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Transfer Pricing Policy for Bangladesh

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Abstract

As Bangladesh tries to increase the level of foreign direct investment, the authorities may formulate a transfer pricing policy to reduce the scope for detrimental profit-shifting activities of transnational corporations. A simple model to illustrate the role of transfer pricing in intra-corporate cross-border trade is presented. It is argued that while Bangladesh’s transfer pricing policy should be based on internationally accepted principles, it will have to be suitable to the situation of the country and congruent to the administrative capability of the national tax authorities. Key challenges and further research topics in transfer pricing issues pertaining to Bangladesh are identified and discussed.

(JEL D21, F13, H25, H32, L11, O23)

Key words: Bangladesh, Transfer Pricing, Tax, Transnational Corporations, Multinational Corporations, Foreign Direct Investment
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Introduction

In recent years, Bangladesh has attracted some foreign direct investment, particularly in the natural gas sector. Bangladesh is trying to attract more foreign direct investment in order to foster growth and economic development and to exploit its natural resources. The principal foreign direct investors around the world are transnational corporations. Transnational corporations can engage in profit-shifting activities in order to maximize their risk-adjusted after-tax profit. If transnational corporations engage in profit-shifting activities, then these activities can have detrimental effects on the national exchequer. How can the authorities prevent or reduce the scope for transnational corporations to engage in profit-shifting activities? It is argued here that the authorities may formulate prudential transfer pricing policies to try to deter detrimental profit-shifting activities of transnational corporations. Bangladesh’s transfer pricing policy could be based on generally accepted international principles. However, such principles have to be adjusted to the specific circumstances of the country and the administrative capability of the national tax authorities. Some features of a prudential transfer policy for Bangladesh are outlined and proposed.

There are many reasons for establishing a prudent transfer pricing policy in Bangladesh at a time when policy makers are actively seeking to encourage transnational corporations’ foreign direct investment in the country. Transactions among affiliates often take place under conditions different from those taking place between unrelated parties. The arm’s length principle stipulates that transactions priced among related parties should be in conformity with prices that would be charged between unrelated parties. The volume of transactions among related parties in international trade is substantial. The share of intra-firm transaction in trade increases as country’s trade grows and the pattern of trade is transformed through development. Finally, there should be consistency in the tax treatment of all similar transactions among affiliates of transnational corporations and independent firms. Thus, the authorities should have a well-defined, clearly articulated, consistent and coherent transfer pricing policy. It is hoped that the issues discussed in this paper will be useful to the authorities in setting a prudential transfer pricing regime in Bangladesh and will provide the basis for practical policy recommendations that can be implemented.

There is a substantial scholarly literature on the size, the scope, the growth and the structure of transnational corporations’ intra-corporate international trade (Bounturi and Fukasaku 1993; Clausing 2000; Eden 1998; Encarnation 1993; Hipple 1990a and 1990b; Rangan 2000). National authorities, particularly in the United States and OECD countries, have also provided quantitative measures of intra-corporate international trade (Covari and Wisner 1993; Mataloni 1997; UNCTAD 1999; Whicard and Lowe 1995; 1998; and Zeilie 1997). Industry and consulting groups and professional service firms
have also studied different aspects of intra-corporate international trade (Ernst and Young 1999; Krajewski 1992). However, at present the authorities in Bangladesh do not have an articulated transfer pricing policy. Issues related to transfer pricing in Bangladesh have not been rigorously studied. This paper attempts to initiate the task of filling this critical lacuna by outlining the basis for a prudential transfer pricing policy.

The paper is structured as follows. Section I explains transfer pricing and the arm’s length principle. Section II provides a simple model that illustrates the role of transfer pricing in intra-firm international trade of the transnational corporation. Section III examines some simple empirics of (a) global intra-corporate trade and transfer pricing; and (b) transnational corporations presence and the tax regime in Bangladesh. Section IV covers the arm’s length principle, the basic foundation for prudential transfer pricing regime. Section IV furnishes the principal methods of transfer pricing. Section V presents some of the challenging issues in transfer pricing policy for Bangladesh. Section VI identifies further research topics on transfer pricing in Bangladesh. Section VII concludes.

**Section I: Transfer Pricing and the Arm’s Length Principle**

Transfer pricing sets the prices at which the transnational corporate group trades goods and services among its affiliates. Transfer price is the price that the transnational corporation chooses for the valuation of goods, services, know-how, and intellectual property exchanged among different divisions or affiliates under its ownership or control. *Inter-divisional transfer pricing* involves transactions among divisions within the transnational corporations in the same tax jurisdiction. *Intra-corporate transfer pricing* involves transactions among affiliates that are based across national borders and located in different tax jurisdictions. Transfer prices may exist among corporate affiliates irrespective of the spatial location of the firm. However, the problem of transfer pricing acquires a public policy dimension with tax consequences when the transnational firm has affiliates located in different countries or different tax jurisdictions within the same country.

Transfer pricing provides opportunities for lucrative profit-shifting activities. The simple example given in Table 1 below illustrates how the transnational corporation can secure higher after-tax profit through transfer pricing due to differences in corporate tax rates in different jurisdictions. Here a vertically integrated transnational corporation’s parent is domiciled in a high-tax country (20 percent). It has a foreign affiliate in a low-tax country (10 percent). In **case 1**, a component is produced by the affiliate at a cost of $800 and is sold to the parent company at the transfer price of $1,100, which is part of the parent company’s cost of goods sold. The parent incurs an additional cost of $600 to transform the good that is sold at $4,000. Tax liabilities of the transnational corporation are calculated using the before-tax incomes of the parent company and its affiliate. The resulting tax liability is $1,130. In **case 2**, the component produced by the affiliate is sold to the transfer company at the transfer price of $1,400 instead of $1,100. The parent incurs the same additional cost to transfer the good that is also sold at the same price as in **case 1**. While there is no effect on total revenue, costs, and pre-tax income of the
transnational corporation, there is a net reduction of $30 of its overall tax liability, resulting in a $30 increase in its after-tax profit in case 2. Whereas in case 1 the transnational corporation pays 19 percent tax on its pre-tax income, in case 2 it pays 17 percent tax on its pre-tax income. These cases demonstrate how the transnational corporation can increase its profit by shifting income from high-tax to low-tax countries through transfer pricing if the corporation is able to arbitrarily set its transfer prices.

[Insert Table 1 here]

The tax authorities of major advanced countries and key emerging markets are well aware of the ability of the transnational corporation to shift profit through transfer pricing. Transfer prices and transfer pricing methodologies deployed by the transnational corporation affect the amount of revenue, cost, and profit reported in host countries. This in turn affects the tax revenues of the concerned countries. The tax authorities in various countries have recognized the revenue leakage and have established transfer pricing regulations to mitigate it. Hence the authorities may insist that the corporation sets transfer prices for inter-affiliate exchanges of goods and services appropriately in accordance with suitable methods to deter profit-shifting activities and evasion of tax liabilities.

Both tangibles and intangibles are important parts of inter-group transactions. Tangibles are any goods, either finished products or intermediate inputs, such as raw materials or components. Tangibles are frequently transferred among affiliates of the transnational corporation. Intangibles are an important component of inter-affiliate transactions of the transnational corporation. Intangible property includes a wide range of categories, such as: (i) patents, inventions, formulas, processes, designs, and patterns; (ii) copyrights, and literary, musical, or artistic compositions; (iii) trademarks, trade names, and brand names; (iv) franchises, licenses, and contracts; (v) methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, and technical data; and (v) other intellectual properties.

Different types of flows characterize inter-group transactions among the affiliates of the transnational corporation. The flow of tangible goods includes raw materials, intermediate goods and components, and finished goods. The flow of intangible property includes a wide range of intangibles. The flow of services covers a variety of intra-corporate services, such as transport and travel services, construction services, accounting and legal services, shareholder services, technical assistance with the transfer of intangibles, stand alone technical assistance, and so on. The flow of capital occurs in the modes of equity capital, reinvestment earnings, equity securities, debt securities, bonds and notes, money market instruments, financial derivatives, loans, trade credits, currency and deposits, and other forms of capital and investment. These flows are often contributions to the capital stock, long-term lending and short-term lending. The flow of income payments comes in various forms, such as compensation for employees; charges and profit repatriations for direct investment, portfolio investment and other investments; and payments for royalties and fees.
**Arm’s Length Principle**

The arm’s length principle provides the foundation for transfer pricing policy. Controlled transaction is a transaction between related parties, whereas uncontrolled transaction is either between two unrelated parties or between a related party and unrelated party. Transactions for same or similar goods and services between unrelated parties or between related and unrelated parties are used to determine the “arm’s length” price for a transaction among related parties.

The arm’s length principle is the only internationally accepted basis for transfer pricing methods. According to OECD (2001): “[When] conditions are made or imposed between the two enterprises in their commercial or financial relationships which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and tax accordingly.” When unrelated enterprises deal with each other, open market conditions generally determine the commercial and financial relationships and dealings. The objective of transfer pricing methodology is to determine the prices at which goods and intangibles are exchanged among affiliates within a transnational corporate group. According to OECD (1979, 1984, 1987, and 2001) guidelines, transfer pricing must be based on the arm’s length principle which states that exchanges among related parties should be set by reference to conditions which would have obtained between independent enterprises in comparable transactions and comparable circumstances. The arm’s length principle treats the affiliates of the transnational corporate group as if they were independent enterprises. Suppose company A and company B both belong to the same transnational corporate group. Company A sells an intermediate good to company B. Hence, under the arm’s length principle, company A should charge company B what it should have charged if it were an independent enterprise not connected in any way with company A.

**Section II: A Simple Model of Intra-Firm Trade**

A simple model is constructed below to illustrate the importance of transfer pricing in intra-firm trade. The model compares the cross-border trade between two unrelated parties and two related parties of a transnational corporation. This will enable one to compare the pricing decisions for cross-border trade.

**Arm’s length trade between unrelated parties**

Suppose there are two unrelated firms: a northern firm \( N \) and a southern firm \( S \). The northern firm \( N \) sends an intermediate good to the southern firm \( S \) for sale. Let \( Q_i \) be the domestic output, \( Y_i \) domestic sales, \( R_i(Y_i) \) total revenue from \( Y_i \) and \( C_i(Q_i) \) total cost of \( Q_i \), where \( i = N, S \). Let \( X \) be the volume of trade and \( p \) the price of \( X \). Hence, the value of trade between the firms is \( pX \). One unit of \( X \) makes one unit of \( Q_s = Y_s = X \). Suppose the \( i \) th firm’s transaction cost of international business is \( \alpha_iX \) for each firm and that other forms of transaction costs may be ignored.
The profit functions of the two firms are as follows:

\[ \Pi_N = R_N(Y_N) + (p - \alpha_N)X - C_N(Q_N) \]
\[ \Pi_S = R_S(Y_S) - C_S(Q_S) - (p + \alpha_S)X = R_s(X) - C_s(X) - (p + \alpha_S)X \]

The first order conditions are as follows:

\[ \frac{\partial \Pi_N}{\partial X} = (p - \alpha_N) - MC_N = 0 \]
\[ \frac{\partial \Pi_N}{\partial Y} = MR_N - MC_N = 0 \]
\[ \frac{\partial \Pi_S}{\partial X} = MR_S - MC_S - (p + \alpha_S) = 0 \]

Hence, the following two conditions hold:

\[ p - \alpha_N = MR_N = MC_N \]
\[ p + \alpha_S = MR_S - MC_S = NMR_S \]

Combining the equal conditions above yields:

\[ p = MC_N + \alpha_N = NMR_S - \alpha_S \]

Hence, the equilibrium arm’s length price is such that the marginal cost of the exporter (northern firm) is equal to the net marginal revenue from imports (southern firm).

Two unrelated firms, both faced with the transitional costs of cross-border trade, will arrive at an arm’s length price \( p_0 \) (or \( p_0' \)) with the volume of trade \( X_0 \) (or \( X_0' \)), as shown in Figure [1]. The parent firm’s return is \( p_0 - \alpha_N \) (or \( p_0' - \alpha_N \ )); and the affiliate’s cost is \( p_0 + \alpha_S \) (or \( p_0' + \alpha_S \ )).

**Intra-firm trade between related parties**

Suppose that northern affiliate \( N \) and the southern affiliate \( S \) are related parties of a transnational corporation \( \Psi \). Hence \( X \) is the volume of intra-firm trade between the related parities of \( \Psi \). Suppose the transfer price is \( p \). Since the firms are related parties, the transaction costs are less than those incurred by unrelated parties. Without loss of generality, we assume that the transaction costs are zero. The profit function for the transnational corporation is as follows:

\[ \Pi_\Psi = \left[ R_N(Y_N) + pX - C_N(Q_N) \right] + \left[ R_S(X) - C_S(X) - pX \right] \]

The transnational corporation’s profit function is composed of the northern firm’s profit function and the southern firm’s profit function.
The transnational corporation $\Psi$ optimizes the joint profits of both the northern affiliate and the southern affiliate. The first order conditions of maximization are as follows:

$$\frac{\partial \Pi}{\partial Y} = MR_N - MC_N = 0$$
$$\frac{\partial \Pi}{\partial X} = -MC_N + MR_S - MC_S = 0$$

The first order conditions yield the following two conditions:

$$MR_N = MC_N$$
$$NMR_S = MC_N$$

These conditions can be combined as follows:

$$MR_N = MC_N = NMR_S = \kappa$$

Here $\kappa$ is the marginal cost of the northern affiliate. The nominal transfer price $p$ disappears when transnational corporation’s joint profits are optimized. The efficient transfer price is based on the shadow price of intra-corporate trade. The above condition can be expressed as follows:

$$MC_N = NMR_S = \kappa$$

The above condition states that the marginal cost of the northern affiliate (exporter) should equal the net marginal revenue earned by the southern affiliate (importer) from intra-firm trade. The efficient transfer price $\kappa = MC_N = \kappa$, that is, the marginal cost.

The open market price at which the unrelated firms trade may differ from the price at which the transnational corporation’s affiliates trade. The price $p_0$ used by the unrelated parties to trade between themselves is the arm’s length price. However, this price may differ from the efficient price $\psi$, that a profit-maximizing transnational corporation’s affiliates may use. The arm’s length open market price may be greater than, less than or equal to the efficient price used by the transnational corporation. Even though the open market price may differ from the efficient price depending upon the circumstance, the open market volume of trade is between unrelated parties is lower than the trade between related parties.

The volume of trade between affiliates under transnational corporation is greater than the volume of trade between unrelated parties, $X_\psi > X_0$ because of the transaction costs of trade of the unrelated parities. Figure [1] illustrates the above points. In Figure [1], the volume of trade among related parties is always greater than the volume of trade among unrelated parties; that is, $X_\psi > X_0$ and $X_\psi > X'_0$. However, the open market price can be may be higher than or equal to the transnational corporation’s efficient price as in $p'_0 \geq \psi$, or it may be lower than the efficient price as in $p'_0 < \psi$, depending on the transactions costs of trade of the unrelated parties.

If among the unrelated parties there is no transaction costs, that is if $\alpha_N = \alpha_S = 0$, then $p = \psi$ and $X = X_\psi$. 

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Hirshleifer (1956, 1957) has shown that in the absence of interdependencies of demand and supply between the related parties, the transnational corporation will choose to buy or sell at the external market price.

Let $Z$ be the amount that the parent firm can sell in the open market at price $p^*$. Let $Q = Y_N + Z + X$. Hence the transnational corporation’s profit function is as follows:

$$\Pi_p = \left[R_N(Y_N) + p^*Z + pX - C_N(Q_N)\right] + \left[R_S(X) - C_S(X) - pX\right]$$

The first order conditions:

$$\frac{\partial \Pi}{\partial Y} = MR_N - MC_N = 0$$

$$\frac{\partial \Pi}{\partial X} = -MC_N + MR_S - MC_S = 0$$

$$\frac{\partial \Pi}{\partial Z} = p^* - MC_S = 0$$

The first order conditions yield:

$$MR_N = MC_N$$

$$NMR_S = MC_N$$

$$MC_N = p^*$$

Hence, $MC_N = NMR_S = p^* = \kappa$.

Hence valuing intra-firm trade at external market price is efficient and profit-maximizing for the transnational corporation. Figure [2] shows this. If the affiliates of the transnational corporation only traded among themselves, it would do so at the efficient price $p_\psi$ and the volume of trade would be $X_\psi$. However, as shown as in Figure [2], when the transnational corporation trades at external market price $p^* > p$, that is it is higher than the internal price, the northern affiliate will produce $X^* + Z > X_\psi$ amount of the good of which $X^* < X_\psi$ be exported to the southern affiliate while $Z > 0$ will be sold to unrelated parties in the external market.

Section III: Some Simple TNC and Tax Empirics

Intra-firm trade is an important part of global trade. According to some estimates, around one-third of world trade is in the form of intra-firm trade. In order to understand the empirics of global intra-firm trade, it would be useful to consider related party trade for the United States, the world’s most advanced economy. Related party trade includes both US companies trading with their overseas affiliates and US subsidiaries of foreign companies trading with their foreign parents. In 2001, related party trade accounted for
US$526 billion of imports or 47 percent of US total annual value of imports and US$223 billion of exports or 32 percent of total annual value of exports.

Examining US data on intra-firm trade reveals some patterns in intra-corporate trade. The share of related party trade in total US merchandise trade varies enormously by commodity and differs substantially between exports and imports (US Census 2001 and 2000). The 2001 intra-firm trade shares of the top five US imports for consumption by value under three-digit NAICS (North American Industrial Classification System) code are: transport equipment (74.3 percent), computer and electronic products (66.8 percent), chemicals (50.1 percent), machinery (except electronics) (50.1 percent), and electrical equipment and appliance (48.7 percent). The 2001 intra-firm trade shares of the top five US exports by value under by three digit NAICS (North American Industrial Classification System) code are: plastics and rubber products (38.5 percent), chemicals (38.4 percent), computer and electronic products (37.7 percent), transport equipment (36.5 percent), and re-exports (34.9 percent). Most US intra-firm trade is from US parents to their foreign subsidiaries, not from US affiliates to their foreign parent firms. Most US intra-firm imports are from foreign parents to their US affiliates. The direction of intra-firm trade is primarily shipments from parents to their affiliates (Whichard and Lowe 1998; Zeile 1997).

Antras’ (2002) data on US trade by related parties shows interesting patterns in related party trade. These data are obtained from the US Census Bureau. The data on trade is decomposed into related party and unrelated party trade. Data on intra-firm imports by industry is based on combined data from majority-owned foreign affiliates of US firms and US affiliates of foreign firms. Intra-firm imports consist of (a) imports shipped by overseas affiliates to their US parents by industry of the affiliate and (b) imports shipped to US affiliates by their foreign parents by industry of the affiliate. Two key results emerge from Antras’ (2002) study. Firstly, the share of intra-firm imports to the US tends to be higher for countries with a high capital to labor ratio. See Figure [3]. Secondly, the share of intra-firm imports to the US tends to be higher in capital-intensive sectors. See Figure [4]. These findings suggest that the intra-corporate transactions increase as a share of trade for capital-abundant countries and that intra-corporate trade dominates over unrelated parties’ cross-border trade in capital-intensive sectors. Transnational corporate activities are more concentrated in capital-abundant countries and capital-intensive sectors.

A brief review of foreign direct investment in Bangladesh as compared to neighboring South Asian and other Asian countries would render better an empirical understanding of transnational corporate presence in Bangladesh. Table 2 shows that the number of foreign affiliates located in Bangladesh as compared to other Asian is fairly low; even Myanmar, Vietnam, and Sri Lanka host more foreign affiliates than Bangladesh. At present there are over 60 major transnational corporations already operating in Bangladesh. Table 3 provides the evolution of FDI inflow by host countries during 1989-
Since 1997, inflow of FDI to Bangladesh increased. In spite of the rise of FDI inflows to Bangladesh, it remains lower than most Asian countries except Laos, Maldives, and Nepal. Table 4 shows that the evolution of the stock of inward FDI in Asia countries. Bangladesh’s stock of inward FDI remains quite low. As of 2000, Sri Lanka had nearly three times and Pakistan twelve times the stock of FDI in Bangladesh. Table 5 furnishes the evolution of FDI inflows as a percentage of gross fixed capital by economy from 1989 to 1999. Here again Bangladesh has one of the lowest FDI inflows as share of gross fixed capital among the Asian countries. Table 6 provides the evolution of inward FDI stock as percentage of GDP. As of 1999 Bangladesh had the lowest inward FDI stock as a percentage of GDP among Asian countries except Bhutan. UNCTAD (2001) has constructed an index of inward FDI flows. It is based on three variables: the ratio of the economy’s share of world FDI inflow to the economy share of world GDP; the ratio of the economy’s share of world FDI inflow to the economy’s share of world employment; and the ratio of the economy’s share of world FDI inflow to the economy’s share of world exports. Table 7 and Table 8 show the FDI Index score for selected Asian countries respectively from 1988 to 1990 and from 1998 to 2000. In both time periods, Bangladesh scores inadequately. These tables reveal that the country is yet to attract substantial FDI inflow and that the presence of transactional corporations in the country is low compared to most Asian countries. In order to attract more foreign direct investment, Bangladesh has adopted one of the most liberal FDI regimes in South Asia. As shown in Table 9, the authorities have identified several thrust sectors, while reserving only a few sectors as off-limits to FDI and discouraging FDI in ready-made garments and financial sectors.

The number of transnational corporations operating in Bangladesh is likely to increase in the near future, particularly if the country is able to commercially exploit its natural resources, become an export platform, and take advantage of its comparative advantages. Transnational corporations operate in many different sectors in Bangladesh, including finance and banking; services and information technology; infrastructure (power and telecom); chemicals, pharmaceuticals, and paints; manufacturing; gas; construction; agro-industry; food, beverage and various consumer goods. Data obtained from UNCTAD (2000) based on the transnational corporations listed in Bangladesh’s Federation of International Chamber of Commerce and Industry furnishes useful information about the industry sectors and the regional origins of transnational corporations operating in the country. Figure [5] provides a breakdown of the major transnational corporations operating in Bangladesh by sectors. By number of corporations, foreign direct investment is highest in manufacturing (33 percent); then in finance and banking (18
percent); chemicals, paints, and plants (18 percent); infrastructure (10 percent); food and beverage (8 percent); and others (13 percent). Figure [6] provides the breakdown of major transnational corporations operating in Bangladesh by the key regions of the world. Transnational corporations from all regions of the world operate in Bangladesh. However, most transnational corporations in the country originate primarily from Europe (45 percent), North America (23 percent), and East Asia (16 percent).

Intra-firm transactions and trade will matter for Bangladesh. As a country’s economy develops, accumulates more capital and obtains more sophisticated technology, intra-firm trade and investment becomes important. Bangladesh is trying to attract more foreign direct investment, increase its exports and particularly develop its energy and infrastructure sectors. With more foreign direct investment in energy and infrastructure sectors, the level of intra-firm transactions is bound to rise. Transnational corporations’ economic activity can benefit developing countries by providing technology, capital, management, skills, proprietary know-how, access to global markets, and international best practices if the host country’s policy framework is prudential. It is widely recognized that transnational corporations’ foreign direct investment and know-how played a valuable role in the diffusion of managerial and marketing skills and know how for the ready-made garment textile industry in Bangladesh (Rhee (1990); Rashid and Quddus (2000); and Mahmood (2002)). Even though transnational corporations have a lot of beneficial effects on the economy, the effects of their activities are not solely benign. It is possible that transnational corporations can have harmful effects on the economy if they are able to engage in profit-shifting activities and unfair competition with indigenous firms. Transfer pricing offers lucrative avenues for profit-shifting activities and tax avoidance. In a corrupt business and bureaucratic environment, a transnational corporation’s scope of engaging in profit-shifting activities and malfeasance is magnified.

The tax base in Bangladesh is narrow. Tax revenue in Bangladesh mainly comes from indirect tax, such as VAT and customs duty. Table 10 gives a brief overview of the Bangladesh’s tax regime. Table 11 gives a more detailed description of the tax rates in Bangladesh by different categories. Table 12 compares Bangladesh’s tax rate with selected South Asian countries.

Given the already existing presence of transnational corporations and the likelihood of increased foreign investment in the country, Bangladesh needs to have a prudential transfer pricing policy to secure tax revenue and extend its tax base. The authorities shall need to formulate, legislate and enforce transfer pricing regulations. Transfer pricing regulations are required for several reasons. Firstly, it will support the national
exchequer’s efforts to mobilize adequate revenue. Secondly, it will help to ensure that foreign direct investment and transnational corporate presence in the country are not used as guises for profit-shifting activities and tax-fencing transactions. Thirdly it will assure that local investors, joint venture partners, interlinked suppliers and customers receive fair treatment vis-à-vis transnational corporations.

In setting prudential transfer pricing policy and regulations, Bangladesh tax authorities can take a cue from the recent introduction of transfer pricing policy in India. The Indian tax authorities have promulgated detail transfer pricing regulations and documentation requirements under Section 92 of the Income Tax Act effective from April 1, 2001. The Indian authorities have specified several requirements on all related parties transactions. All cross-border transactions with related parties should be conducted at arm’s length. Arm’s length price should be determined by apply the most appropriate method. The taxpayer should maintain detailed documentation including a transfer pricing report on a contemporaneous basis. These documents must be reviewed and authenticated by a chartered accountant. The taxpayer is required to provide the authorities with documents and information within 30 days of the notice of assessment. Non-compliance with documentation requirements will authorize the authorities to determine the arm’s length price on the basis of information and documentation available. The authorities can impose stringent penalties for non-compliance with the procedural requirements and for understatement of profits.

**Section IV: Transfer Pricing Methods**

There are several different types of methods for establishing transfer prices. These can be classified into three categories as follows: (a) Transactional methods; (b) Transactional profit methods; and (c) Unconventional methods. The different categories of the methods of transfer pricing are described below.

**Transactional Methods**

Transactional methods are the most direct and effective means of establishing transfer price based on the arm’s length principle. Transaction based methods are the preferred methods of establishing transfer pricing. Three transactional methods are used for transfer pricing. These are described below.

**Comparable uncontrolled price method:** This method compares the price for the good or the intangible property transferred in a controlled transaction to the price charged for a good or an intangible property transferred in comparable uncontrolled transactions in a similar situation. The comparison verifies that the price for the good or intangible property transferred between affiliates is the same as would be charged if the product would have been sold in an arm’s length transaction. This method is appropriate when products are similar and when such unrelated transactions can be found. If, however, there are material differences for which adjustments cannot be made, this method is inappropriate and inapplicable. Problems with this method arise because often products are different in terms of designs and features, and many intermediate products are not traded in the open market.
**Resale price method:** This method uses the price at which a product that has been purchased from an affiliate is resold to an unrelated party. The resale price is reduced by the resale gross margin. What is left after subtracting the resale price margin after adjusting for other costs associated with the purchase of the product is an arm’s length price. Potential comparables are obtained from gross margins earned by unrelated parties, gross margins earned by the related party on transactions with unrelated buyers or re-sellers, and discounts provided by the related buyer or seller to unrelated buyers or re-sellers. In order for the resale price method to be applicable there should be a substantial product-market and functional comparability in volume, terms of payment, contractual obligations, industry and market conditions, risks assumed, and so forth.

**Cost-plus method:** This method uses the cost incurred by the affiliate in a controlled transaction between the transnational corporation’s entities. An arm’s length price is arrived at by allowing an appropriate cost-up to be added to this cost. An appropriate surplus should be chosen in view of the functions performed and the market conditions. The cost-markup should be based on comparing it with those of similar unrelated parties. For this method to be valid, substantial product-market and functional comparability are required.

**Transactional Profit Methods**

Though transaction based methods are the preferable means of obtaining transfer prices for intra-firm transactions, there are often practical difficulties in applying transaction methods. When no data are available, or available data are insufficient or of questionable quality, it may be necessary to resort to transactional profit methods. Transactional profit methods examine the profit that arises from particular controlled transactions. Profit arising from controlled transactions can be an indicator of whether the transaction was affected by conditions that differ from those that would have been made by unrelated parties in otherwise comparable circumstances. The application of the transactional profit methods can provide an approximation of transfer pricing in a manner consistent with the arm’s length principle. There are three transactional profit methods used for transfer pricing. These are described below.

**Profit-split method:** This method splits the combined profit from a controlled transaction among the concerned affiliates of the transnational corporation. The combined profit is split or allocated among the concerned entities based on an economically valid basis that approximates the division of profit that would have been anticipated and reflected in an arm’s length transaction with an independent customer.

**Transactional net margin method:** This method examines the net profit margin relative to an appropriate base (such as costs, sales, and assets) that the transnational corporation realized from a controlled transaction with its affiliates. The transactional net margin method should be applied in the same manner as the resale price or cost-plus method.

**Comparable profit method:** The comparable profit method determines an arm’s length result using the amount of operating profit that the tested party would have earned on
related party transactions with other affiliates of the transnational corporation, if its profit level indicator were equal to that of an uncontrolled comparable transaction. Hence, the comparable operating profit of the affiliate would approximate what it would have earned in a transaction with an unrelated party.

**Unconventional methods**
The authorities often resort to unconventional methods for transfer pricing when other methods are not applicable. There are two unconventional techniques used for transfer pricing that are worth mentioning. These are as follows: (a) advanced pricing agreement and (b) global formulary apportionment method.

**Advanced Pricing Agreement:** Advanced pricing agreement is an arrangement that determines, prior to a transaction among related parties, appropriate criteria for the determination of the transfer prices for those transactions over a fixed period of time. Advance pricing agreement can be unilateral, bilateral, or multilateral. These agreements are initiated by a transnational corporation and require negotiations between the taxpayers, that is, the affiliates involved, and the tax authorities concerned. These agreements supplement conventional mechanisms for resolving transfer pricing issues, and are often useful when conventional methods are difficult to apply. Such agreements have numerous advantages, such as the elimination of uncertainty in tax treatment of cross-border transactions, the creation of non-adversarial relations between the taxpayer and the authorities, the reduction of costs, and so on.

**Global Formulary Apportionment Method:** Global formulary apportionment method is a method to allocate the global profits of the transnational corporation on a consolidated basis among its associated affiliates in different countries on the basis of a predetermined formula. There are three essential components to the application of this method: determining the unit to be taxed; accurately determining the global profits; and establishing the formula to be used to allocate the global profits of the unit. The formula is based on costs, assets, payroll, sales, or some combination of these. Formulary apportionment is not based on the arm’s length principle. There are many complex and practical problems that prevent it from developing a complete solution to the allocation of profits in a transnational corporate group. OECD (2000) explicitly rejects global formulary apportionment as a method for determining the proper level of profits across national tax jurisdictions.

**Section V: Challenges in Transfer Pricing Issues**

There are many challenging and complex issues in transfer pricing analysis. Transfer pricing analysis is a multi-step process. Transfer pricing process starts with the selection of the appropriate method. Once a method is selected, comparables have to be chosen. The selected comparables need to be analyzed. This is followed by analysis of the tested party. Finally, applying the method to the tested party allows one to determine appropriate transfer prices. Transfer pricing regulations overlap with various tax issues. Both corporate tax policy and double taxation treaties affect the countries’ transfer pricing regulations. In assessing the appropriate transfer prices of goods and services
exchanged among affiliates the authorities need to undertake function analysis. Functional analysis is a method of finding and organizing facts about a corporation in terms of its functions, risks and intangibles, in order to identify how these are allocated among the affiliates involved in the transaction under review.

Bangladesh’s transfer pricing regulations should be appropriate to the conditions of the country. Transactional methods should always be the preferred means for determining transfer pricing for tax assessment. However, when such methods cannot be used and suitable comparisons cannot be obtained the authorities may use transactional profit methods. There can also be provisions for the use of advanced pricing agreements. In rare cases the authorities may resort to global formulary apportionment even though this is at discord with the arm’s length principle.

The depth of documentation required for transfer pricing should be moderate. However all documentation should be contemporaneous and detailed. The transnational corporation should be required to maintain appropriate documents and be prepared to authenticate and file such documentation for examination and audit by the authorities. The authorities should require the transnational corporations to make reasonable efforts to determine the transfer pricing in accordance with the arm’s length principle. The authorities should have the right to obtain the documentation from the corporation to verify compliance with the arm’s length principle. The burden of proof should fall on the taxpayer, not on the authorities. The authorities should impose high penalties for underpayment and non-compliance. Both the transnational corporation and the authorities should be responsible for transparency in all decisions concerning the determination of transfer prices for taxation. Transparency of process will help ensure credibility.

The authorities need to develop their capability for developing and implementing transfer price regulations. Multi-disciplinary capability is essential for the evaluation of transfer pricing. Knowledge of economics of industry, accounting, auditing, finance, law, management and marketing is required for assessing transfer pricing. The authorities would need to strengthen tax administration’s technical, surveillance, and database capabilities. Authorities would need qualified, trained, and skilled staff for designing, implementing, enforcing, and evaluating transfer price regulations. Adequate resources would be required to design, implement, enforce, and evaluate transfer pricing. The authorities need to establish various administrative procedures to minimize transfer pricing disputes and ensure transfer pricing compliance.

Customs valuation provides a useful consistency check for the validity of transfer pricing values. Taxpayers have diametrically opposite incentives in setting values for customs and corporate tax purposes. In general, a taxpayer importing goods is interested in setting low prices to them for customs purposes, so that the customs duty imposed will be low. For tax purposes, however, the taxpayer may report a higher price paid for those goods in order to increase deductible costs. Given these incentives, the customs authorities would be primarily concerned with under-invoicing whereas the tax authorities would be mainly concerned about over-invoicing.
The transfer pricing value and the customs value of a good can be compared. The difference between transfer pricing value and customs value of a good will generally have an economic explanation. If there is systematic deviation of a transfer price and a customs value and no adequate explanation can be found, then it would convey a cautionary signal to the authorities that such cases may warrant an audit or an investigation. The existence of large outliers may be subject to investigation for possible tax avoidance or evasion. The size and the direction of the over- and underreporting of intra-firm transactions would be of interest. Econometric testing of deviations of customs value and transfer price may be useful. By obtaining information from customs authority, tax authorities can check whether the difference in the declared values are justified and do not represent an attempt to evade either income taxes or customs duties.

Customs valuation procedure and administration are likely to be more robust than the transfer pricing regime in developing and emerging market economies. Hence, it may be useful to rely on customs valuation for transfer pricing assessment, with appropriate adjustments as required. While transfer pricing and customs valuation are likely to be different between firms and across products, customs assessment is based on transaction values and on methods that are similar to that of transfer pricing. Hence, if the transfer pricing capabilities are not well developed, the authorities may be able to use customs assessment values. Given the competing incentives of under-invoicing for customs purpose but over-invoicing for transfer pricing, the tax authorities may use customs assessment valuation as a starting point for transfer pricing valuation. When alternative measures for comparable prices paid or payable for imports and received or receivable for imports are readily available such approximation may well suffice. Although there are substantial differences between the two, the similarities allow for the use of customs valuation in transfer pricing with proper adjustments as a first approximation, particularly in jurisdictions where the authorities’ transfer pricing assessment capabilities may be limited.

The authorities in Bangladesh should engage in information exchange with competent authorities abroad. Such information exchange will enable the authorities in assessing the tax liabilities of transnational corporations. The national authorities should enter into treaties with other countries to prevent double taxation and treaty shopping. Bangladesh already has bilateral investment treaties with 20 countries. There are double taxation treaties with 20 countries. The authorities will need to expand the number of bilateral treaties with more countries. The authorities should take advantage of cooperation and technical assistance provisions. The authorities should consider setting simultaneous examination agreements with foreign authorities.

**Section VI: Further Research Topics**

Transfer pricing in Bangladesh is an issue of policy-relevant research. It touches on two key areas of research: (a) research on multinational corporations, and (b) research on tax issues and fiscal administration. Research on both these areas has been rather limited despite their importance to the growth and the development of the national economy.
There are many research areas on taxation, such as direct taxation, indirect taxation, local taxation, tax administration, tax evasion and tax avoidance, corruption and transparency. There are also many areas of research on transnational corporations in Bangladesh. Research on transnational corporations in Bangladesh should focus on their conduct, practice, structure, performance; pattern of direct investment; motivation and modality; financing, fund transfer, and cost of capital; incentives; transfer of technology; and employment. The research on transfer pricing should draw on the research and knowledge of both tax issues and transnational corporations in Bangladesh. Some of the topics of research on transfer pricing would pertain to the following issues: the magnitude of intra-firm transfers; the extent of usage of transfer pricing; transfer pricing methods used in practice; the influence of the company’s size, sectors, and national origins on the orientation of transfer pricing; environmental variables of transfer pricing; regulation and administration of regulations; and policy formulation, implementation, enforcement, and revisions.

Section VII: Conclusion

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 increase its attractiveness as a destination for transnational corporations, the authorities will have to face the practical issues of determining the income and expenses of firms that are subsidiaries of transnational corporate groups. The national tax authorities should be concerned with the possible erosion of the national tax base and adverse effect on local firms if transnational corporations have undue advantage due to profit-shifting activities through transfer pricing. Establishing and implementing a prudential transfer pricing policy would enable the authorities to reconcile the legitimate right to tax the profits of the transnational corporation based on the income arising from operating within the territory, with the need to avoid the taxation of the same item of income by more than one tax jurisdiction and to deter detrimental profit-shifting activities.

References


