ADOPTING TRANSFER PRICING REGIME IN BANGLADESH

Rationale and the Needed Initiatives

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Dissemination of information and knowledge on critical developmental issues continues to remain an important component of CPD's activities. Pursuant to this CPD maintains an active publication programme, both in Bangla and in English. As part of its dissemination programme, CPD has been bringing out CPD Occasional Paper Series on a regular basis. It may be noted in this connection that since November 2011 the Series has been re-introduced as **CPD Working Paper Series**. Dialogue background papers, investigative reports and results of perception surveys which relate to issues of high public interest are published under this series.

The present paper titled **Adopting Transfer Pricing Regime in Bangladesh: Rationale and Needed Initiatives** has been prepared jointly by *Professor Mustafizur Rahman*, Executive Director, CPD; *Mr Md. Shabbir Ahmed*, Deputy Director General, Central Intelligence Cell (CIC), National Board of Revenue (NBR); and *Mr Towfiqul Islam Khan*, Senior Research Associate, CPD.

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Acronyms

ADB	Asian Development Bank
ALP	Arm's Length Price
APA	Advance Pricing Agreement
BRIC	Brazil, Russia, India and China
CCA	Cost Contribution Arrangement
CD	Customs Duty
CIC	Central Intelligence Cell
CPM	Cost-Plus Method
CPSM	Comparable Profit Split Method
CSA	Cost Sharing Arrangement
CUP	Comparable Uncontrolled Price
EBIT	Earnings Before Interest and Taxes
EU	European Union
FDI	Foreign Direct Investment
FICCI	Foreign Investor's Chamber of Commerce & Industry
FSI	Financial Secrecy Index
GBP	British Pound
GDP	Gross Domestic Product
HMRC	HM Revenue and Customs
IMF	International Monetary Fund
IRAS	Inland Revenue Authority of Singapore
LDC	Least Developed Country
LTU	Large Taxpayers Unit
MAP	Mutual Agreement Procedure
MNC	Multinational Corporation
NBR	National Board of Revenue
ODA	Official Development Assistance
OECD	Organisation for Economic Co-operation and Development
OEEC	Organisation for European Economic Co-operation
REER	Real Effective Exchange Rate
RPM	Resale Price Method
R&D	Research and Development
SD	Supplementary Duty
SRO	Statutory Regulatory Order
TIN	Tax Identification Number
TNMM	Transactional Net Margin Method
UK	United Kingdom
US	United States
USD	United States Dollar
VAT	Value Added Tax

1. INTRODUCTION

In today's globalised world, transfer pricing is assuming growing importance both from the perspective of tax agencies which are interested to combat the abusive use of it, and of many of the multinational corporations (MNCs) with cross-border operations and transactions for which this is becoming a common practice. MNCs are increasingly operating in regions with differentiated taxation systems and diverse regulatory situations. Global trade and trade mispricing are two closely bonded issues; growing volume of global trade has been creating increasing opportunities for trade mispricing. Indeed, the rapid rise of global trade and corporate power offers increasing opportunities for abusive use of transfer pricing (Sikka and Willmott 2010). The use of transfer pricing for tax evasion and tax avoidance is difficult to detect by tax agencies as the schemes of mispricing are carefully designed to outsmart conventional tax scrutiny. Growing incidence of abusive transfer pricing practices and their adverse economy-wide implications have attracted the attention of many academics[1] beyond the accounting discipline; many policy advocacy groups including civil society organisations[2] have been seeking more information and actions in view of the emergent situation. Some activists have tried to relate and link the issue of transfer pricing with poverty, threat to sustainable growth (Ayadi 2008) social injustice and capital outflow, in addition to the issues of tax avoidance and evasion. A number of studies have found relationship between transfer pricing, tax evasion and avoidance, profit transfer and capital flight. Consequently, transfer pricing is becoming a major indirect source of social conflict (Armstrong 1998; Oyelere and Emmanuel 1998; Gramlich and Wheeler 2003; KPMG 2004; Baker 2005).

Theoretically, transfer pricing is considered as the price of goods or services (both tangible and intangibles) that one enterprise charges to a related enterprise. This enterprise can be a department or division, affiliated company, sister concern, subsidiary or joint venture of the other and vice versa (Horngren *et al*. 2002; Atkinson *et al*. 2004). It is used as a means of distributing revenues and costs, and thus profits among various related enterprises.

Deviation from independent commercial price (*fair transfer price*) in the process of transactions is termed *transfer mispricing*. *Mispricing* usually takes place in five broad areas: trade, contracts, intangibles, cost sharing and management services. Evidence suggests that transfer mispricing is becoming a common practice in all regions, and in all industries. Evidence also shows that this is costing global tax system a significant amount of revenue. No wonder that the tax agencies across the world have made combating transfer mispricing their top priority agenda. Modern tax authorities are becoming increasingly aware of the fact that many enterprises are taking resort to various maneuvering practices to transfer profits from tax jurisdiction with a higher tax structure to those with a lower tax structure (Tanzi 2000). Clausing (2003) has argued that the objective of tax minimisation has a significant impact on prices charged for intra-firm trade. Weichenrieder (1996) quoted an executive of a renowned MNC that his company tried to transfer costs to countries with higher tax rates. Ernst & Young (2005) argued that, for a firm which tries to maximise its profit, considers tax charged on profit as a cost, and it is expected that the firm would like to

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[1]For example, see Brittain-Catlin (2005); Baker (2005); Kar and Cartwright-Smith (2008).

[2]For example, see Global Witness (2005); ActionAid (2009); Christian Aid (2008), (2009).

minimise the tax. Given this reality, it is not unexpected that tax agencies across the world have put the task of combating transfer mispricing as one of their priority agendas. Many countries around the world have entered into various bilateral and multilateral agreements, including joint frameworks and treaties, with a view to addressing this challenge; they have also developed international standard guidelines on transfer prices to improve fiscal regulations (Picciotto 1992; Eden *et al*. 2001; European Commission 2004; OECD 2009b). In some countries, tax agencies have been awarded with considerable authority to challenge corporate accounting practices with a view to identifying and detecting related malpractices. The presence of a transfer pricing regime not only benefits tax agencies, but also the affiliated entities of the concerned jurisdictions; adoption of the transfer pricing regime helps the entities to avoid the pitfalls of double taxation (Sikka and Willmott 2010).

Sikka and Willmott (2010) provided a number of evidences that show transfer pricing is a common practice across the globe – in developed, transitional and emerging economies alive. The problem of transfer pricing is no less persistent in least developed countries (LDCs) (Kar 2011a; McLure 2006). In some LDCs, illegal financial outflows arising from transfer pricing tends to outpace official development assistance (ODA) inflow. Kar (2011a) argued that a number of structural characteristics including limited domestic savings and the resulting foreign aid dependence influence illicit flows from LDCs. McLure (2006) identified four broad weaknesses of LDCs in negotiating the abuse of transfer pricing. *First*, legislative framework in the LDCs is inadequate to deal with the issue. *Second*, LDCs often lack adequate administrative capacity, including specially trained professionals, to deal with transfer pricing issues. Administrative capacity is an important issue in dealing transfer pricing. Without proper organisational set in place, mere existence of a legal framework does not guarantee desired compliance. *Third*, 'comparable uncontrolled transactions' and relevant evidences on profitability are less likely to be detected by, and accessible to, LDCs compared to their developed counterparts. *Fourth*, prolonged legal procedures which could emerge from transfer pricing cases tend to discourage LDCs from taking interest in this issue in earnest.

In view of the growing presence of transnational corporations and the likelihood of increased foreign investment in the country, Bangladesh needs to take more interest in the issue of transfer pricing. The country should have a prudential transfer pricing policy to secure tax revenue, extend the tax base, protect the balance of payment, and ensure economic and social justice. Bangladesh should develop a comprehensive and detailed set of rules in relation to the establishment, maintenance and documentation of transfer pricing policies and procedures and mechanism for resolving disputes. As Bangladesh tries to enhance her credentials and attractiveness as a destination for transnational corporations, appropriate authorities and agencies will need to be equipped adequately to face the practical issues of determining the income and expenses of firms that are subsidiaries of transnational corporate groups. The national tax agency should be concerned with the problem of likely erosion of national tax base, and the adverse impact on local firms if transnational corporations enjoy undue advantage due to profit-shifting activities through transfer pricing. Establishing and implementing a prudential transfer pricing policy would thus enable the tax agency to enforce the legitimate right to tax the profits of the transnational corporation based on the income arising from operating within the jurisdiction.

Transfer pricing has tended to remain an under researched area in Bangladesh. Not many academic works have been carried out on related issues. The issue is yet to be fully appreciated in academics and policy making quarters of the country. The objective of this paper is to raise awareness about the issues and to propose a basis for adoption of a transfer pricing regime in Bangladesh. The present study is an attempt to review the relevant international experience, secondary information and data and current global regulations and literatures, and provide the rationale for design and implementation of the necessary fiscal reforms related to transfer pricing. Based on analysis, the paper has attempted to put forward a comprehensive legal and administrative framework which can be used as a guideline to the policymakers to address the issue of transfer pricing in the context of Bangladesh. A large number of academic works, policy briefs and legal documents have been reviewed to draw upon the relevant experiences and evidences. The study also attempts to link global standard and Bangladesh context in making the policy recommendations. The policy proposals in this paper will also be relevant for other low-income countries in similar situation which are yet to put in place a transfer pricing regime.

The paper contains seven core sections. Following the introductory section, the study sets off by providing a brief overview of transfer pricing issues in the global context in Section 2. Section 3 introduces related concepts and a standard administrative framework. Section 4 briefly focuses on global and Asian experience of transfer pricing, and puts forward a detailed case study of the Indian experience in adopting transfer pricing. Relevance of transfer pricing in Bangladesh context is analysed in the Section 5. Section 6 proposes a comprehensive legal and administrative framework for transfer pricing in Bangladesh. The paper ends with a summary of observations and a few concluding remarks.

2. AN OVERVIEW OF TRANSFER PRICING

2.1 Illegal Capital Flow, Trade Mispricing and Tax Evasion

Flow of capital across countries is a common global economic phenomenon. Capital flow falls into two broad categories: legal capital flow and illegal capital flow. Most countries have their own policies and regulations in place to deal with capital flows. When capital tend to flow beyond the recognised channels, violating the regulations of respective country, it is treated as flown illegally. However, most low-income countries do not have mechanisms in place to deal with this particular type of capital flow.

The terms *illegal capital flow* and *capital flight* are synonymous in developing countries. Empirical studies show that illegal capital tends to leave developing countries, and flow into the developed world. Weak governance, absence of political and economic stability (Kramer 2000), frequent depreciation of currency, and lack of security of capital funds often motivate the fund owners in developing countries to seek safe haven for their tax-evaded money. The money finds welcome refuge in 'socio-economically stable good-governance countries.' Financial secrecy practices and regulatory incentives of capital-seeking good-governance countries incite illegal capital fund to desert developing countries (Fiskaa 2011).

The intensity of capital flight from developing countries is indeed high and is on the rise. Kar and Curcio (2011) estimates that each year, capital flowing out of developing countries

amounts to USD 725 to 810 billion. Hollingshead (2010) estimates that average annual illegal financial flow from developing countries, during the period from 2002 to 2006, was between USD 859 billion and USD 1.06 trillion. Illegal capital flowing out of developing countries amounted to ten times as much as the development assistance flowed into those countries (Norwegian Government Commission on Capital Flight from Poor Countries 2009). Almost all developing countries suffer from loss of capital flight, to various degrees. Asian countries top the list in this regard – they account for more than 50 per cent of total capital loss by the developing world.

Flight of capital takes place through various modalities and means. The most popular form is trade mispricing, smuggling, and fraud and other illegal cross-border transactions (Schneider 2003; Schneider 2005). A EURODAD, CRBM, WEED and Bretton Woods Project Report (2008) identifies three major categories of capital flight: capital flight related to criminal activities, corruption-induced capital flight, and capital flight due to illegal commercial flows in the manner of trade mispricing.

Mispricing in international trade is one of the oldest means of transferring fund to other countries (Zdanowicz 2004). Shifting profit and capital under the guise of cross-border transactions is a practice common in all over the world. Mispricing in international trade not only leads to transfer of capital fund, but also shifts profit from the host country. Transfer of profit results into tax evasion. In effect, tax evasion is the biggest driver of trade mispricing. Every year tax agencies around the globe lose billions of dollars of potential tax revenue due to trade mispricing. Hollingshead (2010) estimates that on an average, developing countries lose more than USD 100 billion of tax every year. The estimate is supported by a Christian Aid (2009) report that finds the average annual loss of tax by all non-EU (European Union) countries stood at USD 121.8 billion in the period between 2005 and 2007.

2.2 Concept of Transfer Pricing

Two trading parties enter into a malicious pricing practice only when the practice brings benefits to both of them. In order to yield maximum benefit from mispricing, transacting parties must be bonded by common interest. Here comes the concept of *related party*. Related parties are parties having common interest in ownership, management, control and economic distribution of a business. Subsidiaries and associates, management partners, employees, family members and relatives and parties bonded by interest in any other form of relationship make related parties.

International trade can be grouped into two broad categories: trade between independent parties, and trade between related parties. About 40 per cent of total global trade is conducted among related parties (Trade Agreements Blog n.d.). Related party transaction accounted for 46 per cent of import and 33 per cent export in United States in 2001 (Sikka and Willmott 2010). Since related parties have common goal in cross-border trade, mispricing occurs at more frequency and magnitude in transactions between related parties than in transactions between *unrelated* independent parties.

Multinational enterprises control significant share of global economic activity. As Sikka and Willmott (2010) reports, *the 200 top corporations accounted for 28 per cent of the world*

economic activity. The top 500 transnational corporations controlled 70 per cent of the worldwide trade; 80 per cent of the foreign investments; 30 per cent of the global gross domestic product (GDP); one-third of all manufacturing exports; 75 per cent of all commodities trade; and 80 per cent of the trade in management and technical services. Multinational enterprises have subsidiaries, associates, trade partners, joint ventures and other forms of business interest in different jurisdictions, and a significant share of their total trade are concluded within the related parties or affiliated entities. Therefore, the affiliated entities or the members of a multinational group turn out to be each other's related party in majority of the group's international transactions.

One good way of curbing trade mispricing is to monitor the price of international transaction. Monitoring transactions enables countries to unearth the incidences of pricing abuse and to recover the evaded tax through such abuse. But monitoring all transactions is a difficult, if not impossible, task. Independent parties are often located in diverse jurisdictions, having difficult-to-trace identity. Transactions executed among independent parties are often very high in numbers, but small in volume. Therefore, the time and resource spent on the examination of independent party transactions may not be sufficiently compensated by the benefits of such examination. Moreover, independent parties are commonly believed to have no common interest, and therefore, no visible motivation for distorting price.

Related parties, on the other hand, are mostly the big multinational enterprises and their affiliated entities bonded by common interest. They usually maintain sizeable transaction records, commit long-term investment in a jurisdiction, and demonstrate better compliance. Regulatory agencies, therefore, find it more rational and useful to concentrate on transactions executed between related parties. Instead of going after the whole gamut of transactions, tax agencies narrow their focus down to the pricing of transactions between related parties. Here comes the issue of *transfer pricing*.

Transfer pricing refers to *the determination of prices at which goods, services and intangible properties are transacted between* ***related parties*** (Inland Revenue Authority of Singapore 2006a). As was discussed earlier, related parties may be the members or sister concerns of a group or the entities bonded by any form of common economic interest. Prices agreed in related party transactions often deviate from independent market prices. As observed in the website of Inland Revenue Authority of Singapore (IRAS) (2006b):

> *When unrelated parties deal with each other, independent market forces shape the commercial pricing of such transactions. However, in transactions involving related parties, their commercial and financial relations may lead to the setting of prices that deviate from independent commercial prices. This results in distortion of the profits derived by each related entity to the transactions as well as in the tax liabilities of each.*

2.3 Practice of Transfer Mispricing

2.3.1 Loss of Tax Revenue

Transfer mispricing is so unrelenting a global practice that even the seemingly flawless tax machinery of developed countries cannot help sustaining significant amount of tax loss on its account (Norwegian Government Commission on Capital Flight from Poor Countries 2009). No wonder, developing countries are even more susceptible to this practice, with significant losses on this account each year. Between 2005 and 2007, 49 low-income countries lost about GBP 1,796 million (USD 3,414 million[3]) of tax revenue due to mispricing in bilateral trade with EU and US (Christian Aid 2009). The loss of tax in this period was about GBP 186 million (USD 359 million) for Bangladesh; GBP 20,160 million (USD 44,934 million) for China; GBP 3,603 million (USD 6,753 million) for India; and GBP 3,339 million (USD 6,453 million) for Brazil.

The surge in tax demand emerging from transfer pricing audit testifies the fact of growing tax evasion through multinational transactions. For example, in India where transfer pricing audit was introduced only in 2004-05 Financial Year (Ranjan 2005), the aggregate amount of transfer pricing adjustment was made to the tune of USD 5,000 million by the end of 2009-10 Financial Year (Taxguru 2010). China made a transfer pricing adjustment of more than USD 382 million in the year 2010 alone (Sheng 2011). UK raised GBP 2,114 million in a period between 2007 and 2009 from transfer pricing audit (Sikka and Willmott 2010).

2.3.2 Capital Flight

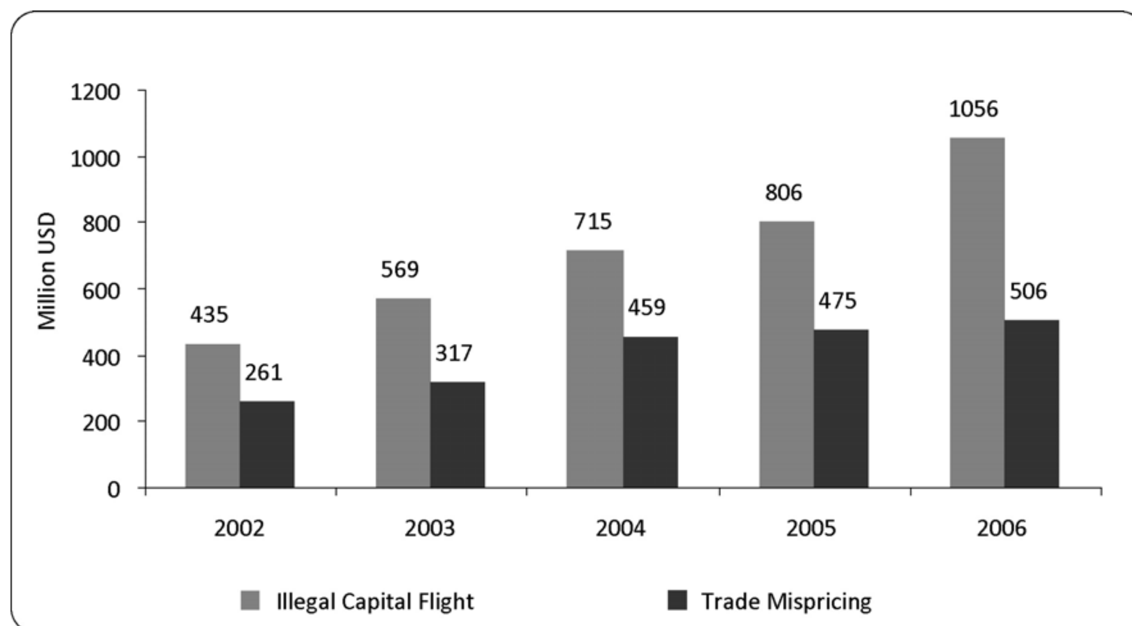
Transfer mispricing and capital flight go hand-in-hand. Transfer pricing is indeed the most commonly applied instrument of shifting capital from a country. Regrettably, developing countries are always tend to be the losers in the distribution of flown capital. Bhagwati (1974) is among the first to study trade mispricing as a tool of illicit capital transfer. Since then a number of the seminal studies have been carried out. Tikhomirov (1997) reported that between 1990 and 1995 about USD 400 billion of capital may have been trasferred from Russia to the United States and to a number of European countries. de Boyrie *et al*. (2005) estimated a capital outflow of USD 8.92 billion through under-voicing of exports of 25 commodities between 1995 and 1999 from Russia to the United States. Similar studies were also carried by Gunter (2004) for China, and Ndikumana and Boyce (2008) for Sub-Saharan African Countries.

Christian Aid (2008) estimates that the illegal capital flown from non-EU countries to EU 27 and US, resulting from trade mispricing between 2005 and 2007, amounted to USD 1,100 million. Amount of capital flew out of Sub-Saharan African countries in the period from 1970 to 2004 was about USD 420 billion (ActionAid 2008). Kar (2011b) reports that India lost a colossal amount of USD 213 billion between 1948 and 2008 by way of illegal capital flow. Trade mispricing plays a key role in this fund-flowing scenario, accounting for 50 to 65 per

[3]Converted into United States Dollar (USD) from British Pound (GBP) using the respective exchange rates for 2005, 2006 and 2007. The exchange rates have been taken from http://www.x-rates.com/cgi-bin/hlookup.cgi (for each year, the rate of the closing date of June has been considered).

cent of the total illegal capital flows (DIIS 2009). Figure 1 provides a five-year comparison of capital flight from developing countries and the contribution of trade mispricing in that flight.

Figure 1: Relationship between Capital Flight and Trade Mispricing



Source: Based on the data from DIIS (2009).

2.3.3 Money Laundering

Money laundering affects developed and developing countries equally, and is creating threat to global security and soundness of financial system. Laundered money is often used in organised crime, drug trafficking and terrorist financing. Money laundering also affects the supply of capital and the flow of foreign currency.

Money laundering is an issue of global concern particularly given its growing and alarming presence. Camdessus (1998)[4] observed that the global size of laundered money could be as much as 2 to 5 per cent of the world GDP (AUSTRAC, John Walker Crime Trends Analysis and RMIT University 2007). According to Zdanowicz (2004), the amount of money laundered out of USA in 2001, by means of over and under valuation in international trade, was about USD 156.22 million.

Transfer pricing is a popular mean of laundering money (Rijock 2006). Money launderers use trade-based techniques such as over and under invoicing, false description, multiple billing and fictitious transactions (OECD 2009a) for moving money across political jurisdictions.

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[4]Michel Camdessus, the longest serving Managing Director of the International Monetary Fund (IMF) (from 16 January 1987 to 14 February 2000) observed in his address to the Plenary Meeting of the *Financial Action Task Force on Money Laundering*, in Paris, in 1998: "*… while we cannot guarantee the accuracy of our figures … the estimates of the present scale of money laundering transactions are almost beyond imagination — 2 to 5 per cent of global GDP would probably be a consensus range.*"

2.3.4 Shadow Economy

Trade mispricing, shadow economy and illegal capital flow are three inseparably linked aspects of the same phenomena. Trade mispricing leads to tax evasion. Evaders of tax tend not to consider it safe to keep their *untaxed* money within the evaded jurisdiction. This apprehension leads to illegal transfer of capital to foreign jurisdictions that offer safe haven for tax-evaded funds. As Kar (2011b) reports, the total volume of India's shadow economy in 2008 was about USD 640 billion, and of that, USD 462 billion moved out of India. The relationship among shadow economy, capital flight and transfer mispricing is evident from the recommendations made in Kar's study; he advocated in favour of curtailing trade mispricing as an instrument of trimming shadow economy and checking illegal financial flow Kar (2011b).

2.4 Conducive Environment for Transfer Mispricing

Traditional views tended to take a simplistic assumption that transfer pricing or illicit financial flows was a mere corporate practice for profit maximisation. However, recent research showed that a country's economic and governance situation had much to do to influence such practices. Kar (2011a) classified factors that drive illicit financial flows into three broad categories – macroeconomic, structural, and governance-related. He argued that macroeconomic tensions tend to evolve as a result of unmanageable fiscal deficits, inflationary phenomenon and overvaluation of exchange rate (in terms of real effective exchange rate – REER). Such macroeconomic scenario, in addition to factors such as negative real rates of return on assets and outflow of short-term portfolio capital by the private sector, contribute to transfer mispricing practices (Sheets 1996; Schineller 1997; Chipalkatti and Rishi 2001). Illicit financial flows are also driven by a number of structural factors including worsening income inequality, fast but non-inclusive economic growth, and growing trade openness without having necessary regulatory oversight. A non-inclusive economic growth pays disproportionately higher dividends to the rich sections of the society. And the weak state of governance offers the people of these sections the opportunity and impetus to evade taxes on their income (or profit). The situation is exacerbated when these people do not find lucrative investable areas for their profit or surplus income within the tax jurisdiction; they look safe refuge of their money outside the jurisdiction. In countries where kickbacks, not the consideration of internal rate of return, dictate the allocation of public resources, illicit financial flows are more likely to occur.

2.4.1 Incentives within the Global System

Financial Secrecy Practice

In order to attract capital, many jurisdictions across the world relax exchange control provisions. They formulate regulations that offer banking institutions, trusts, companies and other fund-seeking entities the right not to disclose investors' identities and maintain secrecy in financial and accounting practice. Such financial secrecy provides immunity to illegal fund owners even from international investigations. Financial secrecy practices distort global financial integrity and contributes to the spreading of money laundering, transfer mispricing, tax evasion and capital flight (Blickman 2009). As Tax Justice Network (2009)

observes, financial secrecy shield "... *distorts trade and investment flows, and creates a criminogenic environment for a litany of evils that hurt the citizens of rich and poor countries alike: tax evasion, fraud, insider-dealing, embezzlement, non-payment of alimony, money laundering, evasion of prudential banking regulations, and much more besides.*"

Interestingly, financial secrecy providers are not only traditional *secrecy jurisdictions* such as Switzerland, or the tiny offshore havens such as Cayman Island, but also the big names such as USA (Delaware), UK (City of London), Singapore, Belgium and Ireland (Tax Justice Network 2009 and 2011).

The Financial Secrecy Index of Tax Justice Network provides a ranking of secrecy jurisdictions. The names and the opacity rankings of the ten top *secrecy jurisdictions* can be seen from Table 1.

Table 1: Financial Secrecy Index (FSI) in 2009 and 2011

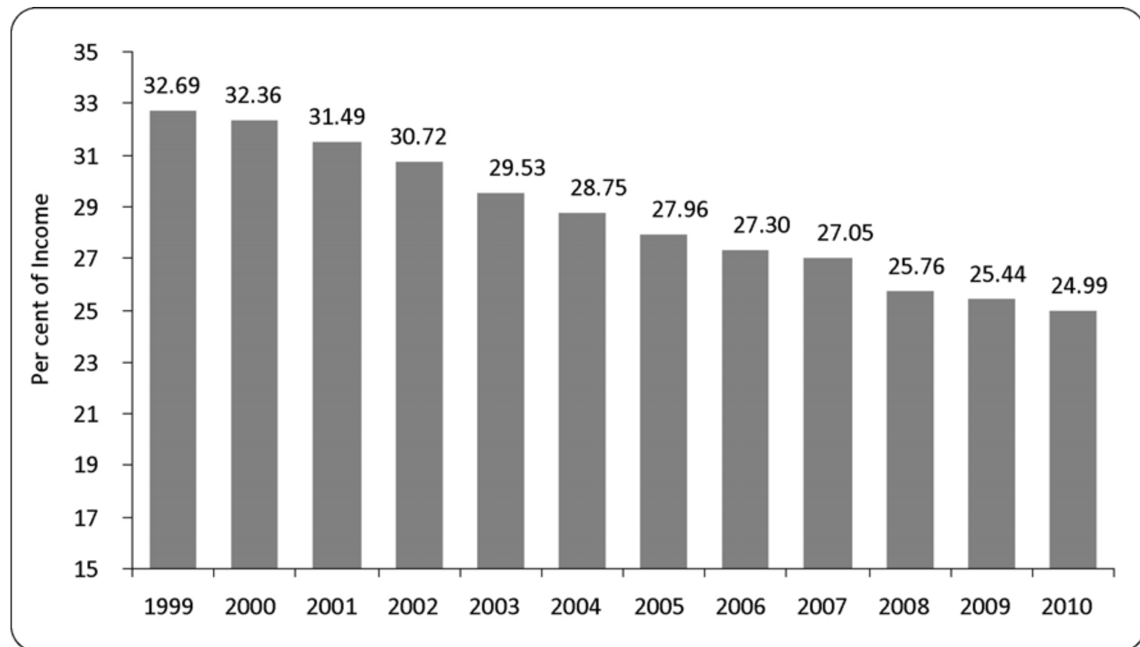
Jurisdiction	**Ranking**	
	2011	**2009**
Switzerland	1	3
Cayman Islands	2	4
Luxembourg	3	2
Hong Kong	4	10
USA	5	1
Singapore	6	8
Jersey	7	11
Japan	8	-
Germany	9	-
Bahrain	10	14
British Virgin Islands	11	16
Bermuda	12	7
United Kingdom	13	5
Panama	14	19
Belgium	15	9
Marshall Islands	16	46
Austria	17	12
United Arab Emirates (Dubai)	18	31
Bahamas	19	33
Cyprus	20	18

Source: www.financialsecrecyindex.com

Inter-jurisdiction Tax Rate Difference

Difference in tax rate across jurisdictions encourages profit transfer. Countries are increasingly competing with one another to attract international capital. Capital-owning entities take the advantage of this *fund-fetching competition*; they engage in 'tax-shopping.' This results in gradual reduction in global tax rates. The global tax rate surveys of KPMG (2010) validates this statement of rate reduction; the global average rate of corporate tax has come down to about 25.0 per cent in 2010 from 32.7 per cent in 1999 (Figure 2).

Figure 2: Global Average of Corporate Tax Rate

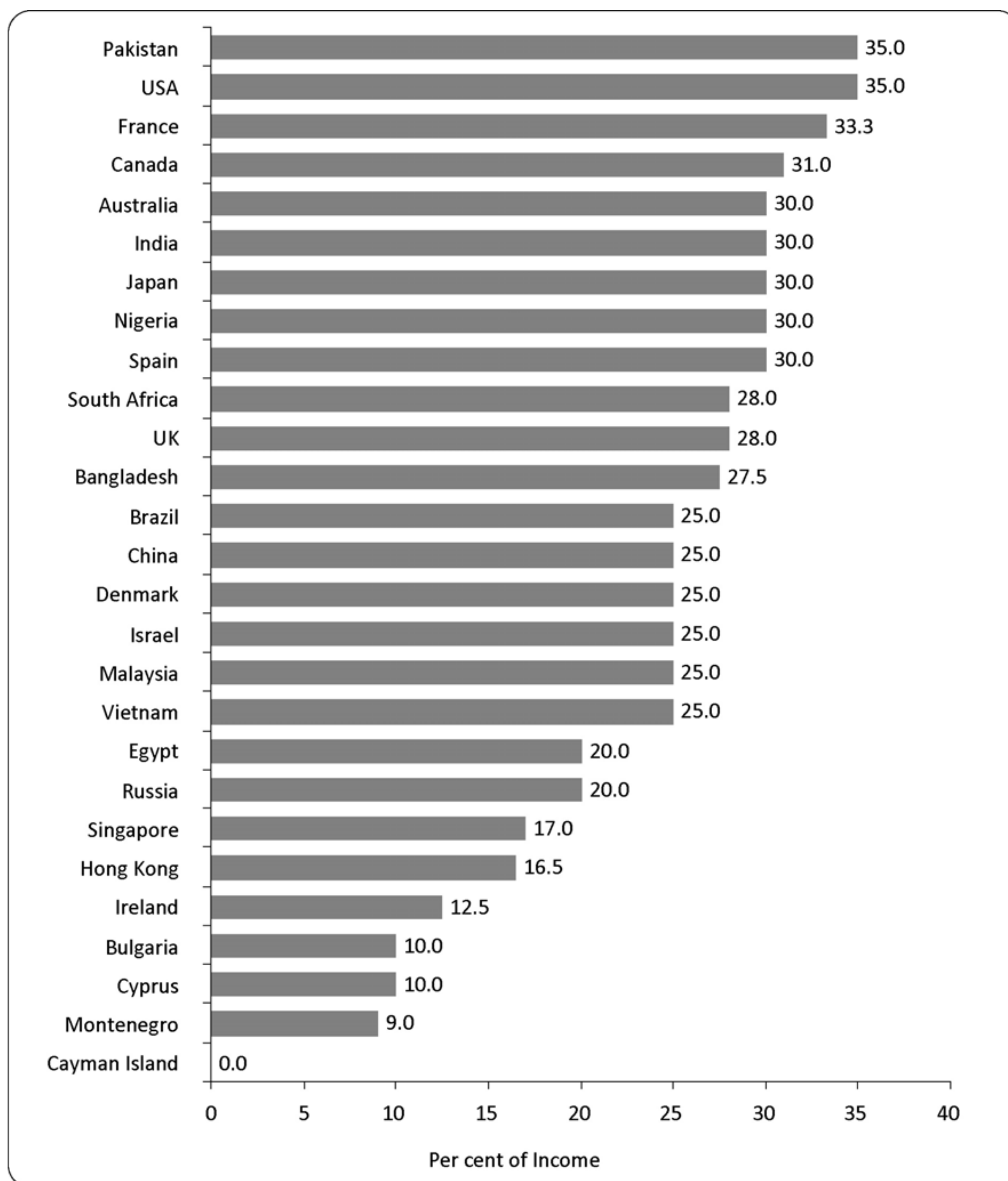


Source: KPMG (2009a) and KPMG (2010).[5]

Not every country can afford to maintain this race to the bottom and keep on reducing corporate taxes in a sustained manner; financial realities, particularly the need to generate domestic revenues, do not allow these countries to reduce their respective tax rates beyond a certain limit. Such uneven race in the reduction of tax rates results in tax rate differences among jurisdictions (Figure 3). Inter-jurisdiction variation in tax rates motivates multinational business enterprises to shift profit from higher tax jurisdictions to lower ones.

[5]Rates for 2005 and onwards have been taken from KPMG's *Corporate and Indirect Tax Survey 2010*.

Figure 3: Comparison of Corporate Tax Rates of Selected Countries in 2010

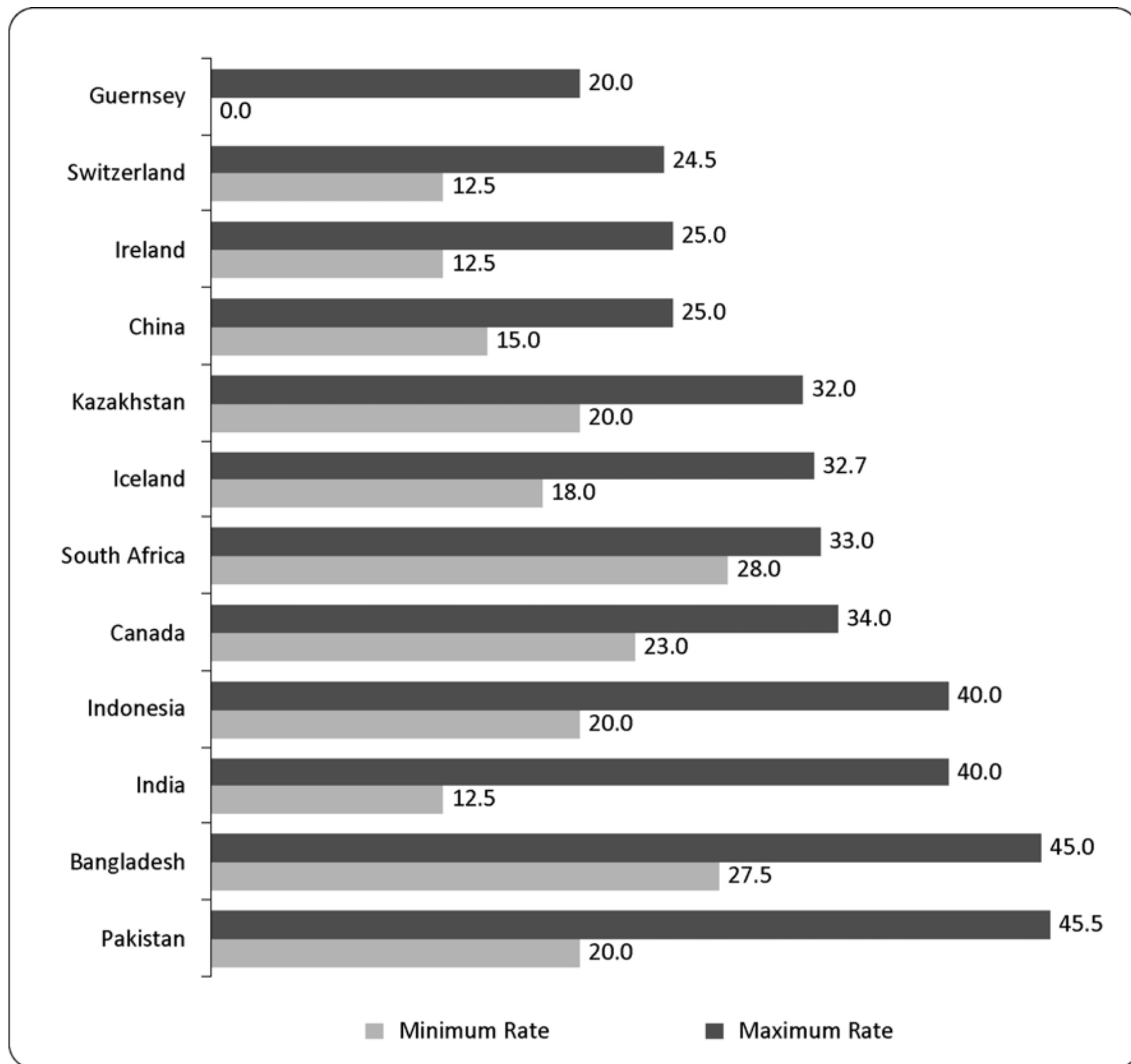


Source: KPMG (2010).

Intra-jurisdiction Tax Rate Difference

In many countries, different entities within the same tax jurisdiction enjoy different tax treatments. Favourable tax treatment for certain classes of taxpayers in the form of tax holiday, reduced tax rates or other kind of tax privilege often results into formidable gaps between maximum and minimum tax rates. Figure 4, which presents the picture of maximum and minimum tax rates of a number of countries, brings out the scenario quite clearly.

Figure 4: Intra-jurisdiction Tax Rate of Selected Countries in 2010



Source: Based on the data from KPMG (2010).

There is little doubt that when tax rates differ significantly within the same tax jurisdiction, profit shifting is encouraged. Large corporate groups shift profits from higher tax sectors to lower ones.

Global Business Restructuring and Remodelling

Business restructuring and relocation by multinational enterprises creates space and scope for transfer mispricing. Under the traditional scenario, multinational enterprises tended to operate through their subsidiaries in different locations and countries. Before restructuring, these subsidiaries produced, marketed and distributed goods and services, and were the owners of profits from their local operation. Profits were taxed locally (at local rate), and the after-tax-profits were transferred to the parent corporation. Following introduction of business restructuring practices, new *legal entities* (often *shell corporations*) are created in low tax jurisdictions. Such entities own brand name, bear supply risk and record profit in

their accounts. Local subsidiaries, that earlier hold the status of own-product-manufacturers, are being restructured to function as contract-manufacturers. Though these local subsidiaries are performing the same manufacturing functions as these were doing in the past, they are now recording only the sub-contracting fees (and also charging cost against that fee) instead of profit in their books of accounts. Profit thus tends to be transferred to the parent company through the *legal entities* located in low-tax jurisdictions.

Increased Mobility of Intangibles

Intangibles are defined as assets that do not embody any tangible or financial form, but from which future economic benefits are accrued. In an era of economic globalisation where services sectors are on the ascendancy, *intangibles* are gaining increasing prominence. Intangibles such as brand name, design, system, network and innovation are the core capital of newly modeled service industries, and have emerged as core component of corporate asset value. Renaud (2010) and Ocean Tomo (2011) found that intangible assets comprise about 75 to 80 per cent of a firm's market value. Investment in intangibles has also been rapidly increasing. OECD (2010a) estimates that the amount of global annual investment in intangibles is about USD 800 billion.

As is to be noted, intangibles are knowledge assets. These are unique in their utility, mobility and earning ability. However, there is a grey area in terms of their valuation. Business entities differ significantly in estimating the value of intangibles, allocating the cost of their development, and distributing the earning yielded from these assets. The absence of a universally accepted method of valuation of intangibles creates an opportunity to assign arbitrary value and numbers to intangibles-related transactions. This creates a possibility to shift profit.

2.4.2 Weak Institutional and Regulatory Capacity

Detecting suspicious transactions and determining their open market value (*arm's length price*) require sound institutional set up supported by proper human and physical resources. However, most low-income countries lack this capacity; on the other hand, tax evaders are affluent, big-spender entities. They employ teams of accountants and transfer pricing specialists that can confound tax officials and exploit loopholes and inefficiencies (ActionAid 2008).

Tax agencies lag behind the evaders not only in committing resources, but also in taking initiative. Misinvoicing and mispricing in international transactions have been a traditional, century-long practice. However, it was not until 1980s that developed countries started to take any significant step in building the required institutional capacity to combat transfer mispricing. To compare, developing countries, particularly low-income countries, are still at a nascent stage in this respect, with serious lacking in terms of transfer pricing institutions and demanded capabilities.

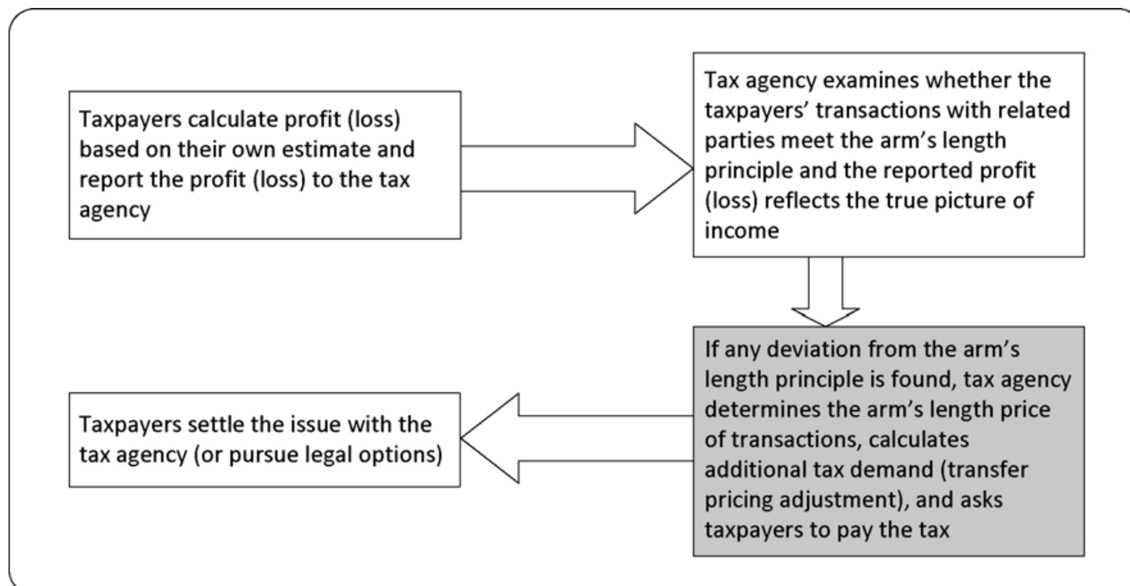
Absence of strict regulations is another reason for the continuation of widespread trade mispricing. Though the presence of transfer mispricing was detected and the adverse affect

of it has been felt for many years, no substantial regulations came out until 1960s[6] and 1970s when US and the Organisation for Economic Co-operation and Development (OECD) countries initiated a number of changes in tax legislation to address transfer pricing. OECD published its first model tax convention in 1979. However, it was not until 1990s that explicit transfer pricing legislation was enacted in a significant number of countries.

2.5 How Transfer Pricing Regime Can Help

The adoption of transfer pricing regime discourages profit shifting in a number of ways. *Firstly*, a transfer pricing regime facilitates audit. Transfer pricing audits detect mispricing-induced tax evasion, and take back from entities the money they gained by means of mispricing. *Secondly*, the incidence of tax evasion, once detected, is rebuked by heavy penalty. *Thirdly*, it discourages adoption and continuation of the practice by other entities. Figure 5 summarises the process of loss recovery under a transfer pricing regime.

Figure 5: Recovery of Lost Tax under Transfer Pricing Regime



Source: Authors' elaboration.

2.6 Objectives of Transfer Pricing Regime

Transfer mispricing is a global phenomenon. In this era of increasing economic openness, it is hardly practicable for countries to control the price at which particular transaction takes place. What countries could perhaps do is to reduce the adverse effect of transfer mispricing by building an institutional capacity that can serve two basic purposes: enabling countries to minimise the loss of tax and capital, and creating an administrative and regulatory environment that discourages the mispricing of transactions. These purposes are served by meeting the following three strategic objectives:

[6]Countries such as Sweden and Singapore have had indirect reference of transfer pricing in there tax regulation prior to 1960s.

2.6.1 Safeguarding Revenue and Capital

As was noted earlier, profit transfer, capital flight and tax evasion are three closely bonded issues. When an entity hides or under-reports a profit, concurrently it evades tax on the said amount of profit. And when the unreported profit is transferred out of a particular jurisdiction, the jurisdiction loses capital equivalent to the aggregate of the tax and the after-tax profit. But when the evasion is detected, the taxpaying entity must bring the capital (which includes tax) back to the taxing jurisdiction. The detection of tax evasion thus ensures the retention of capital within the taxing jurisdiction. Minimising tax loss and safeguarding capital, are therefore, the fundamental objectives of combating transfer mispricing.

2.6.2 Tracking and Monitoring Transactions

Creating paper trails with regard to transfer mispricing practices is the key to identifying it. If regulatory agencies can track dubious transactions, the loss of tax relating to such transactions can be identified and recovered. Data mining techniques, such as gathering and analysing background information on the transacting parties, examining the source and destination of transaction funds and comparing transaction prices with the normal market prices, help to unearth abusive transfer pricing practices. But this is easier said than done.

2.6.3 Acquiring the Power of Information

The cases of transfer mispricing are usually unearthed by means of *post-transaction* investigation and analysis, popularly known as *audit*. Success in audit largely depends on the availability of relevant information. Information related to economy, industry, transaction parties and transaction prices is immensely valuable in post-transaction audit and enforcement.

In order to maintain fiscal and financial integrity, and enforce prudential practice, countries endeavour to adopt transfer pricing regime. Under the transfer pricing regime, a country develops the system that can track and monitor dubious transactions, locate the incidence of mispricing, determine the fair value of transactions, and recover the lost revenue for the country.

To foster gathering and storing information, a transfer pricing regime undertakes the following steps:

a. Requires business entities to maintain records and documents relating to entity, industry and price;
b. Encourages the establishment of data support companies by providing necessary policy support and fiscal incentive;
c. Develops and maintains a database by storing data provided by taxpayers.

Lack of transparency and opacity in transactions and regulations fosters mispricing. Access to the relevant information could address this. The mere fact that the regulatory agencies possess fair scale of transfer pricing information is likely to discourage potential mispricers, and thus reduce potential losses to tax authorities.

2.7 Steps towards Transfer Pricing

Adoption of a transfer pricing regime involves two core activities: a) formulation of transfer pricing regulations; and b) administration of regulations. These are, as a matter of fact, intertwined: regulations are framed keeping in mind the form and the nature of administration, while administrative structure is designed based on the scope and the purpose of regulations.

2.7.1 Agency to Administer Transfer Pricing

Two basic queries need to be addressed when a transfer pricing regime is to be adopted: a) which agency would administer transfer pricing work; and b) what would be the organisational structure of that agency. Traditionally, a number of state agencies have legitimate access (immediate or distant) to private transactions. They are the central bank, the revenue agency, the anti-corruption body, the customs agency, and the law enforcing agency. Since the recovery of lost revenue is the principal and immediate concern of every country, it is a universal practice that the task of administering transfer pricing regulations is assigned to the revenue agency of the respective countries.

The work of transfer pricing is very complex. It demands specialised workforce of multidimensional skills. Before 1990s, most countries administered transfer pricing through their respective existing and conventional institutional set up. However, the 1990s witnessed a stream of institutional reforms; many tax agencies restructured their organisations to establish dedicated units for handling the transfer pricing work. At present, most of the advanced tax agencies have separate dedicated unit for dealing transfer pricing issues.

2.7.2 Transfer Pricing Regulations

The existence of transfer pricing regulations can be traced back to as early as 1920s when a number of countries made indirect reference to transfer pricing in their tax regulations.[7] Indeed, the new common *arm's length principle* was considered in tax and trade treaties during and after the World War I. Over the next few decades the League of Nations tried hard to find an acceptable way of allocating profits between related parties having cross-border operations. A number of model tax conventions were adopted under the auspices of the League of Nations.[8] In spite of the fact that the model conventions mainly dealt with the issue of double taxation, these evinced concern about transfer pricing and arm's length issue.

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[7]Section 45, first enacted in 1928, gave the tax agency in USA the authority to make adjustment in disclosed income if the agency finds that the transactions between enterprises having common interest do not reflect their true value. Section 45 is one of the earliest examples of transfer pricing bylaws.

[8]The first international model tax convention was published by the League of Nations in 1928 (*Draft Model Treaty on Double Taxation and Tax Evasion)* (McIntyre 2005). The effort of the League of Nations continued, and resulted in the preparation of 1946 Mexico Draft (*Model Bilateral Convention for the Prevention of the Double Taxation of Income and Property*), and 1946 London Draft (*Model Bilateral Convention for the Prevention of the Double Taxation of Income and Property*).

As soon as Organisation for European Economic Co-operation (OEEC) came into existence in 1948, the responsibility of developing model tax convention shifted to the new body. Throughout 1950s OEEC (later OECD) worked on formulating a model tax convention that could address transfer pricing issue in an appropriate manner (Owens 2009). The continuous efforts of OECD have produced a number of model conventions and guidelines, including the 1963 OECD Model Convention, the 1979 OECD Report, Reports of 1984[9] and 1987[10], and finally, the first comprehensive guideline on transfer pricing – *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, in 1995. The guidelines of 1995 were further revised, and the 2010 version of the guidelines was approved by the OECD Council in July 2010 (OECD 2010b).

Explicit transfer pricing regulations were first adopted in the United States in 1968 (UN 2001). By 1980s, a sizeable number of countries had enacted transfer pricing legislation. Countries continued to come under the shield of transfer pricing regime throughout the next two decades. At present, more than 50 countries have explicit transfer pricing regulations, and this number has been on the rise as other countries started to appreciate the need for such regulations.

3. UNDERSTANDING TRANSFER PRICING REGIME

3.1 Transfer Pricing Administration Framework

Adopting transfer pricing regime requires a clear understanding of transfer pricing administration framework. An ideal transfer pricing administration framework has four essential components: a) the subject of administration (entities and transactions); b) the administrator (transfer pricing organisation); c) legal environment (regulatory framework); and d) data support environment (Figure 6).

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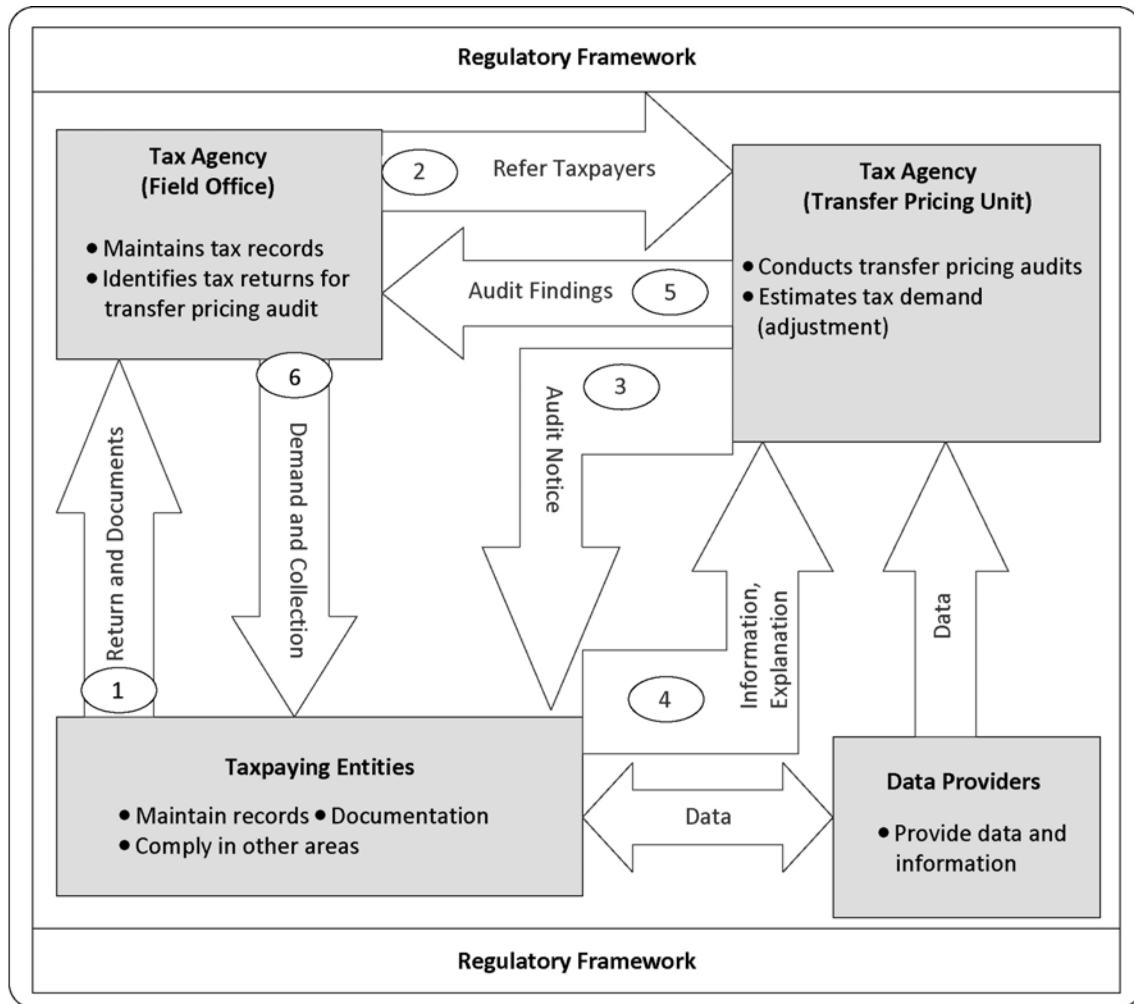
[9] The 1984 OECD report was *Three Taxation Issues*.

[10] The 1987 report of OECD was *Thin Capitalisation*.

Figure 6: Transfer Pricing Administration Framework



Source: Authors' elaboration.

3.1.1 Subjects of Transfer Pricing Administration

Under a transfer pricing regime, not all taxpayers and transactions come under the purview of transfer pricing regulations. Typically, transactions with related parties become the subject of transfer pricing. In India, for example, associated enterprises having *international transactions*[11] come under the ambit of transfer pricing regulation (Ernst & Young 2011). In China, transactions conducted between foreign multinationals

[11]The term 'international transaction' has an extended definition to include both actual and deemed transactions. Any "...mutual agreement or arrangement between two or more associated enterprises for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises..." shall also be treated as international transaction.

and their local subsidiaries[12] come under the ambit of transfer pricing (Asia Briefing Ltd. 2009).

3.1.2 Transfer Pricing Organisation

The work of transfer pricing is different from that of conventional tax administration. Transfer pricing work demands the arrangement of a separate and dedicated organisational set up. The nature and the depth of transfer pricing organisation may vary among countries depending on the functions of transfer pricing teams. In many countries, transfer pricing teams enjoy a considerable degree of autonomy; they formulate strategic policy, decide business procedure and perform transfer pricing audit. In other countries, the function of transfer pricing teams is limited to performing audits under the operational guidelines set by the tax agency.

At the early years of transfer pricing history, most of the countries, that have adopted transfer pricing regime, used to operate in the conventional administrative set up. But soon, they realised that efficient discharge of transfer pricing function is difficult without a dedicated organisational set up. In view of this, organisational structure was reformed to establish separate division for transfer pricing. At present, most of the advanced tax agencies have separate organisational set up for transfer pricing. UK, for instance, has a separate Transfer Pricing Group[13] *which is dedicated to work on transfer pricing* (HM Revenue and Customs n.d.(b)). India has a dedicated Directorate General of International Taxation, and China has a separate International Taxation Department to take care of transfer pricing issue.

Ideally, a Transfer Pricing Unit is not a tax assessment or revenue collection unit. It rather functions as a specialised audit unit. The unit does not receive tax returns or collects tax. Tax returns, along with transfer pricing documents, are usually received by the regular field offices. The field offices, based on certain criteria, refer returns to transfer pricing units. Transfer pricing units conduct audit, summarise findings, estimate the amount of adjustment (if any), prepare reports, and send them to the respective field offices. The field offices, upon receiving the audit report, make assessment, issue demand notice, and initiate collection and enforcement procedures.

3.2 Regulatory Framework

Regulatory framework is the foundation of transfer pricing administration. Transfer pricing is a part of overall tax administration, and is administered under almost the same regulatory framework of conventional tax administration supported by a separate legislation. Transfer

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[12] According to Article 13 of the Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises, "...the payment or receipt of charges or fees in business transactions between an enterprise with foreign investment, or an establishment or place set up in China by a foreign enterprise to engage in production or business operations, and its associated enterprises shall be made in the same manner as the payment or receipt of charges or fees in business transactions between independent enterprises."

[13] The Group consists of four components: a Transfer Pricing Board, two Transfer Pricing Panels, four Transfer Pricing Units, and a Transfer Pricing Secretariat.

pricing legislation consists of convention, codes, rules and administrative guidelines. The legislation of transfer pricing must maintain all core qualities of a standard legislation: clarity, integrity, simplicity and completeness. Since transfer pricing is an issue of cross-border engagement, the codes of transfer pricing must also maintain the quality of international compatibility. The sample legislation of transfer pricing published by OECD can be a fundamental guide for tax agencies in drafting their own transfer pricing codes.

3.2.1 Components of Transfer Pricing Legislation

Transfer pricing legislation may have the following components:

Laws	Laws include Tax Code, Act or Ordinance;
Rules/Regulations	Rules/regulations prescribe standard methods and procedures to be observed in complying with legal provisions;
Guidelines/Circulars	Administrative guidelines/circulars further clarify the *modus operandi* of legal provisions; they are issued in accordance with the power assigned by laws;
Court Decisions	Court decisions interpret legal provisions, and thus become part of the legislation.

3.2.2 Essential Qualities of Transfer Pricing Legislation

Following qualities must be possessed by an ideal transfer pricing legislation:

Clarity	Provisions must be clearly stated (no ambiguity in meaning and statement);
Integrity	Must not be conflicting with the constitution or other laws in force, and values or norms of the society;
Simplicity	Must be simple, easy to understand, and user-friendly;
Completeness	Must cover all related areas;
Compatibility	Must be compatible with transfer pricing codes of other jurisdictions.

3.2.3 Transfer Pricing Terminologies

Transfer pricing is a specialised area. Transfer pricing administration and legislation base on a set of concepts expressed in the language of transfer pricing literature. Understanding transfer pricing requires the understanding of these concepts and terms. Based on current international vocabulary practices, the following section briefly explains different concepts that are commonly used in transfer pricing administration.

Related Party[14]

Related parties are the parties (such as sister concerns and other type of associated entities) bonded by common economic interest. Inland Revenue Authority of Singapore (IRAS)[15] defines a related party as follows:

> *A 'related' party, in relation to an entity, means any other entities that, directly or indirectly, controls that entity, or is controlled, directly or indirectly, are under the common control of that entity. Hence related parties include associated enterprise and separately taxable entities of an enterprise, such a permanent establishment of the enterprise* (Inland Revenue Authority of Singapore 2006b).

The Indian tax law[16] defines associated enterprise as:

> *An enterprise shall be the associate enterprise of other enterprise (a) if it participates, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise; or, (b) in respect of which one or more persons who participate, directly or indirectly, or through one or more intermediaries, in its management or control or capital, are the same persons who participate, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise.*

Prices agreed in related party transactions often deviate from independent market prices. As observed in the website of IRAS:

> *When unrelated parties deal with each other, independent market forces shape the commercial pricing of such transactions. However, in transactions involving related parties, their commercial and financial relations may lead to the setting of prices that deviate from independent commercial prices. This results in distortion of the profits derived by each related entity to the transactions as well as in the tax liabilities of each* (Inland Revenue Authority of Singapore 2006a).

The Arm's Length Principle

The arm's length principle[17] is an internationally accepted standard which is widely followed in pricing of transactions between related parties. The arm's length principle stipulates that transactions made between the related parties must meet open market conditions, i.e. the prices of transactions should be similar to the prices that would have been agreed between the independent parties[18] in similar situation.

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[14]Also termed as affiliated party or associated enterprise.

[15]'Related party' is defined in the Section 2.2 of Transfer Pricing Guidelines 2006 (IRAS Circular).

[16]Section 92A of Income Tax Act, 1961 (India).

[17]The term *arm's length principle* was first mentioned in a draft model convention on allocation of profits of cross-border transactions. The draft convention was prepared in 1933 by the Fiscal Committee of the League of Nations. Neither the original draft of 1933 or its revised version of 1935 was ever adopted (McIntyre 2005).

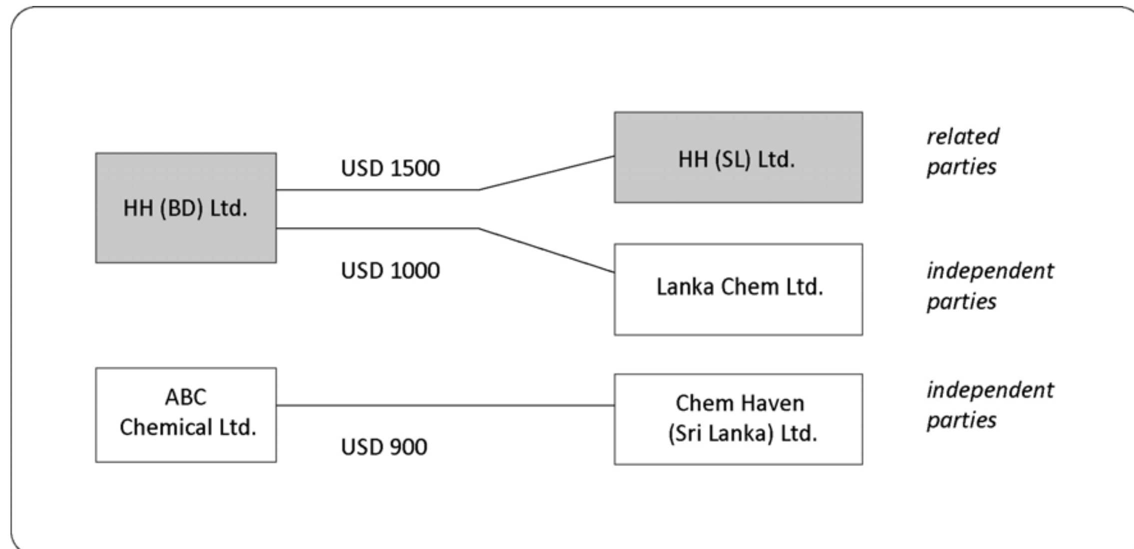
[18]An independent party is an entity that has no common business interest with the corresponding transacting party.

Arm's Length Price (ALP)

The arm's length price, in simple terms, is the *open market price,* i.e. the price at which two unrelated and non-desperate parties would agree to transact (Investorwords n.d.). A price is considered to be at arm's length when it follows the *arm's length principle.* The following example may further elucidate the concept of arm's length price.

> Entity A, a Bangladeshi subsidiary of a multinational group, purchased a chemical (raw material) at a price of USD 1,500 per unit from its affiliated company; Enterprise B purchased similar chemical from Enterprise C (an independent supplier from Sri Lanka) at USD 1,000 per unit (Figure 7).
>
> Another company of Bangladesh, ABC Chemical Ltd., purchased similar raw materials from yet another company of Sri Lanka, Chem Haven (Sri Lanka) Ltd. at USD 900 per unit.

Figure 7: Arm's Length Price



Source: Authors' elaboration.

Under a simplistic interpretation of the definition of ALP, the arm's length status of the above transactions may be as follows:

i. ABC Chemical Ltd. and Chem Haven (Sri Lanka) Ltd. are independent parties. Therefore, the price agreed between them (USD 900) can be considered as the open market price.
ii. HH (BD) Ltd. and Lanka Chem Ltd. are also independent parties. The price of transaction between these two parties (USD 1,000) also represents fair commercial price.
iii. HH (BD) Ltd. and HH (SL) Ltd. are related parties. Price claimed to have been paid by HH (BD) Ltd. to HH (SL) Ltd. is much higher than the price agreed

between independent parties in the similar transaction. Therefore, the price (USD 1,500) is not at arm's length.

iv. The arm's length price should be the transaction price agreed between the independent parties (between USD 900 and USD 1,000).

Transfer Pricing Documentation

Transfer pricing documentation refers to the maintenance and filing of prescribed forms, records and documents by taxpayers who are subject to transfer pricing regulation. Documentation requirement varies among countries depending on their own economic and regulatory realities. In most cases, documentation covers three broad areas of information: a) entity-related; b) industry-related; and c) transaction-related.

Inland Revenue of New Zealand (2010) observes that a standard documentation package[19] should include the followings:

- *A detailed discussion of the facts (analysis of functions, risks and assets – especially intangibles);*
- *Industry analysis (to put the taxpayer's facts in the context of its industry), especially identifying the key profit drivers, performance of major competitors, and where the value added arises for the company;*
- *Careful consideration of associated party transactions (each category should be examined separately);*
- *A discussion as to the efforts made to find internal comparables (if there are any sales or purchases whatsoever involving unrelated parties);*
- *Reasoning as to the selection of the best pricing method available;*
- *Full details as to the comparables search undertaken (database utilised, criteria employed, accept/reject list including reasons for rejection);*
- *An analysis of why the companies selected are indeed comparables;*
- *An unadjusted income statement for each comparable with adjustments explained in detail;*
- *A cross-check using at least a second profit level indicator (for example, if an Earning Before Interest and Taxes (EBIT): sales yardstick has been applied, then a Berry ratio cross-check should be carried out for a distributor or a return on assets calculated for a manufacturer) – if one methodology produces a result that is significantly different to another it is not sufficient to simply assert that one method is preferable without exploring why those results are different;*
- *Conclusions, including sanity checks to demonstrate commercial realities; and*
- *Copies of all inter-company agreements as well as the local and global corporate structures.*

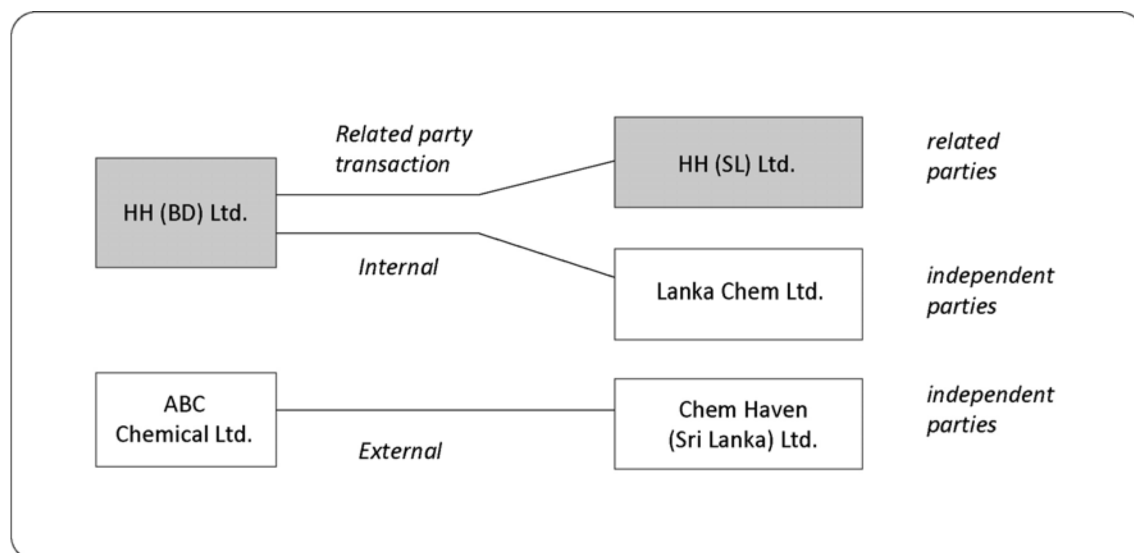
[19] Actual documentation requirement varies among countries depending on their own business and regulatory environment.

Comparables

Comparables are basically *the set of similar transactions* executed between independent parties under similar business conditions. When tax officials find that a transaction between the related parties is not at arm's length, they reject the value of that transaction and proceed to determine its arm's length price. In doing so, tax officials collect data on similar transactions from various sources. They then compare prices of similar transactions executed between the independent parties. Tax officials may find hundreds of similar transactions in databases. Not all similar transactions are considered as comparables. Transactions must meet certain criteria to qualify as comparables. Tax agency conducts *comparability analysis*[20] to decide whether a transaction qualify as *comparable*.

Comparables may be *internal* or *external* (Figure 8). When comparable data are gathered from an internal source (in-house record of the entity), these are called *internal comparables*. On the other hand, data gathered from external sources are called *external comparables*. In the example below, HH (BD) Ltd.'s transaction with Lanka Chem Ltd. can be termed as internal comparables, while ABC Chemical Ltd.'s transaction with Chem Haven (Sri Lanka) Ltd. is external comparable.

Figure 8: Comparable Transactions



Source: Authors' elaboration.

Transfer Pricing Methods

Transfer pricing methods are techniques or procedures used for determining the arm's length price and estimating the amount of adjustment. When a transaction is not at arm's length, tax officials reject the disclosed price of that transaction, and calculate its arm's

[20]In *comparability analysis*, a number of factors relating to the tested party are considered. The factors include: i) the nature of products, services and intangibles; ii) functions of taxpayers; iii) contractual agreement; iv) business and economic environment; and v) business strategy.

length price. Tax officials do not assign arbitrary value to the transaction; they instead follow one or more generally accepted methods to determine the arm's length price. Transfer pricing guidelines of OECD (OECD 2009b) endorse the following transfer pricing methods.[21]

(a) Comparable Uncontrolled Price (CUP) Method:

Comparable uncontrolled price (CUP) method is generally recognised to be the best method when these are available. This method determines transfer price for tax purposes by considering similar sales by one of the related party to another unrelated buyer, when the transaction is not controlled to verify the arm's length principle. CUP method is appropriate in cases where products are similar and comparable unrelated transactions are available. The limitation of this method is that in the real world commodities are often different in terms of their designs and features. At the same time some inputs are not even traded in the open market. Thus, this method often turns out to be inappropriate and inapplicable.

(b) Resale Price Method (RPM):

Absence of comparables for the CUP method makes the resale price method the second best solution. This method is particularly helpful when a buyer does not make significant value addition to the final product. Under this method, the price of a product is taken from the transaction where it is bought from a related party and then again resold to a party that is not related. This resale price is subtracted by the gross margin from resale and then adjusted for all other associated costs. The comparables are taken from unrelated parties' gross margins and related party's gross margins where transactions are made with unrelated buyers or re-sellers.

(c) Cost-Plus Method (CPM):

To obtain the arm's length price under the cost-plus method, first the total costs of the seller arising from sale to a related party are calculated. Then a suitable mark-up profit is added to determine the reasonable price to be paid by the related party. The cost and mark-up profit is generally based on comparables from similar transactions between unrelated parties. This method is desirable when CUP method and RPM are difficult to apply.

(d) Comparable Profit Split Method (CPSM):

Comparable profit split method (CPSM) divides the combined profit from a transaction which is controlled among the concerned related parties. Under this method, the aggregate profit of the shareholders is distributed. The proportion of distribution is calculated from the aggregate profit of unrelated parties whose transactions are similar.

[21] Detail description these methods is available in OECD Guidelines or any standard administrative guideline issued by a tax agency (for example, the IRAS *Transfer Pricing Guidelines, 2006* (Singapore) and the LHDN *Transfer Pricing Guidelines, 2003* (Malaysia) discuss the methods in detail.

(e) Transactional Net Margin Method (TNMM):

Transactional Net Margin Method (TNMM) compares between the profit margin and an appropriate base (such as costs, sales and assets) that the company gained from controlled transactions among the related parties. This method can be applied in a similar way as the RPM or CPM.

Most of the tax agencies across the world follow the aforesaid five[22] methods. Many tax agencies, however, use modified versions of any of these methods, or a combination of two or three methods.

Adjustment

Adjustment is the process of making or enhancing tax demand based on the findings of a transfer pricing audit. When, in the course of audit, tax agencies find that a transaction has not been carried out at arm's length price, it (arm's length price of that transaction) is determined by applying appropriate transfer pricing method(s). Consequently, the income (and the amount of tax) calculated by the tax officials may be higher than what the taxpaying entity originally had declared in its tax return. The amount of additional tax demand, resulting from a transfer pricing audit, is called *adjustment*.

Intangibles

Intangibles are assets that have no physical or financial form. Section 936(h)(3)(B) of the Internal Revenue Code of IRS defines (Cornell University Law School n.d.) intangible property as:

i) Patent, invention, formula, process, design, pattern, or know-how;
ii) Copyright, literary, musical, or artistic composition;
iii) Trademark, trade name, or brand name;
iv) Franchise, license, or contract;
v) Method, programme, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data; or
vi) Any similar item, which has substantial value independent of the services of any individual.

OECD (2010a) classifies intangibles in the following three major categories:

Computerised information:	Software and databases;
Innovative property:	Scientific and non-scientific research and development (R&D), copyrights, designs, trademarks;

[22] The first three methods are called Traditional Transaction Methods, while the last two are known as the Transactional Profit Methods.

Economic competencies: Brand equity, firm-specific human capital, networks joining people and institutions, organisational know-how that increases enterprise efficiency, and aspects of advertising and marketing.

Non-financial performance such as leadership, workplace organisation and culture, adaptability and strategy execution also constitute intangibles (Low and Kalafut 2002).

Cost Contribution (Sharing) Arrangement (CCA or CSA)

A Cost Contribution Arrangements is an agreement between the related parties regarding the allocation of costs of a joint project. Two or more entities may engage in a joint venture of R&D programme, and could have a formal agreement regarding the allocation of cost and the share of benefit of that programme.

When a Cost Sharing Arrangement is concluded among related parties, it may allocate more-than-rational-proportion of cost to a certain party. The allocation of more cost to the parties located in higher tax jurisdiction shifts profit to the parties in the lower tax ones. Tax agencies under the transfer pricing regime examine whether the CCA meets the arm's length principle.

Intra-group Services/Management Services

Intra-group services are a popular means of transferring profit. Intra-group services are services rendered by a parent company to its subsidiaries or a member company to its affiliated entity. Not all services rendered by an entity to its subsidiaries or affiliated entities constitute a *service*. In order to qualify as service rendered[23], an activity must have economic importance and must enhance the commercial value of the service receiver. Regular and natural parental duties to subsidiaries, duplication of services, shareholder activities, and incidental benefits do not constitute *intra-group services*. In examining intra-group services, tax agencies consider two conditions: a) whether an intra-group service has actually been rendered, and b) whether the fees for the service are at arm's length.

Advance Pricing Agreement (APA)

An APA is a negotiated arrangement between a taxpaying entity and the tax agency regarding transfer pricing methodology. A taxpaying entity may not be certain whether the transfer pricing methods used by it would be accepted by the tax agency or not. Therefore, in order to avoid future disagreement, the entity enters into an agreement with the tax agency regarding the selection of transfer pricing methods and the determination of arm's length prices. Such pricing arrangement, made in advance between the tax agency and taxpaying entity, is called the Advance Pricing Agreement. Inland Revenue Service of USA

[23] According to Barry Spitz, the test of qualification may be "*.......whether an independent enterprise in comparable circumstances would have been willing to pay for the activity or perform it for itself in-house. If the independent enterprise would not have been willing to pay for or perform the activity itself, the activity ordinarily should not be considered as an intra-group service under the arm's length*" (Barry Spitz n.d.).

(2000)[24] defines APA as *a binding contract between the IRS and a taxpayer, by which the IRS agrees not to seek a transfer pricing adjustment under IRC section 482 for a covered transaction if the taxpayer files its tax return for a covered year consistent with the agreed transfer pricing method.*

The agreement can be bilateral or multilateral. It can be a free-of-cost or a charged service. An APA is usually negotiated for a fixed period.[25] The agreement may not necessarily cover all transactions. Tax agencies may prescribe transactions that will come under the purview of an APA.

Mutual Agreement Procedure (MAP)

A Mutual Agreement Procedure is a grievance mitigating measure that allows *a taxpayer who considers that it is being taxed otherwise than in accordance with the terms of the Double Taxation Agreement to present its case to the tax administration* (HM Revenue & Customs n.d.(a)). An example may further elucidate the concept of MAP. The tax agency of country A, in the process of conducting transfer pricing audit for the taxpaying entity X, may find that a transaction of X with the related party Y (who is under the jurisdiction of country B) does not meet the arm's length principle. Countries A and B have double taxation agreement. If the tax agency of country A intends to make transfer pricing adjustment (i.e. make additional tax demand) on X, the taxpayer may claim that the profit-in-question has already been reported in the tax return of the related party Y in Country B, and has duly been taxed in that country. Any adjustment of this profit again in country A would result in a *double taxation*. If country A still proceeds to make the adjustment, the taxpayer Y may apply to the tax agency of country B to seek remedies. The *competent authority* in country B would then proceed to address the issue of double-taxation with country A under MAP.

3.2.4 Structural Framework of Legislation and Regulation

An ideal transfer pricing legislation may have the following structural framework:

Scope

The scope outlines the ambit of transfer pricing. It defines the entities and transactions that will come under the purview of transfer pricing. At present, most countries apply transfer pricing only to international transactions. In a number of countries[26], however, domestic transactions also come under the purview of transaction pricing regulation.

Definition of Terms

The language of transfer pricing is different from that of conventional tax administration. Transfer pricing terms such as related party, international transactions, arm's length price,

[24] IRS announcement 2000-35 titled: Announcement and Reporting Concerning Advance Pricing Agreement Issued in pursuant to Publication. L. 106/170, Section 521(b).

[25] Typically, the period is between 3-5 years. After the expiry of agreement period, tax agencies and taxpayers may enter into new arrangement.

[26] Indonesia is an example.

pricing methods, comparables and documentation are almost foreign to conventional tax legislation. These terms have specific *application meaning* that may differ from their *dictionary meaning*. Therefore, in order to avoid litigation, these terms should be clearly defined. The terminology of transfer pricing must be lucidly explained in the text of legislation, regulation and guidelines.

Authorities

Legislation should clearly define transfer pricing authorities along with their respective power, duty and responsibility.

Provisions Relating to Administration

Administrative provisions outline procedures regarding the reference of returns to transfer pricing officers, the selection returns for transfer pricing audit, the manner of conducting audit, and the process of making transfer pricing adjustment.

Instructive Provisions

Transfer pricing legislation must also contain compliance instructions for taxpayers. Instructive provisions outline the manner in which the taxpaying entities maintain records, file returns, submit supplementary information and comply with other legal requirements.

Enforcement/Penal Provisions

Penal provisions ensure compliance by taxpayers. The provisions are generally related to penalty for not maintaining records and documentation, and for not furnishing reports and information.

3.3 Data Support Environment

Transfer pricing administration by tax agencies and transfer pricing compliance by taxpayers require access to extensive data on business, industry, market and economy. It is very difficult, if not impossible, for a single entity or a tax agency to gather all necessary information. Fortunately, tax agencies and taxpayers find a number of database companies coming to their aid. These companies collect data from reports and records of business houses, statistical agencies and regulatory bodies. They also depend on in-house research and studies conducted by external bodies. Data are collected from throughout the world, grouped into different categories based on industries, sectors and regions, and marketed under different brand names. Following is the list of a number of popular transfer pricing databases (Table 2).

In addition to their regular product, database companies also offer tailor-made data package customised for different transfer pricing user groups.

Table 2: Widely Used Popular Transfer Pricing Databases

Service Provider	Database (Product Name)	Coverage
Bureau van Dijk	Amadeus, ORBIS, Mint	International and Regional
Thomson Reuters	Fundamentals, Thomson ONE	International and Regional
Standard & Poor's	Compustat	International and Regional
Korea Information Service	KISLine	Regional
Dun & Bradsteet	WOW	International and Regional
CMIE	Prowess	Regional
Capital Market India	Capitaline	Regional
Kompass	KOMPASS	International and Regional
International Tax Institute	edgarstat, royaltystat	International and Regional

Source: Authors' compilation.

4. GLOBAL EXPERIENCE ON TRANSFER PRICING WITH PARTICULAR FOCUS ON INDIA

4.1 Global Experience

Tax agencies around the world started to adopt transfer pricing regime mostly since the 1980s. By the end of 2000s, most of the developed countries and a sizeable number of developing countries have adopted transfer pricing regime. By now more than 50 countries have exclusive transfer pricing regulations (Norris 2011). The number has been on the rise particularly in recent years. Table 3 lists the countries that have already adopted transfer pricing regime.

Table 3: Countries Having Explicit Transfer Pricing Regulations[27]

Argentina	Finland	Mexico	South Korea
Australia	France	Montenegro	Spain
Austria	Germany	Netherlands	Sri Lanka
Belgium	Greece	New Zealand	Sweden
Brazil	Hungary	Norway	Taiwan
Canada	India	Peru	Thailand
Chile	Indonesia	Philippines	Turkey
China	Israel	Poland	Ukraine
Colombia	Italy	Portugal	UK
Croatia	Japan	Romania	Uruguay
Czech Republic	Kazakhstan	Russia	USA
Denmark	Kenya	Serbia	Venezuela
Ecuador	Latvia	Singapore	Vietnam
Estonia	Lithuania	Slovenia	
Egypt	Malaysia	South Africa	

Source: KPMG (2009b).

[27]The list is not exhaustive. Many countries beyond this list have either formulated transfer pricing regulations or issued administrative guidelines in limited scale.

Countries which have already adopted transfer pricing have now stepped up with their audit and investigation efforts. Many of these countries are going for toughening of their transfer pricing regulations. Others are also strengthening their workforce and allocating more resources. Tax agencies in USA, Finland (Saltmarsh 2010), China and Australia (KPMG 2011) have recently committed additional resources and workforce as part of consolidating respective transfer pricing administrations.

The frequency and intensity of transfer pricing audit have also been on the rise. Multinational enterprises report that they are facing transfer pricing audits more frequently than was the case before (Stanton 2011). Collection from transfer pricing audit has also been on the rise. China, for example, has fetched additional tax demand of more than RMB 2.5 billion in 2010 (Sheng 2011), a significant rise from RMB 500 million in 2005 (KPMG 2011). Many other Asian and Latin American countries have been witnessing similar surge in revenue accruing from transfer pricing audits.

4.2 Asian Experience

As is known, many of the world's fastest growing economies now belong to Asia. Robust international trade and increasing cross-border investment have transformed Asia into a fertile ground for potential transfer pricing abuse. Combating transfer mispricing has, therefore, become a priority issue for the Asian tax agencies. Most of the advanced tax agencies in Asia have already adopted transfer pricing regime (Table 4). The last decade witnessed a growing urgency in the adoption of transfer pricing regime in Asia. India introduced full-fledged transfer pricing regulations in 2001, followed by Thailand in 2002, Malaysia in 2003, Taiwan in 2004, Israel, Singapore and Vietnam in 2006, Sri Lanka in 2008, and Kazakhstan in 2009.

Table 4: Adoption of Transfer Pricing Regime by Asian Countries

Tax Jurisdiction	Transfer Pricing Administering Agency	Year of Adopting Explicit Regulation
Indonesia	Indonesian Tax Office	1983
Japan	National Tax Agency (NTA)	1986
China	State Administration of Taxation (SAT)	1991
South Korea	National Tax Service (NTS)	1996
India	Central Board of Direct Tax (CBDT)	2001
Thailand	The Revenue Department, Thailand (TRD)	2002
Malaysia	Inland Revenue Board of Malaysia (LHDN)	2003
Taiwan	Ministry of Finance	2004
Vietnam	General Department of Taxation	2005
Singapore	Inland Revenue Agency of Singapore (IRAS)	2006[28]
Hong Kong	Inland Revenue Department (IRD)	2009
Philippines	Bureau of Internal Revenue (BIR)	2006
Sri Lanka	Department of Inland Revenue (DIR)	2008

Source: KPMG (2009b); Asia Briefing Ltd. (2009); Punongbauan & Araullo (2010); Prasetyo and Widjajarso (2008).

[28] Singapore has had transfer pricing provisions in her tax laws since much before 2006.

The aforesaid countries are now putting emphasis on strengthening their transfer pricing efforts. Asia's seriousness in anti-avoidance and anti-evasion efforts is evident from the TPWEEK's ranking according to degree of strictness of transfer pricing enforcement. Table 5 shows that in 2007 and 2010 among the top ten, four places belonged to Asia, and five to the Asia-Pacific (KPMG 2011).

Table 5: Toughest Tax Agencies in Respect of Transfer Pricing

Country	Ranking in 2010	Ranking in 2007
Japan	**1**	**1**
India	**2**	**6**
China	**3**	**8**
Canada	4	9
United States	5	3
France	6	5
Germany	7	2
Australia	**8**	**4**
Korea	**9**	**7**
United Kingdom	10	10

Source: KPMG (2011).

4.3 Adopting Transfer Pricing Regime in a Developing Economy: The Case of India

The taxation systems of Bangladesh and India have close legal and administrative affinity. The *Income Tax Ordinance, 1984* of Bangladesh and the *Income Tax Act, 1969* of India stemmed from the same root: the *Income Tax Act, 1922* of the British India. Both countries have similar organisational structure with respect to direct taxation. The transfer pricing system of India can, therefore, serve as a good model for Bangladesh which can be adjusted to conform to Bangladesh's particular context.

The work of adopting transfer pricing regime in India was initiated in November, 1999 through forming an expert group to look into the issue (Krishnamurthy 2001). The recommendation of the group resulted in the enactment of a comprehensive transfer pricing legislation in 2001. The legislation came into effect from 1 April 2001. Only a decade has passed since then; however, within this short period, India has made a remarkable progress in the transfer pricing area. The country is already a big name in the world of transfer pricing. India has been ranked as the world's second toughest transfer pricing country (KPMG 2011) in 2010, marking a four point elevation from 2007.

4.3.1 Organisational Structure

India has a separate administrative structure to carry out the transfer pricing function. The Directorate General of International Taxation is in charge of international taxation and transfer pricing issues (OECD 2011). A Directorate of Transfer Pricing, joined by nine Directors of Income Tax (Transfer Pricing) looks after transfer pricing matters. The Directors have offices in seven commercially important locations: New Delhi, Mumbai, Kolkata, Chennai, Bangalore, Ahmedabad and Pune. Each Director is supported by several transfer pricing officers, who perform basic transfer pricing functions. About 70 officers work under

different Directors (Chandra 2008). The number of transfer pricing officers in India is the highest among the BRIC countries (Brazil, Russia, India and China) (India PRwire 2010).

Transfer pricing units (directorates) perform only audit function. Conventional tax administration functions such as assessment, collection and enforcement are carried out by regular tax units (field offices). Transfer pricing officers, after conducting audit, refer audit findings to the regular tax office. Assessing officers in the regular tax office then make assessment and adjustment based on the findings.

4.3.2 Transfer Pricing Regulations

The current version of *Income Tax Act, 1969* of India has comprehensive coverage of transfer pricing issues. Necessary rules to elaborate compliance procedures were also included in the *Income Tax Rules, 1962*. In addition to the changes made in the Act and the Rules, a number of administrative circulars have been issued to further elucidate the provisions of law.

Under the existing law, transactions[29] *between two or more associated enterprises, either or both of whom are non-residents* (Income Tax Act, 1969) come under the ambit of transfer pricing regulations. Two parties would be deemed to be associated if they are bonded by common interest in defined areas. Table 6 summarises the transfer pricing related sections.

Table 6: Transfer Pricing Legislation in India (Income Tax Act, 1969)

Related Section	Topic
92	Scope of transfer pricing and arm's length price
92A	Definition: associate enterprise
92B	Definition: international transactions
92C	Methods to be followed in determining arm's length price
92CA	Referring cases to transfer pricing officers for audit
92D	Documentation
92E	Reporting of information of international transaction
92F	Definition: various terms used in transfer pricing
271AA	Penalty for failure to keep and maintain information and document
271BA	Penalty for failure to furnish report under Section 92E
271G	Penalty for failure to furnish information or document under Section 92D

Source: www.law.incometaxindia.gov.in/DIT/Income-tax-acts.aspx

The list of sections is not exhaustive. Transfer pricing administration uses many other Sections[30] of Income Tax Act, 1969 that are common in general tax administration.

[29]The legal definition of transaction has been given an extended meaning to include *deemed transactions*.
[30]For example, Sections 133, 139, 143, 149 and 153.

4.3.3 Transfer Pricing Methods

Following methods are used in determining arm's length price:

(a) Comparable Uncontrolled Price Method
(b) Resale Price Method
(c) Cost-Plus Method
(d) Comparable Profit Split Method
(e) Transactional Net Margin Method
(f) Such other method as may be prescribed by the Board.

4.3.4 Transfer Pricing Documentation

Sections 92D and 92E of Income Tax Act, 1969, and Rule 10D of Income Tax Rules, 1962 list the documents that a taxpaying entity must maintain and file. The sections and the rule also prescribe the manner in which the documents are to be maintained and filed. Information and documents required by tax agency can be classified in three groups: entity-related, price-related and transaction-related.

The documentation requirement as prescribed in Rule 10D of the Income Tax Rules, 1962 have been mentioned below.

Information

1. Profile of the taxpaying entity;
2. Profile of the group where the taxpaying entity belongs;
3. Business details of the entity, the group and its associated enterprises;
4. Transaction details (party, nature, terms, quantum, value and prices of transactions);
5. Functional analysis (functions performed, assets employed, and risks involved by related parties);
6. Details of financial analysis (economic and market analysis, budgets and forecasts of entity as a whole and of each segment);
7. Details of uncontrollable transactions that have been considered in comparability analysis;
8. Methods applied in conducting comparability analysis;
9. Transfer pricing methods used in determining the arm's length price;
10. The manner in which the arm's length price has been determined (calculation, workings, details of financial information and the description comparable data);
11. Key assumptions, policies and price negotiations;
12. Details of transfer pricing adjustment;
13. Any other fact that is important in the determination of the arm's length price.

Documents

1. Reports, studies and publications from the respective governments of the associated enterprise;

2. Reports of market research and publications of technical nature from the reputed institutions;
3. Official publication of pricing data;
4. Published financial statements of associated enterprises;
5. Copies of comparable agreement and contracts;
6. Letters, correspondence or any documents that stand as evidence of the negotiation between the taxpayer and the associated enterprises;
7. Business letters corresponding between the transaction parties.

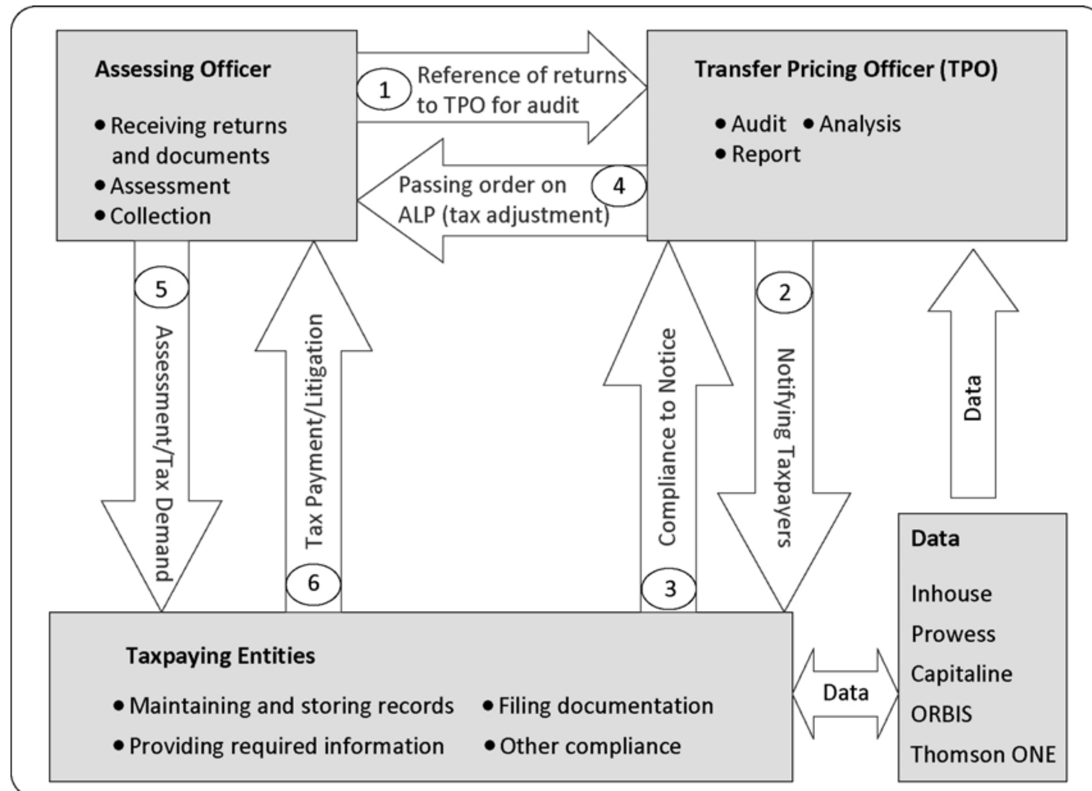
The information and the documents must be contemporaneous. They must be maintained for a minimum period of eight years from the end of the relevant assessment years.

4.3.5 Transfer Pricing Audit

Audit Procedure

The transfer pricing audit procedure in India starts with the field officer's reference of tax returns to the transfer pricing officer. A tax return is selected for audit only when it meets certain criteria. Transfer pricing officers, on selection of a return for audit, notify the concerned taxpaying entity about the selection, request the entity to furnish required information and document, and seek the necessary explanation from it. Transfer pricing

Figure 9: Transfer Pricing Audit Procedure in India



Source: Authors' elaboration.

officers also gather relevant information from external sources. After conducting appropriate analysis, transfer pricing officers summarise findings, prepare reports and forward the reports to the respective assessing officers. Assessing officers then make assessment and issue demand notice, if any, based on the audit findings of transfer pricing officers. Figure 9 summarises the transfer pricing audit procedure of India.

Audit Outcome

The first round of transfer pricing audit in India (for the Assessment Year 2002-2003) was stared in FY2004-05 (Ranjan 2005). Several rounds of audit have been concluded so far. Each round of audit has fetched a higher amount of tax revenue than the previous one. A summary of the transfer pricing audits concluded so far has been presented below (Table 7).

Table 7: Summary of Transfer Pricing Audit

Assessment Year	No. of Cases Selected for TP Audit	Cases with TP Adjustment	% of Cases Adjusted	Additional Revenue from TP Audit (Million USD)
2001-2002	1081	238	22	305
2002-2003	1501	345	23	572
2003-2004	1768	477	27	858
2004-2005	1479	370	25	1100
2005-2006	1717	1019	59	2165
Total	**7546**	**2449**	**32**	**5000**

Source: Deloitte (2010).

As is evident from the Table, both the number of case adjusted and the amount of additional revenue have been increasing. Between 2001-2002 and 2005-2006 Assessment Years, the amount of tax demanded from audit has increased by 609.8 per cent, while the number of cases selected for audit has only increased by 53.8 per cent. Also the rate of transfer pricing adjustment is on the rise.

4.3.6 Transfer Pricing Database

Transfer pricing officers may use both in-house and external data. Returns, accounts, documents and other information submitted by taxpaying entities constitute in-house database. Transfer pricing officers also reach external sources such as the reports of different national and international entities[31] and agencies, and the data products of domestic and international companies. Among the commercial data products, two Indian databases: Prowess and Capitaline, and two international databases: ORBIS (by Bureau van Dijk) and Thomson ONE (by Thomson Reuters) are used most widely.

[31]Section 133(6) of Income Tax Act, 1969 authorises a transfer pricing officer to ask any entity or agency to provide any information.

4.3.7 Looking into the Future

Gradual increase in additional tax revenue from transfer pricing audit speaks of India's growing efforts to combat transfer pricing abuse. The country has been planning to further tighten her grip on transfer pricing abusers. Existing transfer pricing norms are going to be upgraded to enhance tax department's capacity and attain global standard. As the Finance Minister Mr. Paranb Mukharjee said, "...*as and when the economy is developing, new ways of tax evasion are also developing. We have to keep in mind, after all those tax planners are not less intelligent than the tax deductors. So it is a constant competition. We are also improving our skill*" (One India News 2011). The Budget 2011 has provided for extending the jurisdiction and increasing the power of transfer pricing officers (Deloitte 2011). The proposed Direct Tax Code, expected to come into effect from 1 April 2012, has proposed to broaden the scope of transfer pricing audit by bringing more taxpayers under the ambit of audit (Deloitte 2009).

5. RATIONALE FOR ADOPTING TRANSFER PRICING REGIME IN BANGLADESH

Bangladesh's revenue-GDP ratio still remains one of the lowest in the world. Over the years, total revenue and tax receipts as percentage of Bangladesh GDP has increased – from 6.5 per cent and 5.5 per cent respectively in FY1981-82 to 11.2 per cent and 9.4 per cent respectively in FY2009-10 (Table 8). The National Board of Revenue (NBR) is the apex tax authority of the government to mobilise tax revenue. Tax revenue roughly generates four-fifth of the total revenue. The average yearly growth of total tax revenue between FY1981-82 and FY1990-91 period was 13.77 per cent, while it came down to 11.8 per cent during FY1991-92 and FY2000-01. The average yearly growth picked up between FY2001-02 and FY2009-10, and was 14.21 per cent. From revenue mobilisation perspective, Bangladesh still has a long way to go as the tax-GDP ratio is still considerably low when compared to other regional countries. Average tax-GDP ratio in South Asian countries is approximately 12 per cent.

Table 8: Revenue and Tax Revenue as Per cent of GDP

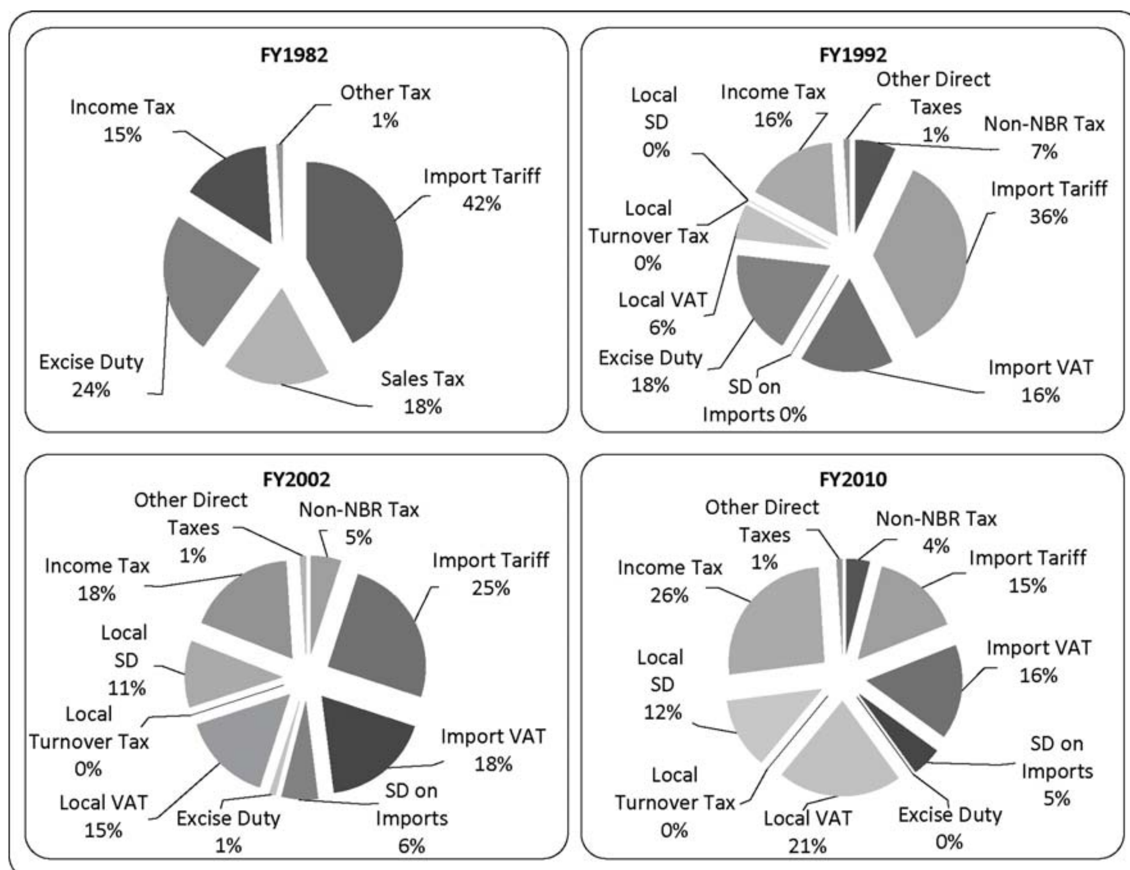
Year	Revenue	Tax Revenue
FY1981-82	6.5	5.5
FY1992-93	8.2	6.6
FY2002-03	9.5	7.8
FY2009-10	11.2	9.4

Source: NBR (2011a).

Customs duty (CD), which is basically the import tariff, has been the major contributor to the revenue envelope in the early 1980s – providing 42 per cent of the total tax revenue of the country in FY1981-82 and 36 per cent in FY1991-92 (Figure 10). In FY1991-92, value added tax (VAT) was introduced to gradually replace the sales tax, and became one of the major components of tax revenue. However, dependency on the tax collection at import stage dominated at that point which was 52 per cent of total tax collection originated from CD, VAT and supplementary duty (SD) at import stage. The 1990s was marked as the decade of trade liberalisation in Bangladesh with import duties being slashed significantly. As a result, the share of CD and total tax collection at import stage declined to 14.7 per cent and

35.3 per cent respectively in FY2009-10. VAT emerged as the major tax revenue source – VAT (import plus local) as share of total tax revenue has improved from 22 per cent in FY1991-92 to 33 per cent in FY2001-02, and further to 37 per cent in FY2009-10. Contribution of income tax increased during the last decade – from 16 per cent in FY1991-92, to 18 per cent in FY2001-02, and finally 26.4 per cent in FY2009-10.

Figure 10: Tax Revenue Composition



Source: NBR (2011a).

During the last two decades, Bangladesh had implemented a number of fiscal reforms including introduction of VAT through repeal of Sales Tax, Business Turnover Tax and shifting of 90 per cent of excisable goods and services in FY1991-92; establishment of Large Taxpayers Unit (LTU) for income tax in FY1998-99 and for VAT in 2004; introduction of Central Intelligence Cell (CIC) in FY2003-04; making Tax Identification Number (TIN) mandatory in a number of transaction (for example, registration of assets and business, sanctioning bank loans, etc.). More recently, online submission of tax returns for personal income has also been introduced on pilot basis. At present, the government has a plan to increase revenue-GDP ratio and tax-GDP ratio to 15.2 per cent and 13.0 per cent respectively. Being the apex revenue collection authority, the NBR has crafted a 'modernization plan' (strategy paper) for the next five years (2011-2016). The plan document, among other strategies, has recognised the need for introducing transfer pricing regime (NBR 2011b).

5.1 Evidence of Tax Loss and Capital Flight in Bangladesh

Bangladesh has been witnessing a rising trend in her volume of cross-border transactions over the last few decades. The booming consumer market within the country has been attracting significant foreign investment in energy, communication, manufacturing and service sectors. As is known, global openness brings both opportunities for economy and risks for revenue agency. Bangladesh is no exception.

Several international studies have shown that Bangladesh is losing a considerable amount of tax and capital each year by way of transfer mispricing. Kar (2011a) estimated that among the LDCs, Bangladesh had witnessed highest amount of illicit financial flow between 1990 and 2008. According to his calculations, about USD 34.8 billion were lost during this period; this would be equivalent to USD 1.8 billion per year (Table 9). Of the total amount, African LDCs accounted for 69 per cent, followed by Asia (29 per cent) and Latin America (2 per cent). On an average, trade mispricing accounted for about 65-70 per cent of total illicit outflows while unrecorded leakages from the balance of payments accounted for the remainder. During the above mentioned period, trade mispricing in LDCs increased by 5.8 per cent (in real terms) per annum, whereas growth rate of trade was 9.5 per cent. In this backdrop, Kar (2011a) cautioned that if governance does not improve significantly in LDCs including in Bangladesh, the intensity of trade mispricing may grow with the rising external trade.

Table 9: Top Five LDCs with Illicit Financial Flows in 1990-2008

(Billion USD)

Country	Cumulative Amount (1990-2008)	Average Amount (1990-2008)
Bangladesh	**34.8**	**1.8**
Angola	34.0	1.8
Lesotho	16.8	0.9
Chad	15.4	0.8
Nepal	9.1	0.5

Source: Kar (2011a).

Christian Aid (2009) reported that, between 2005 and 2007, Bangladesh lost GBP 186 million (USD 359 million) of tax revenue due to mispricing in trade with EU and US.[32] The country was the fourth biggest tax-loser in all low-income nations, only after Nigeria, Pakistan and Vietnam. In the same period, Bangladesh lost GBP 633 million (USD 1.19 billion) of capital from bilateral trade with US and EU 27 countries. Christian Aid (2009) also noted that, the loopholes in regulations, and lack of expertise and resources of revenue authorities were the main reasons behind such loss of tax and capital.

Following Tables provide a picture of the losses incurred by Bangladesh and some other countries on account of tax erosion and capital flow due to mispricing in trade with EU and US between 2005 and 2007 (Tables 10 and 11).

[32] In 2009, Bangladesh had about 34 per cent of its global trade with EU 27 and US; other trade partners accounted for 66 per cent of her global trade (European Commission 2011). Therefore, actual tax loss for Bangladesh from global trade mispricing will far exceed GBP 186 million, the amount from trade with EU and US.

Table 10: Top Ten Tax Losers (among Developing Countries) due to Mispricing in Trade with EU 27 and US

(Million USD)[33]

Rank	Country	Year			Total
		2005	2006	2007	
1	Nigeria	321	187	445	953
2	Pakistan	222	159	191	572
3	Vietnam	120	146	211	477
4	**Bangladesh**	**65**	**78**	**217**	**359**
5	Ivory Coast	65	67	175	306
6	Ghana	22	55	64	141
7	Cambodia	14	20	24	59
8	Kenya	20	22	18	60
9	Chad	9	20	28	57
10	Senegal	18	17	18	53

Source: Christian Aid (2009).

Table 11: Capital Flight from Bangladesh to EU 27 and US

(Million USD)

Region	Year			Total
	2005	2006	2007	
US	133	154	162	449
EU 27[34]	80	108	553	741
Total	213	262	715	1190

Source: Christian Aid (2009).

As Table 10 shows, Bangladesh lost tax revenue of USD 65 million 2005, USD 78 million in 2006, and USD 217 million in 2007 due to mispricing in bilateral trade with US and EU 27. The aggregate tax loss in three years amounts to USD 359 million (GBP 186 million). In the same period, the country has lost a total of USD 1.19 billion of capital to US and EU 27 as a result of trade mispricing (Table 11).

Developing countries desperately seek foreign investment from multinational enterprises. But investment of multinational enterprises oftentimes comes with various malpractices: country's exposure to the risk of tax loss and capital flight. In order to yield the full benefits of multinational investment, developing countries must put in place proper regulatory and administrative arrangements to combat profit shifting. One obvious way is to adopt an appropriate transfer pricing regime. Adopting transfer pricing regime helps developing countries such as Bangladesh in several ways: it combats profit shifting, safeguards revenue, ensures equal tax treatment for domestic entities (Akram 2002), builds an environment of

[33]Original figures were in GBP and have been converted into USD using the following conversion rates taken from taken from http://www.x-rates.com/cgi-bin/hlookup.cgi: 2005: GBP 1 = USD 1.793; 2006: GBP 1 = USD 1.8491; and 2007: GBP 1 = USD 2.0063.

[34]EU 27 figures were in Euro, and have been converted into USD using the following conversion rates taken from taken from http://www.x-rates.com/cgi-bin/hlookup.cgi: 2005: EUR 1 = USD 1.2098; 2006: EUR 1 = USD 1.2779; and 2007: EUR 1 = USD 1.35.

rightful business practices by tracking dubious transactions, unraveling tax evasion schemes, and getting tough on transfer pricing abusers.

5.2 Transfer Pricing Risk Factors for Bangladesh

5.2.1 Increasing Volume of International Transaction

Bangladesh's international trade is experiencing considerable rise over the recent past. During the last three decades Bangladesh has recorded spectacular performance in enhancing her export capability. The share of export increased from around 4 per cent of GDP in 1980 to move to 16 per cent of GDP in 2010 (Table 12). The share of import during the same period has increased from 13 per cent of GDP to about 24 per cent of GDP. Indeed, over time, Bangladesh economy has become increasing open, with the degree of openness[35] increasing from about 17 per cent (1980) to 40 per cent (2010). According to the Asian Development Bank (ADB) statistics (2011), the volume of international trade for Bangladesh has increased by 142 per cent between 2004 and 2009.

Table 12: Degree of Openness of Bangladesh over the Years

Year	GDP (Million USD)	Export (Million USD)	Import (Million USD)	Degree of Openness (%)
1980	18126.34	749.44 (4.13)	2365.00 (13.05)	17.18
1990	30476.55	1523.71 (5.00)	3759.00 (12.33)	17.33
2000	47124.95	5752.20 (12.21)	8374.00 (17.77)	29.98
2010	100083.77	16204.65 (16.19)	23738.40 (23.72)	39.91

Source: Authors' estimation based on World Development Indicator Database.
Note: Figures in parentheses show percentage of GDP.

Transfer mispricing causes tax loss to both developed and developing countries. But the loss to developing countries has more importance given the limited resources at their disposal. Transfer mispricing results in capital flight. Capital tends to flow from developing countries to developed ones. Therefore, developed countries can offset the loss of tax, at least partially, by gains in terms of the inflow of capital. But for developing countries, transfer mispricing is an entirely losing affair. They lose both in terms of tax foregone and capital outflow. The larger the volume of international trade, the greater is the loss of tax and capital for developing countries through transfer mispricing. Bangladesh is not an exception.

EU 27 and US accounted for about 34 per cent of total global trade of Bangladesh in 2009 (European Commission 2011). These two regions are again two major destinations of trade-based capital flight. Therefore, the exposure of Bangladesh to the risk of capital flight is already high in view of her trading pattern. The increase in the volume of international trade with these countries is adding to this risk.

[35] Degree of openness of the economy being defined as combined share of exports and imports as percentage of GDP. Degree of Openness =[{(EX+IM)/GDP}100].

5.2.2 Increasing Presence of Multinational Enterprises and the Attendant Risks

Tax agencies across the world regularly come across the incidences of tax evasion by multinational enterprises. An analysis of national tax administration of China has found that transfer mispricing accounted for about 60 per cent of China's total tax evasion by multination enterprises (Central People's Government of the People's Republic of China 2005).

The economy of Bangladesh is growing at a steady pace. The country, with her 160 million people, is a lucrative market for multinational enterprises. Already a large number of multinational enterprises are operating in Bangladesh. This number is likely to rise further in the near-term future. The Foreign Investor's Chamber of Commerce & Industry (FICCI), which awards membership to entities having substantial foreign ownership[36], has thus far enrolled 169 members (FICCI 2008). A large number of other entities, which do not enroll with FICCI, have substantial foreign interest. The growing presence of multinational operation in Bangladesh has increased the exposure of country's tax system to the risk of transfer pricing abuse.

5.2.3 High Rate of Corporate Taxation

Bangladesh has significantly high rate of corporate taxation. Companies listed with stock exchanges are taxed at a rate of 27.5 per cent. For non-listed companies, the rate is higher: 37.5 per cent. Corporate tax rates for financial institutions, tobacco manufacturers and mobile phone operators are even higher: 42.5 per cent, 42.5 per cent and 45 per cent respectively (NBR 2011d). Indeed, corporate tax rate of Bangladesh is higher than many developed and developing countries. The rate is also higher than the global, Asian and OECD averages.[37] Table 13 presents the corporate tax rates of selected *non-tax haven* jurisdictions.

Table 13: Corporate Tax Rate of Selected Non-Tax Haven Jurisdictions in 2010

Jurisdiction	Tax Rate (%)	Jurisdiction	Tax Rate (%)
Bangladesh	**27.5**	Macedonia	10.0
Bosnia and Herzegovina	10.0	Mauritius	15.0
Bulgaria	10.0	Montenegro	9.0
Chile	17.0	Paraguay	10.0
Croatia	20.0	Romania	16.0
Czech Republic	19.0	Russia	20.0
Egypt	20.0	Serbia	10.0
Hong Kong	16.5	Singapore	17.0
Iceland	18.0	Taiwan	17.0
Ireland	12.5	Turkey	20.0

Source: KPMG (2010); Worldwide-Tax.Com (2010) NBR (2011d).

[36]To qualify as an ordinary member of FICCI, an entity must have minimum 50 per cent foreign shareholding in their equity. Entities which do not have a global recognition must have a minimum paid up capital of USD 50,000.

[37]In 2010, global, Asian and OECD average corporate tax rates were 24.99 per cent, 24.44 per cent and 25.94 per cent respectively (KPMG 2010).

In addition to the above, a number of tax haven jurisdictions offer full tax exemption on corporate income. Such exemptions make the Bangladesh corporate tax rates appear even higher in terms of inter-jurisdiction comparison. The high rate of corporate taxation makes Bangladesh relatively more vulnerable to the risk of profit transfer.

5.2.4 Presence of Transfer Pricing in Trade Partner Countries

Bangladesh has her lion's share of international transactions with EU, China, US, India, Singapore, Japan, Malaysia, Canada, Hong Kong, South Korea, Australia, Thailand and Indonesia. All of these major global trade partners of Bangladesh have adopted respective transfer pricing regimes (Table 14).

Table 14: Bangladesh's Leading Trade Partners and their Transfer Pricing Status in 2009

Rank	Trade Partner	Trade Volume (Million Euro)	% of Total Trade	Transfer Pricing Regime Status
1	EU 27	6281.0	24.5	Adopted
2	China	2593.8	10.1	Adopted
3	United States	2439.6	9.5	Adopted
4	India	2165.3	8.4	Adopted
5	Singapore	1223.3	4.8	Adopted
6	Japan	813.1	3.2	Adopted
7	Malaysia	716.3	2.8	Adopted
8	Canada	656.7	2.6	Adopted
9	Hong Kong	647.0	2.5	Adopted
10	South Korea	623.3	2.4	Adopted
11	Australia	480.4	1.9	Adopted
12	Thailand	445.8	1.7	Adopted

Source: European Commission (2011); KPMG (2009b).

Multinational enterprises and transnational entities, operating in Bangladesh, have substantial business interest in these regions. As was mentioned earlier, taxpayers, in order to avoid adverse transfer pricing treatment, tend to show *pricing bias*[38] towards countries that have stricter transfer pricing regulation. Bangladesh has not yet adopted transfer pricing regime, while all her leading trade partners have. As a consequence, the latter is most likely to experience favourable pricing treatment since the former has no transfer pricing regulations *per se*.

5.2.5 Domestic Tax Rate Variation

As is known, Bangladesh has different tax rates for different categories of corporate taxpayers. The country also offers tax exemptions and other forms of tax incentives to selective categories of taxpayers. This selective incentive creates differences in domestic tax rates. The following two Tables present the picture of tax rate differences among various categories of corporate taxpayers (Tables 15 and 16).

[38]If a taxpayer has transactions involving Country A and Country B, and Country A has stricter transfer pricing policy, the taxpayer, in order to avoid adverse transfer pricing treatment in Country A, is most likely to follow a pricing method that attributes more profit to Country A.

Table 15: Tax Holiday Schemes in Bangladesh in 2011

Categories of Taxpaying Entity	Applicable Tax Rate (%)	Reference to Legislation
New company established by June 2008, and fulfilling certain conditions	0	Section 46A of Income Tax Ordinance, 1984
New company established after June 2008, and fulfilling certain conditions	0-75 (of actual tax)	Section 46B of Income Tax Ordinance, 1984
Private power generation company	0	SRO 188-Law/Income Tax/2009
Newly set up manufacturing companies in selected industries	5-15	SRO 172-Law/Income Tax/2009
Company engaged in textile and garments manufacturing	15	SRO 207-Law/Income Tax/2008
Company engaged in manufacturing jute products	15	SRO 206-Law/Income Tax/2008

Source: Authors' compilation based on the NBR documents.
Note: This list may not be exhaustive. There are many other classes of entities that enjoy reduced tax rate.
SRO denotes Statutory Regulatory Ordinance.

Table 16: Corporate Tax Rates in Bangladesh in 2011

Category/Sector of Entity	Corporate Tax Rate (%)
Mobile phone operator	45.0
Tobacco manufacturer	42.5
Financial institution	42.5
Other companies not listed with stock exchanges	37.5
Other companies listed with stock exchanges	27.5

Source: Authors' compilation based on the NBR documents.

The difference in tax rate creates an environment for domestic profit shifting. When different entities of the same business group enjoy different tax rates, the group is most likely to shift profit from the high tax units to the low tax ones. Such shifting of profit causes significant revenue erosion each year. Regrettably, Bangladesh at present lacks adequate legal provision to combat domestic profit shifting. The only remote reference of anti-profit shifting measure is in Section 46B(5)[39] of the Income Tax Ordinance, 1984. The section empowers tax officials to revoke tax holiday privilege of an entity if it misprices any transaction executed with any of its related party. Notably, Section 46B(5) is applicable only for entities enjoying tax holiday; no taxable entities come under the purview of this section. Moreover, Section 46B(5) is basically a prohibitive section; it provides no room for the recovery of lost revenue resulting from mispricing.

[39]Section 46B(5) of Income Tax Ordinance, 1984 reads as follows: ... *where an undertaking enjoying exemption of tax ... is engaged in any commercial transaction with another undertaking or company having one or more common sponsor directors, and .... if the Deputy Commissioner of Taxes is satisfied that the said undertaking has purchased or sold goods at higher or lower price in comparison to the market price with intent to reduce the income of another undertaking or company, the exemption of tax of that undertaking shall be deemed to have been withdrawn that assessment year in which such transaction is made.*

5.3 How Transfer Pricing Regime Can Help

The benefits of adopting transfer pricing regime can be identified in three broad areas: a. minimising loss; b. attaining capacity; c. contributing to other areas of governance.

5.3.1 Minimising Loss of Tax and Capital

Minimising the Loss of Direct Tax

Adopting transfer pricing regime will enable NBR to recover the tax lost on transferred profit. Transfer pricing regime capacitates tax officials to detect and combat profit transfer in a number of ways as discussed below:

a. Transfer pricing regulations require taxpayers to maintain and file a complete range of entity-related, price-related and transaction-related information. The information enables tax officials to unearth the incidence of profit transfer or other malicious practices in cross-border transactions.
b. Transfer pricing regulations outline generally accepted methods and procedures of determining the arm's length price of a dubious transaction. Under a transfer pricing regime, tax liability is estimated on the basis of universally accepted procedures of presumption instead of individual judgment-based ones. The assessments, therefore, become more acceptable to all relevant parties. They also lead to fewer incidents of litigation.
c. Transfer pricing regime shifts the burden of proof, from the tax officials to the taxpayers as to whether the position of the tax officials with regard to the arm's length price is justified. In order to justify their price, taxpayers maintain comprehensive records, gather comparable data, conduct comparability analysis, and provide tax agencies a good range of information along with detailed functional, economic and business analyses. Assessing officers are thus equipped with adequate evidential document to support their stand on presumption.

Reducing the Loss of Value Added Tax

VAT is also a transaction-based tax, and is often subject to transfer pricing abuse. In effect, the interest of direct tax and VAT regarding arm's length price runs in the same direction. Any detection of transfer pricing abuse by transfer pricing officers may trigger a VAT alert. An adjustment in direct tax by way of transfer pricing audit may pave the way for similar adjustment in VAT.

VAT legislation in place in a number of countries provides scope for making VAT adjustment for transactions that are not at arm's length price (IBFD 2006). Bangladesh, however, has no such provision in place. Under the existing Value Added Tax Act, base value of VAT for international transactions is determined on the basis of customs valuation.[40] In adopting

[40]Section 5 of the *Value Added Tax, 1991* provides that VAT on import items will be determined based on the customs valuation under Section 25 or Section 25A of *Customs Act, 1969*.

transfer pricing regime, Bangladesh can review the existing VAT code and can make room for VAT adjustment for transactions that do not meet arm's length principle.

Reducing Capital Flight

The recovery of an amount of tax by way of transfer pricing adjustment would mean the prevention of outflow of the equivalent amount of capital. As observed in several studies which were reported above, significant amount of capital flows out of Bangladesh every year (Christian Aid 2009; Kar 2011a). Adopting transfer pricing regime would help in reducing the loss of tax, and would in turn, discourage the flight of capital from the country.

5.3.2 Strengthening Capacity

Resources and Expertise

Adopting transfer pricing regime will need establishment of a specialised international taxation division equipped with adequate workforce and resources, and the expertise on cross-border financial issues. This will be needed to successfully combat not only transfer mispricing, but also other cross-border financial wrongdoings.

Information

One of the most important weapons in combating cross-border financial crimes is information. Combating cross-border financial wrongdoings involves pre-transaction intelligence and post-transaction investigation. Both the functions require information. Adopting transfer pricing regime requires the creation of a conducive data resource environment. Under a transfer pricing regime, tax agencies gather data from different sources, and process, analyse and interpret the data for tracking and monitoring malicious cross-border financial practices. Apprehensions about tax agency's *information power* deter potential wrongdoers from pursuing price misreportings. Moreover, data possessed by the tax agency can also be useful to other law enforcing and investigating agencies.

5.3.3 Contributing to Other Areas of Governance

Reducing the Shadow Economy

Several studies have identified the existence of a sizeable shadow economy in Bangladesh. According to the estimate of Schneider *et al*. (2010), the average size of shadow economy of Bangladesh in the period between 1999 and 2006 was 35.9 per cent of GDP. The estimate is well supported by the study of Hassan (2011); the average size of shadow economy between 1996 and 2008 was found to be 38.1 per cent. In a recent statement, the Finance Minister of Bangladesh, quoting the NBR, stated that the size of shadow economy in Bangladesh was equivalent to 42-80 per cent of the country's GDP. Studies have shown that adopting transfer pricing contributes to trimming the shadow economy.

Strengthening Anti-Money Laundering and other Anti-Crime Efforts

Bangladesh is a strategic partner in global anti-money laundering effort. Adopting transfer pricing can contribute to curbing money laundering by building institutional capacity to detect and track dubious transactions, retaining money (by means of taxation) within the jurisdiction, facilitating information exchange among jurisdictions, and fostering cooperation among agencies. Transfer pricing database developed and accessed by tax officials could be a good support for the operation of other anti-crime agencies.

5.3.4 Issue of Efficiency and Fairness

In the absence of a manifested guideline on transfer pricing, different assessing officers may apply their own different presumptive judgment in making assessment of *related party* income. Multinational enterprises have international affiliations. They serve as the *international broadcasters* of country's taxation events. An arbitrary and injudicious assessment imposed on a multinational entity may tarnish a country's image abroad and undermines its potential for attracting foreign investment inflow. The ultimate goal of a tax administration is to gather the due amount of revenue *in a fair manner*. An efficient transfer pricing system serves the dual purpose of efficiency and fairness of a tax administration: it safeguards revenue by fostering better tax compliance and delivers just taxation by ensuring quality assessment.

6. ADOPTING AN APPROPRIATE TRANSFER PRICING REGIME IN BANGLADESH

Introduction of an appropriate transfer pricing will involve acting in three phases:

a. Study and analysis;
b. Preparing the stage – addressing legislative and organisational issues; and
c. Delivery of the expected results.

It is also advisable to adopt a review mechanism upfront. A functional review mechanism will help the process to adjust with the changing global and country environment. In order to execute these three tasks, financing of the relevant tasks will also need to be planned accordingly. The tasks have been briefly discussed in the following section.

6.1 Study and Analysis

At the study and analysis phase, the tax agency will need to establish a Transfer Pricing Cell to undertake the necessary ground works. The task of the cell, *inter alia*, will include:

1. Study and analyse transfer pricing organisational structure of other tax agencies;
2. Study and analyse transfer pricing legislation of other agencies (including the transfer pricing guidelines of OECD);
3. Exchange ideas and share opinion with major stakeholders (tax officials, multinational enterprises, corporate entities, tax experts and policy groups) regarding the design of the transfer pricing system;

4. Recommend the organisational and regulatory structure of transfer pricing administration.

6.2 Setting the Stage

In this phase, tax agency gets on with organising the tasks. The activities of the agency, in this phase, include enactment of transfer pricing legislation, formulation of transfer pricing regulation (including guidelines), establishment of transfer pricing cell/unit, development of human resources, creation of data support environment, and arrangement of training and education of targeted taxpayers.

6.2.1 Transfer Pricing Legislation

Having a sound transfer pricing legislation is the first important step in adopting transfer pricing regime. As was already mentioned, the legislation must maintain a number of core qualities such as clarity, integrity, completeness, flexibility, simplicity and international compatibility. A standard transfer pricing legislation and regulation should have adequate coverage of the following legal areas:

- Scope of transfer pricing regulation (who will come under the purview of transfer pricing regulations);
- Legal definition of transfer pricing terms;
- Authority, power and responsibilities of transfer pricing officers;
- Documentation and filing requirements for the taxpayers;
- Manner of referring transfer pricing cases to transfer pricing officers by field offices;
- Manner of disposal of cases by transfer pricing officers;
- Transfer pricing methods to be followed;
- Penal provisions for non-compliance;
- Provisions regarding Advanced Pricing Agreement.

Countries generally tend to follow two different approaches in enacting transfer pricing legislation. In some countries, the income tax code covers most of the legal areas relevant to transfer pricing. In other countries, income tax codes only cover the core legal areas such as the scope and the authority. All other areas including transfer pricing methods, reference to transfer pricing officer, audit, documentation and comparability analysis are covered under the administrative guidelines. India belongs to the first group. The Income Tax Act, 1969[41] has comprehensive coverage of all vital areas of transfer pricing. Singapore[42] and Malaysia, among others, constitute the second group. The tax legislation of Bangladesh is similar to India.

[41]Income Tax Act, 1969 is set to be replaced by Direct Tax Codes with effect from 1 April 2012. The Direct Tax Codes have almost the same extent of coverage of legal areas.

[42]The reference to transfer pricing matters has been made in four sections: Section 13(16), 33, 34D and 53(2A). Section 13(16) defines related party; Section 33 outlines the scope of transfer pricing; Section 34D covers general anti-avoidance provisions; and Section 53(2A) covers transactions between a resident and a non-resident.

Hence, in enacting transfer pricing legislation, Bangladesh could follow the example of India and incorporate all relevant transfer pricing provisions in her income tax code.

The existing Income Tax Ordinance, 1984 of Bangladesh has no mention of transfer pricing or arm's length principle. However, the country is planning to enact a new Direct Tax Act with effect from 1 July 2012. The draft Direct Tax Act has included transfer pricing provisions. Transfer pricing related sections of the first draft of the Direct Tax Act read as follows:

202. Determination of income from international transaction having regard to arm's length price

(1) The amount of any income, or expenditure, arising from an international transaction shall be determined having regard to the arm's length price.

(2) The allocation or apportionment of, or any contribution to, any cost or expenditure incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any associated enterprise shall be determined having regard to the arm's length price of such benefit, service or facility, as the case may be, if—

- *(a) two or more associated enterprises have entered into a mutual agreement or arrangement for the allocation or apportionment of, or any contribution to, such cost or expenditure; and*
- *(b) the benefit, service or facility provided to any one or more associated enterprises involves an international transaction.*

(3) The provisions of this section shall not apply in a case, if the determination under Sub-section (1), or Sub-section (2), has the effect of reducing the income chargeable to tax, or increasing the loss computed, on the basis of entries made in the books of account in respect of the financial year in which the international transaction was entered.

203. Determination of arm's length price

(1) The arm's length price in relation to an international transaction shall be determined in accordance with any of the methods as may be prescribed, being the most appropriate method.

(2) The most appropriate method referred to in Sub-section (1) shall be determined having regard to the nature of transaction, class of transaction, class of associated enterprise or functions performed by such enterprises or such other relevant factors as may be prescribed.

(3) The most appropriate method determined under Sub-section (2) shall be applied for determination of arm's length price in such manner as may be prescribed.

(4) The arm's length price shall be—

> *(a) the price determined by the most appropriate method, if only one price is determined by the method; or*
> *(b) the arithmetical mean of the prices determined by the most appropriate method, if more than one price is determined by the method.*

(5) The price at which the international transaction has actually been undertaken shall be deemed to be the arm's length price if the variation between the arm's length price determined under Sub-section (4) and the price at which the international transaction has actually been undertaken does not exceed five per cent of the latter.

(6) The income of an associated enterprise shall not be recomputed by reason of determination of arm's length price in the case of the other associated enterprise.

(7) The determination of arm's length price shall be subject to safe harbour rules, as may be prescribed in this behalf.

(8) For the purpose of Sub-section (7) of this section, safe harbour means circumstances in which the income tax authorities shall accept the transfer price declared by the assessee (NBR 2011c).

Sections 202 and 203 of the Draft Direct Tax Act of Bangladesh are almost a copy of Sections 105 and 106 of the Draft Direct Tax Codes of India. The proposed transfer pricing legislation of the Draft Direct Tax Act of Bangladesh, however, misses a number of essential components of a standard legislation. The missing components have been identified below (Table 17).

Table 17: Missing Components of Draft Transfer Pricing Legislation

Area of Transfer Pricing Legislation	Related Sections of Draft Direct Tax Code, India	Related Sections of Draft Direct Tax Act, Bangladesh
Scope	105, 106	202, 203
Definition of terms	113	missing
Reference to transfer pricing officer	130, 284	missing
Transfer pricing documentation	83	missing
Furnishing information/filing	149	missing
Administrative procedures	160	missing
Assessment procedure	162	missing
Penal provision	226	missing

Source: Based on the comparison of Draft Direct Tax Code, India and NBR (2011c).

Draft transfer pricing legislation of Bangladesh, therefore, needs careful review, and perhaps redrafting, to incorporate the missing areas. Necessary rules and administrative guidelines are to be formulated to bring transparency to different functional procedures.

Defining the scope of transfer pricing regulation is another critical issue. Countries again follow two different approaches in outlining the ambit of transfer pricing. Majority of the

transfer pricing countries bring only international transactions (including the transactions with non-residents) under the purview of transfer pricing regulation. A number of other countries, however, bring both domestic and international transactions under the ambit of transfer pricing.

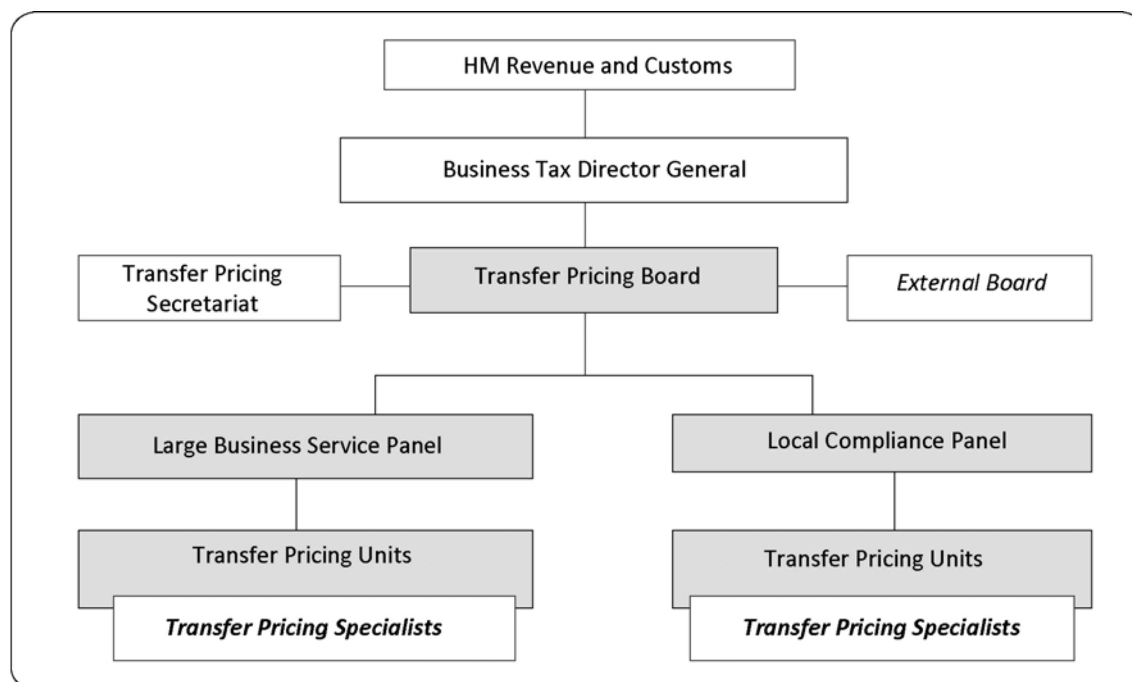
Bangladesh experiences transfer mispricing in both domestic and international transactions. Domestic mispricing perhaps exists at even larger magnitude. Intra-group profit transfer is widespread in all sectors; transferring profit from higher tax units to lower tax units is a common practice of large business groups. Bangladesh, therefore, should opt for applying transfer pricing provisions to both domestic and international transactions.

6.2.2 Organisational Arrangement

Most of the transfer pricing administrations in the world have separate organisational arrangement for transfer pricing work. UK, for example, has a dedicated Transfer Pricing Group, consisting of a board, a secretariat, and, a number of panels and units. India has a separate directorate general, the Director General of Income Tax, International Taxation, to deal transfer pricing and thin capitalisation issues. China and Malaysia have separate department/division for dealing transfer pricing as well.

The Transfer Pricing Group of HM Revenue and Customs (HMRC), UK can serve as a good model for other tax agencies in designing transfer pricing organisational set up. A brief account of the structure, duties and responsibilities of the Transfer Pricing Group of HMRC is provided below with a view to drawing relevant knowledge (Figure 11).

Figure 11: Transfer Pricing Organisational Structure of HM Revenue and Customs, UK



Source: Prepared based on a number of HMRC publications.

Transfer Pricing Group was created in April 2008 (Hay 2008). The group consists of a Transfer Pricing Board, two transfer pricing panels, several transfer pricing units each joined by a number of transfer pricing specialists from a wide range of disciplines. There is also a Transfer Pricing Secretariat. Since 2009, an External Board has also joined the transfer pricing arrangement (Box 1).

Box 1: Transfer Pricing Group of HMRC: Duties and Responsibilities

Transfer Pricing Board

Transfer Pricing Board is responsible for delivering the objectives of Transfer Pricing Group. The Board gives strategic direction for transfer pricing works and makes operational decisions for higher risk cases. High value cases are recommended to Business Tax DG or HMRC ExCom for final decision.

Transfer Pricing Panels

Transfer pricing panels make the key operational decisions. The panels decide the opening of a transfer pricing inquiry, the manner of settling a case (concession, negotiation or litigation) and the parameters of settlement where the cases are negotiated. The panels also monitor the progress of cases on a periodical basis.

There are two panels in the Transfer Pricing Group; one for Large Business Service cases and the other for Local Compliance cases. Each panel consists of representatives from different directorates involved in the transfer princing work. Panel members meet monthly.

Transfer Pricing Units

Transfer pricing units consist of Case Teams who perform risk assessment process. At present there are four transfer pricing units for Local Compliance cases and five transfer pricing units for Large Business Service cases. Several transfer pricing specialists and assistant transfer pricing specialists work in each transfer pricing unit. Each case has an assigned transfer pricing specialist.

Transfer pricing specialists provide specialised technical support to case teams. They also make sure that transfer pricing governance process has been followed in each case.

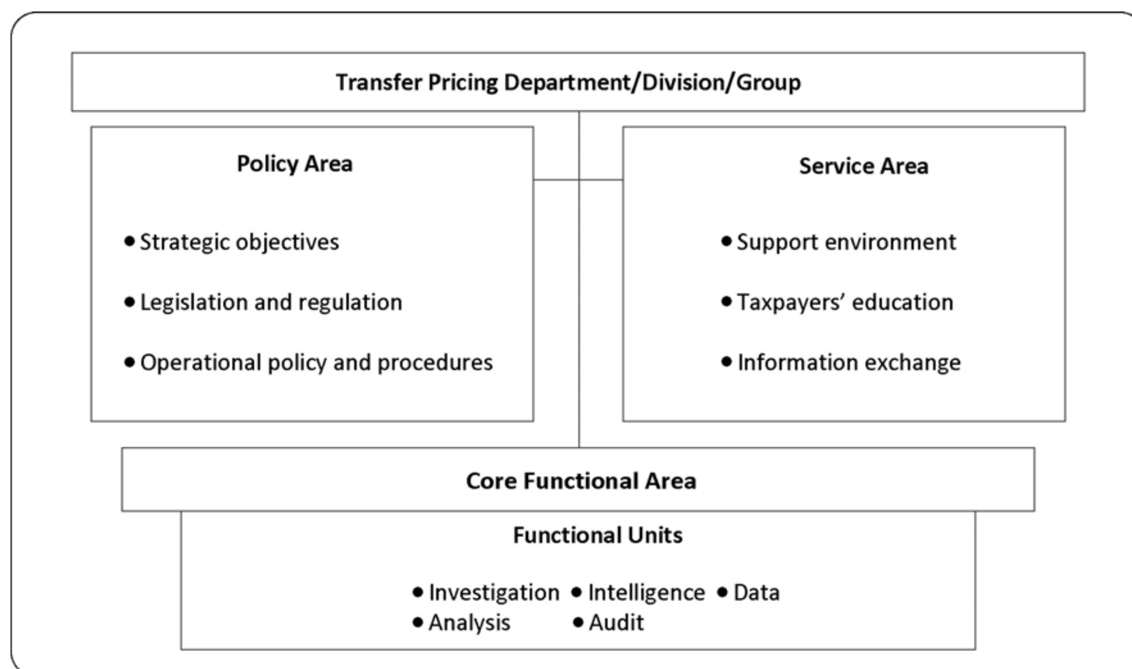
Transfer Pricing Secretariat

Transfer Pricing Secretariat provides administrative support to the Transfer Pricing Board.

Source: HM Revenue and Customs (n.d.(b)); Hay (2008).

A typical transfer pricing division (or group or unit) is basically an *audit unit*. The unit does not involve in regular assessment or collection. The task of the unit is to formulate transfer pricing operational policy, foster transfer pricing compliance, conduct transfer pricing audits and settle transfer pricing cases. A typical transfer pricing unit has the following organisational structure for functioning (Figure 12):

Figure 12: Functional Organisation of Transfer Pricing



Source: Authors' elaboration.

At present, NBR has no separate organisational set up to deal with transfer pricing issues. The existing tax legislation of Bangladesh also does not have any real check against transfer mispricing. Assessing officers often apply Sections 83[43] and 84[44] of the Income Tax Ordinance, 1984 to reject taxpayer's disclosed income if it appears to be infeasible; new estimates of income based on some practice-based requirements presumption are made in view of this. But Sections 83 and 84 can hardly serve the requirements of dealing with the transfer pricing issue. *Firstly*, determining arm's length price requires exclusive information on related party transaction and comparability analysis. Under conventional tax practice, taxpayers usually submit accounts and statements that are often very brief in content, and without the details of related party transactions. Sections 83 and 84 can no way bind taxpayers to maintain and file ALP documents such as related party transactions and comparability analysis. *Secondly*, under the inherent spirit of Sections 83 and 84, the onus lies with the assessing officers to prove that the accounts are inaccurate and the transaction prices are unjustified. Assessing officers hardly find sufficient, if at all any, documentary evidence to disprove the authenticity of *arranged* prices. They have to apply their intuitive

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[43] Section 83 applies when a taxpayer submits returns and appears before the assessing officer for hearing. *According to Section 83(2), ...the Deputy Commissioner of Taxes shall, after hearing the person appearing, or considering the evidence produced .... and also considering such other evidence, if any, as he may require on specified points, by an order in writing assess ... the total income of the assessee and determine the sum payable by him on the basis of such assessment*.

[44] Section 84 applies when a taxpayer fails to submit returns or accounts and to appear before the assessing officer for hearing. *As the Section provides: ... the Deputy Commissioner of Taxes shall, by an order in writing, assess the total income of the assessee to the best of his judgment and determine the sum payable by the assessee on the basis of such assessment; and in the case of firm, may refuse to register it or may cancel its registration if it is already registered*.

judgment based on past experience to make presumption about transaction prices and income. Such presumption, not supported by concrete evidence and explicit legal reference, can hardly stand in the courts of appeal.

In adopting transfer pricing regime, Bangladesh should opt for a separate transfer pricing set up. NBR can initially establish a *Transfer Pricing Cell* which will have a limited number of officers having good track records of professionalism and commitment. The cell will lay the foundations for a full-fledged and fully operational transfer pricing department. Officers appointed in this cell should receive proper training and education on transfer pricing and international taxation issues. In the initial two or three years, a small group of officers may be able to handle the responsibilities. However, with increasing volume and intensity of work, the cell will have to be upgraded to a full-scale International Taxation Directorate which would incorporate several transfer pricing units and employ higher number larger scale of workforce and greater resources.

6.2.3 Data Support Environment

Both taxpaying entities and the tax agency need economic and financial data for discharging transfer pricing responsibilities. Transfer pricing is mostly a cross-border issue, and the work of transfer pricing warrants domestic, regional and global data. Accessing international data is relatively easier. A number of international database companies offer regional and global data service on a commercial basis. Accessing domestic data is a rather more difficult proposition, particularly in a developing country such as Bangladesh. Data on domestic corporate affairs are rather scarce in Bangladesh. Domestic data service companies are limited in number and their data resource is not rich. The disclosure-shyness of domestic enterprises handicaps database companies in their information gathering effort.

In adopting transfer pricing regime, local database companies should be given policy support to enhance their data service capacity. Fiscal incentive would attract new entrepreneurs and resources in the data service sectors. Regulatory support would enable local companies to make deeper inroads into the corporate database.

6.2.4 Taxpayers' Education

The success of transfer pricing work critically hinges on proper understanding of transfer pricing obligations by taxpaying entities. Steps should be taken to educate taxpayers, explain them the provisions of transfer pricing laws, remind them of their obligations, responsibilities and rights, and keep them updated about any changes in legislation.

6.3 Transfer Pricing Delivery

The delivery phase is the real time operational phase. As was mentioned earlier, the main objective of transfer pricing administration is to minimise the loss of tax. Transfer pricing audit is the key instrument to achieve this goal. In order to facilitate audit, transfer pricing officers must make sure that taxpayers maintain and file the necessary documents. Therefore, the delivery phase, is mostly about conducting transfer pricing audit and ensuring compliance.

6.3.1 Audit

It is through audit that the instances of transfer mispricing are unearthed and the amount of tax evasion determined. Transfer pricing audit is a complex task involving multidimensional skills in the area of investigation and analyses. Auditors must have sound knowledge of economics, business, finance, banking, accounting and taxation. Audits should be thoroughly professional, and should conform to international standards.

6.3.2 Compliance

For smooth functioning of transfer pricing system, transfer pricing units must make sure that taxpayers comply with transfer pricing requirements properly. Transfer pricing units need to undertake a number of supportive and enforcement activities to ensure taxpayers' compliance.

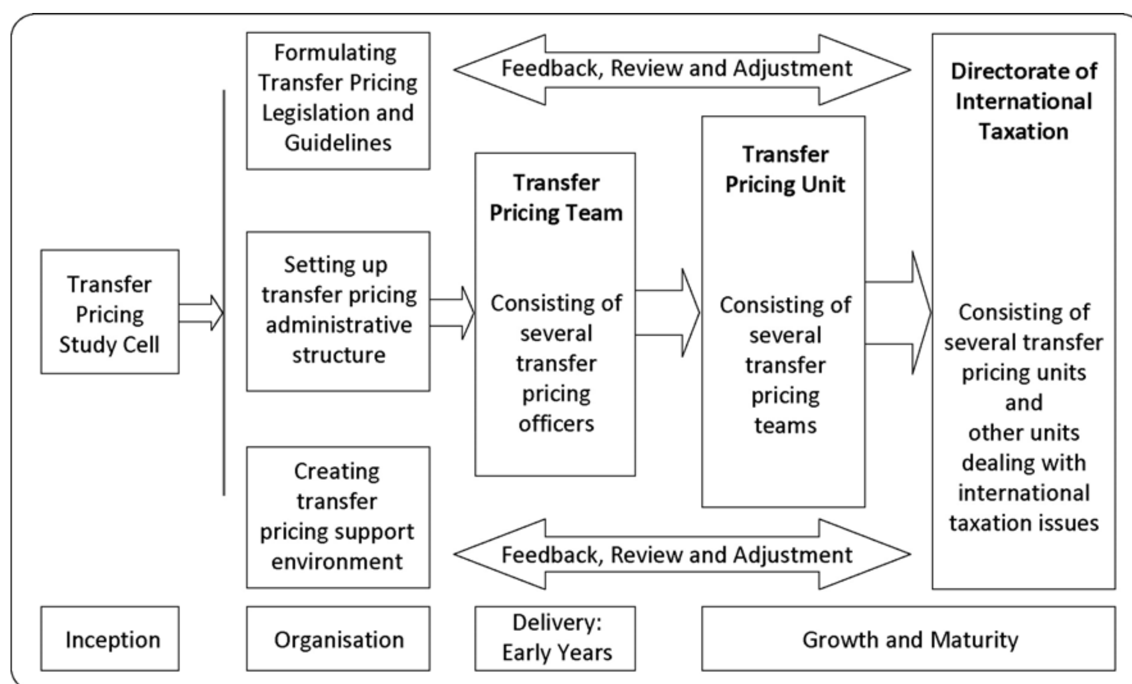
6.3.3 International Exchange of Tax Information

Transfer pricing work involves cross-border parties. In investigating cross-border mispricing schemes, transfer pricing units need to work in collaboration with other tax agencies. Transfer pricing system must facilitate exchange of information among the relevant authorities; they will need to share experience with other cross-border tax agencies as well.

6.4 Feedback and Review

No system is efficient unless it adjusts itself to the changing environment. Transfer pricing deals with constantly evolving global business environment. Consequently, transfer pricing system must go through regular review and reform in order to bring in the required changes (Figure 13).

Figure 13: Phases in Adopting Transfer Pricing Regime in Bangladesh



Source: Authors' elaboration.

6.5 Financing Transfer Pricing Programme

As was noted in the preceding sections, transfer mispricing poses a threat to global financial integrity with significant potential damage to the global and national economies. It erodes the financial strength of countries in general, and of developing countries in particular. Its linkage to capital flight, informal economy, money laundering and other financial wrongdoings makes it a governance issue of global concern. The adoption of transfer pricing regime in Bangladesh requires the commitment of substantial financial resources. The developed economies are deploying large amount of resources for more aggressive legal action and audits. Sikka and Willmott (2010) draws attention to the fact that the US tax agencies employed an additional 2,000 professionals between 2009 and 2010 in order to combat transfer pricing. However, many developing and least developed countries lack required resources which undermine their ability to adequately scrutinise the transfer pricing related issues.

Managing fund from revenue budget for a new programme such as transfer pricing may involve complex bureaucratic process. Development partners in Bangladesh have special interest in governance-related programmes, particularly those related to revenue mobilisation. In order to avoid initial dependence on regular finance, transfer pricing work can be started in Bangladesh under a donor-funded project. If NBR can properly approach, many development partners would be willing to finance the project. Once the project passes its initial few years successfully, the benefits of the transfer pricing work would ably justify the establishment of a full-scale Directorate of International Taxation under regular finance.

7. SUMMARY OF OBSERVATIONS AND CONCLUDING REMARKS

Transfer mispricing is a global economic phenomenon and it has been on the rise in recent years in view of the fast globalising world of commerce and business. Mispricing takes place in various forms such as mispriced international trade, misquoted contract value, misvalued intangibles, disproportioned cost-sharing in joint projects, and fictitious and overvalued management service. Transfer mispricing distorts the financial integrity of a country by promoting tax evasion, capital flight and money laundering, and creating shadow economy. Lack of good governance, insufficient security of capital, financial secrecy practice and encouragement of the inflow of illegal capital by good governance countries, weak institutional capacity, weak regulatory framework, inter and intra-jurisdiction tax rate difference, business remodelling and restructuring, and increasing mobility of intangible-related transactions are key factors responsible for the existence and the rise of transfer mispricing.

Economic globalisation has exposed countries across the world to the increasing risk of the loss of revenue and capital. Transfer mispricing costs global tax system billions of dollars of potential tax revenue each year. A sizeable number of countries have already adopted transfer pricing regime to combat transfer mispricing. Evidence bears out that an increasing number of countries are coming under the shield of transfer pricing regime every year. About 60 countries have already adopted transfer pricing regime. Under this regime, countries build institutional capacity and develop legal and administrative framework to

track and monitor transactions, identify means and channels of money laundering and capital flight, detect incidences of mispricing, determine the fair value of transactions, and recover the lost revenue. Globally, revenue agencies are given the mandate, authority, responsibility and resources to administer transfer pricing regulations. Asia, home of the world's fastest growing economies, is a fertile ground for transfer mispricing due to its booming international trade and increasing cross-border capital flow. Many developing countries of Asia, having considerable international exposure, have already adopted transfer pricing regime. These countries are now toughening their anti-mispricing regulations and strengthening anti-avoidance efforts. According to a ranking, India, China, Japan and Korea are among the world's top ten toughest tax agencies in terms of transfer pricing.

Not surprisingly, evidence suggests that LDCs such as Bangladesh are not immune to this economic malaise. The estimates are not negligible, and have been on the rise in the recent past. In view of its importance, combating transfer mispricing has become a priority agenda in many countries across the world. An international study finds that, between 2005 and 2007, Bangladesh lost about USD 359 million of tax revenue due to mispricing in trade with the EU 27 and US alone. In the same period, as some of the studies indicate, Bangladesh experienced a capital outflow to the tune of USD 1.19 billion due to mispricing in connection with her bilateral trade with US and EU 27 countries. Given the fact that Bangladesh has only one-third of her global trade with EU 27 and US, and other trade partners account for the rest two-thirds, there is no doubt that the actual loss of tax and capital for Bangladesh due to trade mispricing is much higher than is indicated by the estimates presented in the aforesaid studies.

Bangladesh lacks proper institutional capacity to track, mine and monitor cross-border transactions, identify mispricing, detect capital flight, and recover tax and capital. Therefore, the country is in the high-risk zone from the perspective of transfer pricing abuse. International transactions, trade mispricing and transfer mispricing are closely bonded issues. Bangladesh has witnessed a 142 per cent rise in the volume of international trade in the period between 2004 and 2009. This increasing trend in the volume of international trade has also created an environment where the risks of losing tax and capital have been on the rise. Multinational enterprises across the world are increasingly coming under transfer pricing scrutiny; many are being penalised for malpractices. Being a large consumer market of over 150 million people, Bangladesh is a lucrative field for multinational operation. Hundreds of enterprises having multinational interest are operating at present in the country. This number is likely to increase further in future. The presence of multinational operation in Bangladesh exposes the country's tax system to the risk of transfer pricing abuse. All the major global trade partners of Bangladesh, including EU, China, United States, India, Singapore, Japan, Malaysia, Canada, Hong Kong, South Korea, Australia, Thailand and Indonesia have adopted transfer pricing regime. Multinational taxpayers, in order to avoid adverse transfer pricing treatment, tend to show *pricing bias* towards countries that have stricter transfer pricing regulation. Since Bangladesh has no transfer pricing administration, the country is most likely to receive *unfavourable* pricing treatment by multinational taxpayers in the pricing of international transaction. Hence, there is an urgency to tackle the issue by putting in place the required mechanisms to deal with this issue.

Adopting an appropriate transfer pricing regime could help Bangladesh in several ways: i) building institutional capacity to track and monitor suspicious cross-border transactions and combat cross-border financial wrongdoings; ii) maintaining fiscal integrity through safeguarding revenue and capital; iii) negotiating the threat to national security by tracking money laundering, criminal financing and terrorist financing; iv) building an environment of rightful business practices by tracking dubious transactions, unraveling tax evasion schemes and getting tough on pricing abusers. Lack of information makes it difficult to project the exact monetary impact of adopting transfer pricing regime in Bangladesh. However, the findings of several international studies about Bangladesh's loss of tax and capital due to transfer mispricing, and the benefits accrued to other countries including the neighbouring India from adopting transfer pricing system, lead to conclude that Bangladesh will be significantly benefited from the adoption of transfer pricing regime.

In adopting transfer pricing regime, the National Board of Revenue (NBR) will need to amend present laws and regulations, formulate necessary new laws and regulations, make proper organisational arrangement (structure), and create proper support environment. Adoption of transfer pricing should take place in several phases. In administering transfer pricing regulation, NBR initially can establish a *Transfer Pricing Cell* with a limited number of officers having good track record of professionalism and commitment. Officers should receive proper training and education on cross-border trade and taxation issues. The cell may gradually expand, and after initial few years, when the volume and intensity of work will grow, the cell may be upgraded to a full-scale *International Taxation Directorate* incorporating several transfer pricing units and employing larger scale of workforce and resources.

The administration of transfer pricing involves substantial financial resources. Ideally, this should be supported through domestic financing. Transfer pricing should be seen as an issue of fiscal governance. Since development partners in Bangladesh have special interest in governance-related programmes, support may be sought from them if necessary domestic funds cannot be mobilised. Thus, work on transfer pricing may be launched with support from development partners. If the project runs smoothly, the benefits of transfer pricing work would justify the establishment of a full-scale Directorate of International Taxation under regular finance. Successful implementation of a transfer pricing regime would require close cooperation among the relevant government agencies, particularly between the NBR and Bangladesh Bank. This will need to be ensured through proper institutional arrangements.

In this era of trade globalisation, no tax agency can safeguard revenue without the presence of a sound transfer pricing system. Bangladesh is a fast growing economy with increasing exposure to the risk of mispricing in cross-border transactions. As mentioned before, several international studies have reported about the country's enormous loss of tax and capital each year due to mispricing in international transactions. The loss has been increasing every year, posing a rising threat to the country's financial integrity. The growing size of country's informal economy and the need to curb money laundering and discourage terrorist financing have also added urgency to the task of maintaining country's financial health and stability. Adopting transfer pricing regime is a global practice to combat financial wrongdoings and safeguard the national tax and capital. It also needs to be noted that such a regulatory initiative is also good for business environment. MNCs would rather prefer a transparent system, than one based on arbitrary and discretionary decisions of tax officials.

Thus putting in place a transfer pricing regime, which is modern, transparent, globally accepted and geared towards good governance is likely to encourage foreign direct investment (FDI), not deter it. This will also enhance Bangladesh's reputation as a good governance destination and strengthen Bangladesh's compliance record in relation to global initiatives such as Anti-Money Laundering Convention, which she has signed. Perhaps time has come for Bangladesh to adopt an appropriate and adequate transfer pricing regime without further delay.

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