences in corporate income tax rates between countries | By shifting tax-deductible costs to the high-tax country and taxable revenues to the low-tax country, the MNE can minimize the total tax paid to the two countries. |
| Host government foreign exchange restrictions | If the foreign subsidiary cannot directly remit profits to its parent firm because of host country foreign exchange restrictions, profits can be shifted out of the host country by overinvoicing intrafirm exports to, and underinvoicing exports from, the foreign affiliate. |

## *THE IMPORTANCE OF TRANSFER PRICING*

Transfer pricing was the most important international taxation issue facing multinational enterprises in the 1990s, according to one recent, representative study of 582 MNE tax and finance directors (Ernst & Young 1999). About 78% per cent of their survey respondents name "transfer pricing" as the major international tax issue facing MNEs today, and half the respondents say it is the single most important international tax issue facing their particular firm. Over 80 percent admit to facing a transfer pricing audit from local or foreign tax authorities at some time, and almost half are currently under audit. Ernst & Young also noted an increased tendency for tax authorities to target foreign-owned MNEs. Perhaps because of the increased government surveillance, about one-third of the respondents now tailor their transfer pricing policies to local government transfer price regulations. An overwhelming percent of US MNEs acknowledge that they take into account, to some or great extent, the possibility of a tax audit when setting their transfer pricing policies. The study concludes there may be a global tax war underway, and argues that transfer pricing will continue to remain the focus of attention for both firms and governments. Thus, transfer pricing *does* matter. Why is it such a contentious issue?

## *THE PROBLEM: MULTINATIONALS ARE GLOBALLY INTEGRATED BUSINESSES*

Transfer pricing is so contentious because multinational enterprises create particular problems for tax authorities that do not occur when taxing domestic firms. These problems arise because the MNE is an integrated business group. It normally consists of several firms, located in different countries, but under common control, with a common pool of resources and common goals. The enterprise is an interlocking network of activities, working more or less in tandem depending on the control exercised by the parent firm. Its goals are to survive, make profits, increase market share, and grow. The enterprise's rivals are other large multinationals, and its actions are developed as strategic responses to those rivals in an environment of market imperfections, oligopolistic behavior, and substantial risk and uncertainty.

Since its activities cross national borders, the MNE poses several problems to regulatory authorities. MNEs have a global reach whereas governments have a national reach limited by their geographic boundaries. This creates jurisdictional problems for domestic governments because they have to allocate the income and expenses of the MNE group among various national jurisdictions in order to determine taxable income at the national level. MNEs with large international networks also make decisions with a global perspective and in a global context; this reduces the national sovereignty of both host and home countries. Because the overriding goal of the MNE group is maximization of global after-tax profits whereas national governments have complex nation-specific goals such as productivity, growth and employment, their goals are likely to conflict. Lastly, since the MNE has common overheads and resources it has additional advantages of economies of scale and scope not available to domestic firms. These resources allow the MNE to escape national jurisdiction, such as borrowing at low interest rates through the parent rather than financing investments in the local capital market, or conversely a European subsidiary could handle sales to Cuba when Trading with the Enemy Act prohibits the US parent firm from doing so.

Thus, it is the fear that MNEs will engage in transfer pricing manipulation that will reduce government tax and customs duty revenues, harm home and host country balance of payments, and distort the location of international production and employment, that leads governments to regulate transfer prices. It is not transfer pricing, *per se*, that is the problem; it is the potential for transfer price manipulation that governments fear and want to prevent through regulation.

## *THE SOLUTION: GOVERNMENT REGULATION*

Most governments, and all OECD member countries, regulate transfer prices by requiring multinational enterprises to follow the *arm's length standard*, the price two unrelated parties would have chosen if they had traded the same product under the same circumstances as the related parties. The arm's length standard asks the question: What price would the parties have negotiated if they had been unrelated? Since the firms *are* related in the transaction under scrutiny, any answer to this question has to be hypothetical. The best answer is a proxy, done in one of two ways.

In the first approach (the external comparable approach), the price negotiated by two other unrelated parties, which were engaged in the same or comparable transaction under the same or comparable circumstances, is a proxy for the arm's length price in the transaction between the two related firms. The regulator looks for two other firms which are unrelated and engaged in similar activities as the related parties in question, and then uses the price negotiated by the unrelated firms, adjusted if necessary for differences in product and functional characteristics, as the arm's length transfer price. In the second (internal comparable) approach, the price set by one of the related parties in a comparable transaction under comparable circumstances with an unrelated party could be used as an estimate. Where the MNE either buys outside or sells outside under comparable circumstances, the price negotiated with unrelated parties can be used as the arm's length price.

In practice, which approach is used will depend on the available data. Are there unrelated parties engaged in the same, or nearly the same, transactions under the same, or nearly the same, circumstances? Does one of the related parties also engage in the same, or nearly the same, transactions with an unrelated party under the same, or nearly the same, circumstances? Where there are differences, are they quantifiable? Do the results seem reasonable in the circumstances? If the answer to these questions is "yes," transactions-based pricing methods will yield a reasonable result. If the answer is "no," then alternative profit-based methods, using either gross or net profit margins, must be used.

As an example of the legal application of the arm's length standard, we outline US Internal Revenue Code Section 482, the key section dealing with transfer pricing. In one form or another, Section 482 has been "on the books" as part of the US tax system since 1917. The current version as outlined in the IRS Section 482 regulations is:

> The purpose of section 482 is to ensure that taxpayers clearly reflect income attributable to controlled transactions, and to prevent the avoidance of taxes with respect to such transactions. Section 482 places a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer . . . [The] district director may allocate income, deductions, credits, allowances, basis, or any other item or element affecting taxable income. In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer. A controlled transaction meets the arm's

> length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result).

This paragraph clearly states that the arm's length standard is the fundamental norm underlying Section 482. The US customs valuation code, although the wording differs, also follows the arm's length standard. How is the arm's length standard followed in practice in the United States and elsewhere?

## *ACCEPTABLE TRANSFER PRICING METHODS*

Governments have developed sophisticated and complex transfer pricing methods as part of their corporate income tax and customs valuation codes, with the US Treasury taking the lead in this area (Eden, Dacin & Wan, forthcoming). The 1994 Section 482 regulations are based on the best method rule (the best method is the one that yields the most reliable result), include heavy contemporaneous documentation requirements (the MNE must document its transfer pricing methodologies by the time it files a tax return), and impose controversial accuracy-related penalties for large transfer price misevaluations. The OECD's 1995 guidelines, also based on the US regulations, are in the process of being adopted by all OECD members and some non-OECD countries (e.g., Brazil, Argentina, Chile, China). Thus, the arm's length standard has been widely adopted as the international norm for pricing crossborder intrafirm transactions. The acceptable OECD methods are outlined in Table 2.

Good explanations of the basic transfer price methods, with numerical examples, can be found in Berry, Bradford and Hines (1992), Chandler and Plotkin (1993) and Eden (1998). Government regulations, such as the IRS Section 482 regulations and Canada's Information Circular 87-2R, also provide detailed numerical explanations that help clarify the methods. However, since transfer pricing is an issue of *facts and circumstances*, the key is to determine which method is the best and most appropriate method for the particular real-world situation and then attempt to apply that method; that is, the devil is in the details.

## *THE DEMAND SIDE: WHO NEEDS TRANSFER PRICING RESOURCES?*

The transfer pricing methods outlined in Table 2 require multinationals to perform complex empirical analyses of pricing policies set by their competitors. Information on sales, production, profit margins, prices, and so on are

TABLE 2. Acceptable OECD Transfer Pricing Methods

| |
|---|
| *Transactions-based methods* |
| Comparable uncontrolled price method (CUP): the price of a transaction between two unrelated parties for the same product traded under the same circumstances is used as the transfer price. |
| Resale price method (RPM): the gross margin that would be charged by unrelated firms performing the same function(s) as the related-party buyer under the same circumstances is subtracted from the retail price of the product to determine the transfer price. |
| Cost plus method (C+): the gross markup that would be charged by unrelated firms performing the same function(s) as the related-party seller under the same circumstances is added to the standard cost of the related party to determine the transfer price. |
| *Profit-based methods* |
| Transactional net margin method (TNMM): the industry average net profit margin earned by arm's length parties on comparable transactions is used to 'back into' the transfer price. |
| Comparable profits method (CPM): the industry average net profit margin earned by comparable firms is used to 'back into' the transfer price (primarily a US method). |
| Profit split method (PSM): the profit on the transaction is split between the two related parties based on their relative contributions to the transaction as measured by, for example, employed capital, sales or output. |

needed to establish transfer prices for the dozens and hundreds of individual product lines produced by each US corporation every year. Income tax and customs auditors must also perform these analyses when they audit the MNEs' books.

Where there are transfer price disputes between a multinational and a national tax authority, tax attorneys, economists, accountants, academics, and government officials all need transfer price information, in their roles as expert witnesses, litigators, consultants or regulators involved in court cases. Dozens of transfer pricing court cases, and millions of dollars spent in litigation fees in the United States, have made it abundantly clear that transfer pricing is an art and not a science.

In addition, governments outside the United States are regularly updating their transfer pricing policies. A transfer price dispute may as easily arise for a US firm in a foreign country such as Japan or Australia, as for a Japanese or Australian firm in the United States. Both private and public sector transfer pricing professionals must therefore keep up to date not only with US rules but also with foreign regulations. Thus, there is a huge demand from the private and public sectors for transfer pricing resources in both text and data form.

Because there is a shortage of transfer pricing professionals, much of the training occurs inside the international accounting and legal firms and national tax authorities. Both the IRS and the Canadian Customs & Revenue Agency, for example, have in-house training programs for their international tax auditors. Within universities and colleges, transfer pricing is also taught as part of international accounting, tax law, and international business courses. Some organizations (e.g., New York University, the Council for International Tax Education, the Institute for International Research, International Bureau of Fiscal Documentation) offer workshops in international tax and transfer pricing that can be used for legal and accounting accreditation.

## *THE SUPPLY SIDE: THE RESEARCHER'S LIBRARY OF AVAILABLE TRANSFER PRICING RESOURCES*

Developing a collection to support transfer pricing practices or courses can be an expensive and time-consuming endeavor. Many of the accounting, economic and legal resources which follow are available in print or on a subscription basis through the Internet. The Web or electronic sources, of course, are much easier to search and download, and often print well. One can visit large public libraries with extensive legal or business collections, academic business libraries, or perhaps a law school at a public university to see these materials. Many law, accounting and consulting firms also have these sources, but generally, they are not available for the public for consultation.

The following bibliography is not designed to be an exhaustive list, but rather serve as a springboard for research to create awareness of these sources and reduce search costs for the researcher or information specialist. Prices are not given because they vary from distributor to distributor; also some of the sources are subscriptions, thus one has to contact the publisher directly.

### *Core Transfer Pricing Books*

The following is a very select list of recent transfer pricing books that most libraries should have in their collections. Some are aimed at a professional audience; others are scholarly works:

- Atkinson, Mark and David Tyrell. *International Transfer Pricing–The Financial Manager's Guide*. The Financial Times Management Briefings Series. London, UK: Financial Times, 1999.
- Cole, Robert T. *Practical Guide to U.S. Transfer Pricing*. New York: Aspen Publishers, 1999.
- Coopers & Lybrand. *International Transfer Pricing*. Chicago: CCH, Inc, 1993.

- Easson, Alex. *Taxation of Foreign Direct Investment*: *An Introduction*. London: Kluwer Law International, 1999.
- Eden, Lorraine. *Taxing Multinationals*: *Transfer Pricing and Corporate Income Taxation in North America*. Toronto: University of Toronto Press, 1998.
- Emmanuel, Clive and Messaoud Mehafdi. *Transfer Pricing*. San Diego, CA: Academic Press, 1994.
- Feinschreiber, Robert, editor. *Transfer Pricing Handbook*. 2nd Ed. New York: Wiley, 1998. A 1999 paperback supplement is also available.
- King, Elizabeth. *Transfer Pricing and Valuation in Corporate Taxation*: *Federal Legislation vs*. *Administrative Practice*. Boston: Kluwer Academic Publishers, 1994.
- Organization for Economic Co-operation and Development. *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*. Paris: OECD, 1995 and 1999 (update).
- Pagan, Jill and J. Scott Wilkie. *Transfer Pricing Strategy in a Global Economy*. Amsterdam, The Netherlands: IBFD, 1995.
- Tang, Roger Y. W. *Intrafirm Trade and Global Transfer Pricing Regulations*. Westport, CT: Quorum Books, 1997.
- ________. *Transfer Pricing in the 1990s*: *Tax and Management Perspectives*. Westport, CT: Quorum Books, 1993.
- United Nations Conference on Trade and Development. *Transfer Pricing*. New York: UNCTAD, 1999.


### *Core Journals/Newsletters*

Because they have a narrow focus, key journals and newsletters are generally found only in special libraries or law firms, but for transfer pricing professionals, access to the following is a must:

- *International Tax Review*. London: Euromoney Publications, PLC. 10 times annually. 1989-present.
- *International Transfer Pricing Journal*. Amsterdam: IBFD Publications. Bi-monthly. 1993-present.
- *Journal of Global Transfer Pricing*. Chicago: CCH, Inc. Bi-monthly. 1999-present.
- *Journal of International Taxation*. Washington, DC: Research Institute of America. (also found under Warren, Gorham & Lamont) Monthly. 1990-present.
- The journal's cumulative index for the previous year can be found on the Web at http://www.riatax.com/journals/joit/joitidx.html and a few arti-

cles about transfer pricing are indexed by the topic of "advance pricing agreement" or under a country.

- *Tax Management Transfer Pricing Report*. Washington, DC: Bureau of National Affairs Tax Management Division. Bi-weekly. 1992-present. It is available in print (in the *Portfolio* series), on the Web at www.bnatax.com or through Northern Light (article by article basis) for a fee.
- *Tax Notes International*. Arlington, VA: Tax Analysts. Weekly. 1989-present. Note: in addition to transfer pricing articles, Tax Notes International reports on recent developments such as court cases related to transfer pricing issues. Available in print, or better yet, through the Web at http:// www.taxbase.com.
- *Tax Planning International Review*. Monthly. London: BNA International. 1981-present. Also available on the Web at http://www.bnatax.com/.

### *Transfer Pricing Resources on the Internet*

Using metasearch engines such as Google, InferenceFind, Northern Light and Fast yield the best results in locating information about transfer pricing. However, most of the sites are links to professional service firms (accounting, consulting, and legal) who offer transfer pricing services. Knowing how to find firms can be beneficial, however, since some sites offer papers on the topic; moreover, the IRS ruled in 1999 that transfer pricing services are tax-deductible. Two recent sources reviewing the broader topic of international tax sources on the Internet are:

- Klopper, Susan. "Taxing Research." *EContent* 3 (3) (June/July 2000): 12-23.
- Schmidt, Dennis, Roxanne Spindle and William Yancy. "Tax Professionals' Guide to Navigating through Cyberspace." *Practical Tax Strategies/Taxation for Accountants*, 62(6) (June 1999): 324-339.

The following is a selected list of free and fee Web sites that offer "big picture" and/or statistical information with additional links about transfer pricing (reviewed as of August 2000):

- *Lorraine Eden's Transfer Pricing Web Page*
  http://cibs.tamu.edu/leden.htm–click Transfer Pricing.
  The author has a nice webliography of books, articles, Web site, and a chronology of North American transfer pricing regulations.

- *Ernst & Young Transfer Pricing 1999 Global Survey*
  http://www.ey.com/global/gcr.nsf/International/Welcome_-_Library

This survey is performed bi-annually. Summary and statistics are included. At this writing, the survey is under "The Library" section of the E&Y web site.

- *Arieh Gavious's Transfer Pricing Web Page*
  http://www.bgu.ac.il/iem/staff/Gavious/index.html
  The author's website contains a broad range of transfer pricing and international accounting materials, including several of his own papers.

- *Institute of Chartered Accountants in England & Wales* (ICAEW)
  http://libcat.icaew.co.uk/uhtbin/webcat
  The ICAEW's Library and Information Services unit offers an online public catalog that indexes transfer pricing publications published in UK accounting publications. Try under the subject "Transfer Pricing Taxation" or under the title "transfer pricing" to yield the best results.

- *International Tax Law*
  http://intltaxlaw.com/shared/transfer/frontpage.htm
  ITL offers a good reading list, salient links to tax treaties and appropriate IRS forms, and older court cases under the topic "Transfer Pricing and Avoidance of Transfer Pricing Penalties."

- Bradley Smith has compiled a good transfer pricing chronology, located at http://intltaxlaw.com/shared/transfer/tpchron.htm#CHRONOLOGY.

- *International Transfer Pricing*
  http://www.deloitte.com.au/library/includes/internationaltransfer-none-none.asp
  Deloitte & Touche in Australia has links to transfer pricing in different countries.

- *Readings in International Tax Policy*
  http://www.tax.org/International/International_Readings/International_Readings_frames.htm
  Tax Analyst has a Web site that contains links to various articles arranged by broad subject categories. Selected transfer pricing policies in different countries is found under the link "Global Trading."

- *Transfer Pricing Network*
  http://www.transferpricing.com
  This Web site offers free recent news, an extensive bibliography, and papers by experts. It requires registration for access to some sites.

### *Transfer Pricing Legislation and Regulations*

By its very nature, transfer pricing is a legal and regulatory matter. Thus, researchers need the rules, regulations, and codes issued by governmental bodies, which can be electronically found in the following databases or the Web:

- *BNA Tax Products*
  http://web.bna.com/tax.htm
  The Bureau of National Affairs now has a Web platform for its and other related legal materials on a subscription basis. BNA offers e-mail alerts and with an agreement with the publisher, can utilize the information in Lotus Notes. One can still subscribe to the BNA print collection as well.

- *Financial Accounting Research System (FARS)*. Financial Accounting Standards Board (FASB). This is available on CD-ROM or through *LEXIS-NEXIS*.

- *Federal Tax Coordinator 2d Series*, Volume G (Tax Accounting Periods, Methods, Inventories), paragraphs 4000-5000–Allocation of Income and Deductions: Code Section [IRS] 482. Research Institute of America. It is available in print or on the Web at www.checkpoint3.ria.com.

- *Internal Revenue Service*
  http://www.irs.treas.gov/plain/taxi/search.html
  This site is the IRS Digital Daily Search box. Type *transfer pricing* or *arm's length* and click "Search" for a list of related links.

- *Tax Research Network Library*. CCH, Inc.
  http://tax.cch.com/
  CCH has created a Web platform for its tax and other related legal materials on a subscription basis. Of course, one can still subscribe to the CCH print collection.

- *US Tax Code On-Line*
  http://www.fourmilab.ch/ustax/ustax.html
  The site allows full-text searching of the US Tax Code; however, the text is only current through 1994. Section 482 can be located by typing in the search box, "transfer pricing."

- *LEXIS-NEXIS*
  http//:web.lexis-nexis.com
  Select *Tax* Library. Many of the publications mentioned in the journals and newsletter sections are abstracted in the database.

***Key Transfer Pricing Resource Databases***

Table 3 below provides a list of the key transfer pricing resource databases available in print and/or electronic format. Most will be well known to the information specialist. However, they may not have realized that these bases are also important to the transfer pricing researcher since they contain a wealth of information about historical and current transfer pricing and international tax legislation and regulations.

***Glossary of Transfer Pricing and Accounting Terms***

Glossaries of international accounting and taxation terms are useful adjunct transfer pricing materials. Two recent glossaries are (see also Eden 1998: 697-704):

- Susan M. Klopper. "Sailing on the AccountanSea: Accounting Research Sources," in the June/July 1999 issue of *Database* magazine. (the article also provides helpful information on accounting regulations and information sources)
- Susan M. Lyons, editor. *International Tax Glossary*. Revised, Third Edition. Amsterdam, The Netherlands: International Bureau of Fiscal Documentation (IBFD), 1996.

***Numeric Company and Industry Information***

The last category deals with statistical information relevant to conducting transfer pricing analyses. For those who are new to transfer pricing and need quick references to database sources for transfer pricing studies, there are two good recent publications on transfer pricing databases:

- Cools, Martine. "International Commercial Databases for Transfer Pricing Studies," *International Transfer Pricing Journal* 6 (September-October 1999): 167-181. This is a bibliography of commercial databases with lengthy annotations written for the practitioner or someone unfamiliar with these sources.
- Feinschreiber, Robert, editor. *Transfer Pricing Handbook*. 2nd Ed. New York: Wiley, 1998. Note: this two volume set has a key chapter entitled, "Finding and Analyzing Comparable Financial Data" written by Richard A. Clark. However, it lists primarily US company data sources. The 1999 paperback supplement is now available.

In addition to traditional company and industry article sources (which are not listed since many business librarians know these sources), researchers

TABLE 3. Transfer Pricing Resource Databases

| Database/Platform(s) | Vendor | Distributor | Subject Terms |
|---|---|---|---|
| ABI/Inform (available via Web or Internet) | ProQuest, Inc. | *Proquest Direct, DIALOG/Datastar, LEXIS-NEXIS, Dow Jones Interactive* | Transfer Pricing, Transfer Prices |
| Accounting & Tax (available Web) | ProQuest, Inc. | *Proquest Direct, DIALOG/Datastar, LEXIS-NEXIS* | Advanced Pricing Agreement, Transfer Pricing |
| BNA Web Service & publications | Bureau of National Affairs (BNA) | *BNA, LEXIS-NEXIS* | Use Tax Management Transfer Pricing Report for recent articles |
| CCH Tax Research Library | CCH, Inc. | *CCH, Northern Light, LEXIS-NEXIS* | Transfer Pricing, Arm's Length, Advance Pricing Agreement |
| TaxBase (available on CD-ROM as OneDisc or Web) | Tax Analysts | *Tax Analyst, DIALOG, LEXIS-NEXIS, WESTLAW* | Transfer Pricing, Advanced Pricing Agreement, Arm's Length |

need complex numeric sources to locate and massage company and industry segment data on comparable companies for the accepted transfer pricing methodologies. These databases are very expensive. Corporate library rates vary and academic libraries or business school departments can receive substantial discounts. However, academic licenses may allow only their users to access the databases.

There are at least three categories of data types needed for performing transfer price analysis: SIC and NAIC codes, financial statements, specifically income statements, and company and industry ratios. Tables 4, 5, and 6, which are not all-inclusive of resources, are categorized by data type and format.

It should be noted that Primark's SEC and Worldscope data are available through the following aggregator databases:

- *Disclosure Corporate Snapshots via FirstSearch*
  OCLC
  http://www.oclc.org/firstsearch/databases/index.htm

- *Global Access*
  Primark
  http://ga.primark.com

- *PiranahWeb*
  Primark
  http://www.piranahweb.com

- *FactSet*
  http://www.factset.com

COMPUSTAT data is also available through *FactSet* and the *Wharton Research Data System* (for academic institutions) at http://www.wrds.wharton.upenn.edu. Aggregator databases are front-ends for datasets, which allows for easier manipulation. Like the databases themselves, these front-ends are expensive; most of the data have to be leased through the vendor directly first. The exception is the OCLC product, which is more affordable for public and academic libraries with very limited budgets.

A short summary of a typical transfer pricing study might be helpful here in

TABLE 4. Locating SICs or NAICs (North American Industrial Codes)

| | |
|---|---|
| **Print Resources** | • SIC or NAIC Manuals<br>• *Ward's Business Directory*<br>(available through most book distributors on the Internet) |
| **Free Internet Sites** | • SIC Lookup from the US Government<br>http://www.osha.gov/oshstats/sicser.html<br>• 1997 NAISC and 1987 SIC Correspondence Tables<br>o http://www.census.gov/epcd/www/naicsb.htm<br>o (NAICs Canada)<br>http://www.statcan.ca/english/Subjects/Standard |
| **Licensed Databases** | • Primark SEC and Worldscope Data<br>http://www.primark.com<br>• FIS Online<br>http://www.fisonline.com<br>• Dun's Market Identifiers (file 516 Dialog)<br>http://www.dialog.com/<br>• Dun's Principal Businesses on CD-ROM<br>(http://www.dnb.com) |

TABLE 5. Income Statements (i.e., Sales, Expenses, Net Profits) from 10-K, 20-Fs and Annual Reports)

| | |
|---|---|
| **Print Resources** | • Company Annual Reports (requested from the firm–investor relations group)<br>• Industry Directories<br>• *Mergent* (Moody's) Manuals (available to order from http://www.fisonline.com) |
| **Free Internet Sites** | • EDGAR http://www.sec.gov/edgarhp (SEC filings)<br>• CAROL–Company Annual Reports Online (European & Asian Companies) http://www.carol.co.uk/reports/index.html |
| **Licensed Databases** | • Amadeus–Bureau Van Dijk (for European Companies) http://www.bvd.com<br>• *Dun & Bradstreet Credit Reports* (for private companies) http://www.dnb.com<br>• *Economatica Pro* (for Latin American Companies) http://www.economatica.com<br>• *FIS Online* http://www.fisonline.com<br>• *Global Access* http://ga.primark.com<br>• *Standard & Poor's Research Insight* (formerly known as *COMPUSTAT* (Domestic and Global Vantage) on CD-ROM (available to order from http://www.compustat.com/www/) |

order to illustrate how some of these resources may be implemented for transfer pricing methodology. Of course, actual transfer pricing studies are specific to the particular firm and transactions (the facts and circumstances of the case) and are far more complicated than the case outlined here, which is very loosely based on Dora K. Cheng's work (1999).

## *TRANSFER PRICING: CASE STUDY*

Let us return to the case we raised at the beginning of this paper where someone in your organization requests your assistance with a transfer pricing study. Suppose your organization (which in transfer pricing terms is known as the "taxpayer") is a US distributor of imported computer and semiconductor

TABLE 6. Company and Industry Ratios

| | |
|---|---|
| **Print Resources** | • *Dun & Bradstreet Key Industry Ratios* (available to order from http://www.dnb.com)<br>• *IRS Corporate Ratios* by Schoenfeld Associates (available to order from http://www.saibooks.com/fin.html)<br>• *RMA Annual Statement Studie*s (available for order from http://www.rmahq.org/Ann_Studies/asstudies.html)<br>• Troy, Leo. *Almanac of Business and Industrial Financial Ratios 2000* (available for order through most book distributors on the Internet) |
| **Free Internet Sites** | • *Quarterly Financial Report for Manufacturing, Mining, and Trade Corporations* www.census.gov/prod/www/abs/qfr-mm.html<br>• *Statistics of Income* http://www.irs.ustreas.gov/prod/tax_stats/ |
| **Licensed Databases** | • *Compact D/ SEC Worldscope & Canada*<br>• *Global Researcher/SEC & Worldscope* Bureau Van Dijk /Primark (CD-ROM)<br>• *FIS Online* http://www.fisonline.com<br>• *RMA Annual Statement Studies* (CD-ROM) (available for order from http://www.rmahq.org/Ann_Studies/asstudies.html)<br>• *S & P's COMUTSTAT via Research Insight* (CD-ROM)<br>• Troy, Leo. *Almanac of Business and Industrial Financial Ratios* (CD-ROM) (available for order through most book distributors on the Internet) |

products, which are manufactured by its Japanese parent firm. Assume there are no intrafirm transactions in intangibles or business services to complicate the analysis. The products can be grouped into two business segments: computer peripherals (printers and scanners) and semiconductors (semiconductors, microprocessors, memory chips). Both groups sell at arm's length to original equipment manufacturers (OEMs). Section 482 requires that all intrafirm transactions satisfy the arm's length standard. The transfer pricing study would be performed along the following lines:

1. *Identify the transactions.* Arm's length prices are needed for each major product or product group within the firm's business segments (that is, separate analyses are needed for printers and scanners, etc.). If information is not available at that level, the next smallest grouping (probably the business segment) is used.

2. *Obtain the relevant tax code documents*. Internal Revenue Code section 482 is widely available, of course, from the IRS Web site, Accounting and Tax, LEXIS-NEXIS and other sources. Information on foreign country transfer pricing provisions can be found on the national tax authority's home page. Lists of tax links are available through sites such as "Taxes Around the World" at http://www.paradine.com/worldtax.

3. *Look first for internal CUPs for the product or product group*. The comparable uncontrolled price (CUP) method is ranked first by most tax authorities. It requires the taxpayer to find identical or similar transactions between unrelated parties. Normally, the most similar transactions would be *internal comparables* where either the Japanese parent sells the same products to its US distributor and to arm's length buyers, or the US subsidiary buys both from its Japanese parent and from arm's length suppliers. This information would be available internally within the firm. In this particular case, very little is either sold by the parent or purchased by the subsidiary at arm's length so an internal comparable is not available.

4. *Look next for external CUPs.* External comparables are more difficult to obtain. If the products are standardized commodities that are widely available on the open market (e.g., 64K chips), external market prices may be available from industry catalogues and trade magazines indexed in databases found in *Dialog/DATASTAR*, Gale Group, or *Insite* 2 or *LEXIS-NEXIS*. Such prices, possibly with adjustments (e.g., for differences in markets, volume, quality), could be used to generate a comparable uncontrolled price (CUP).

5. *Select comparable firms and transactions*. If CUPs are not available, an initial search is made through databases such as Standard & Poor's *COMPUSTAT* (or Dialog file 516, *Dun's Market Identifiers*) searching for comparable (similarly situated) firms engaged in comparable transactions. For our purposes, we are using *COMPUSTAT* via *Research Insight*, thus the screens needed identify comparable firms are the following:

   a. *Same SIC code*: The firms must be engaged in the same primary business; that is, in SIC Code 5045 (wholesalers of computers and computer peripherals) or 5065 (wholesalers of electronic parts and communications equipment).
   b. *Similar activities*: The firms must be similar in their types of activities, that is, engaged primarily in distribution, with little or no manufacturing

or research & development (R&D) activities. One way to measure this is to screen for similar Selling, General, and Administrative (SG&A) ratios as the taxpayer with low R&D to sales ratios.

c. *Similar transactions*: Since the taxpayer sells only in the US market, comparable firms should also engage primarily in arm's length US sales.
d. *Publicly available data*: Firms must have financial data available for the same time period as the taxpayer. This can be located in a 10-K (or 20-F, for non-US companies) filings from EDGAR, or aggregators such *Global Access*, *FIS Online*, or *PiranahWeb*.

6. *Create financial data sets for the comparable firms*. It is important to set up financial data sheets for each comparable firm for the relevant business segment, or if possible, product group. Data items such as sales, cost of goods sold, SG&A expenses, gross profit, operating profit, operating assets, inventory, accounts receivable and payable and working capital balances are extracted from *COMPUSTAT* and are downloaded or keyed into spreadsheets. The taxpayer then calculates minimum, maximum, median and means for each financial measure and various financial ratios, for the whole sample of firms. These statistical measures are used to calculate the gross and net margin methods.

7. *Move to the gross margin methods*. Since the taxpayer is a distributor to OEMs and does not have any valuable intangibles that would complicate the analysis, the resale price method is more appropriate than cost plus. The resale price method requires that the taxpayer determine a range of gross profit margins (the ratio of gross profits to sales) for comparable arm's length transactions. If the taxpayer's gross profit margin falls within this range, it meets the arm's length test. If not, the transfer price should be set such that the taxpayer's gross profit margin is at or near the median or midpoint of the range.

8. *Move to the net margin methods*. The comparable profits method is similar to the resale price method in that it requires the taxpayer to determine a range of operating profit margins (the ratio of operating profits to sales) for comparable arm's length transactions, and then determines the transfer price that lies within that range. A final method is the profit split, which would allocate operating profit between the taxpayer and its parent firm, on the intrafirm transactions, based on the profit split achieved by comparable firms for comparable transactions. The ratio of operating profit to sales is the most likely profit level indicator, although operating profit to operating assets is also possible.

9. *Determine the best method*. Based on an analysis of the results from the different transfer pricing methods, the taxpayer determines which method provides the best result, in the sense of coming closest to the arm's length result that would be reached between two unrelated parties engaged in the same or similar transaction under the same or similar circumstances.

10. *Prepare the transfer pricing study documentation*. This approach would be repeated for each major product group purchased internally by the taxpayer. The firm until requested by the Internal Revenue Service during a tax audit would keep contemporaneous documentation of the firm's transfer pricing methodology, with background supporting documents. The study should be updated annually.

## *CONCLUSION*

The rapid growth in transfer pricing resources on the Internet and in print is testimony to the importance of transfer pricing for multinational enterprises. Information specialists need to master not only the terminology and know where to find these resources, they also need better knowledge of the relevant statistical data bases in order to assist their clients with transfer pricing analyses. As American multinationals expand globally, this also means following changing national regulations around the world. Keeping abreast of the latest and most important transfer pricing resources is a daunting task. This paper is designed to bring transfer pricing, currently not at arm's length for the average information specialist, within reach.

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SUBMITTED: 03/20/00
REVISION SUBMITTED: 08/15/00
ACCEPTED: 09/20/00