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# TRANSFER PRICING AND ITS METHODS

## Abstract

The transfer pricing is the price determined during transactions between related parties and should be consistent with the prices determined in comparable transactions between independent parties under the same conditions. Transfer pricing applies to controlled transactions. Controlled transactions are transactions between related parties. The price applied in controlled transactions should be consistent with the price applied in transactions between unrelated independent parties under the same circumstances. If the prices of goods, works, or services provided or received within controlled transactions do not align with the prices of comparable non-controlled transactions, the tax authority will recalculate the tax for that transaction based on the transfer prices.The "arm's length" principle is the basis of the application of the transfer price. According to the "arm's length" principle, transactions between related parties must reflect terms of transactions between independent parties.

5 methods are used to apply the transfer price. 1) comparable uncontrolled price method; 2) resale price method; 3) the cost plus; 4) transactional net margin method; 5) the profit-split method.

In the article, the concept of transfer pricing, rules of application, arm's length principle, and methods of transfer pricing application are thoroughly examined.

***Keywords:*** *transfer pricing, arm's length principle, multinational enterprises, related parties, controlled transactions*

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# Transfer qiyməti və onun metodları

## Xülasə

Transfer qiyməti əlaqəli şəxslər arasında aparılan əməliyyatlar zamanı müəyyən edilən və müstəqil şəxslər arasında eyni şərtlər daxilində həyata keçirilən müqayisə edilə bilən əməliyyatlarda təsbit olunan qiymətlərə uyğun olmalı qiymətdir. Transfer qiyməti nəzarət olunan əməliyyatlara tətbiq olunur. Nəzarət olunan əməliyyatlar əlaqəli şəxslər arasında aparılan əməliyyatlardır. Nəzarət olunan əməliyyatlar zamanı tətbiq olunan qiymət eyni şəraitdə əlaqəli olmayan müstəqil tərəflər arasında aparılan əməliyyatlar zamanı tətbiq olunan qiymətə uyğun olmalıdır. Nəzarət olunan əməliyyatlar çərçivəsində təqdim edilən və ya alınan malların (işlərin, xidmətlərin) qiymətləri müqayisə edilən nəzarət olunmayan əməliyyatlar üzrə qiymətlərə uyğun olmadığı halda, vergi ödəyicisi və vergi orqanı həmin əməliyyatdan vergini transfer qiymətləri əsas götürülməklə yenidən hesablayır. Transfer qiymətinin tətbiq olunmasının əsasında “qol uzunluğu” prinsipi dayanır. “Qol uzunluğu” prinsipinə görə qarşılıqlı şəkildə əlaqəli olan tərəflər arasındakı əqdlərin şərtləri bir-birindən asılı olmayan tərəflərin arasındakı eyni əqdlərin müvafiq şərtlərinə uyğun olmalıdır.

Transfer qiymətinin tətbiq olunmasında 5 metoddan istifadə olunur: 1) qiymətlərin müqayisəsi üsulu; 2) sonrakı (təkrar) satış qiyməti üsulu; 3) dəyərin toplanması üsulu; 4) rentabellilik üsulu; 5) mənfəətin bölgüsü üsulu.

Məqalədə transfer qiymətinin anlayışı, tətbiqi qaydaları, qol uzunluğu prinsipi və transfer qiymətinin tətbiqi metodları araşdırılmışdır.

***Açar sözlər:*** *transfer qiyməti, qol uzunluğu prinsipi, çoxmillətli müəssisələr, əlaqəli tərəflər, nəzarət olunan əməliyyatlar*

## Introduction

When two unrelated companies engage in a business transaction, the prices and conditions of their deal are generally determined by market forces. This implies that external factors like supply and demand, competition, and other market influences play a significant role in determining the price of goods and services. When companies within the same multinational group conduct transactions with each other, normal market forces may not apply in the same way as they do in regular transactions. Therefore, these companies need to try and create a simulated market environment to determine fair prices for their internal transactions. This is necessary to ensure that the prices reflect what would have been agreed upon if the companies involved were independent of each other, by the arm's length principle. Although transfer pricing policies can be abused for tax avoidance or evasion, it is important to note that the process of examining these policies is different from investigating tax fraud. The primary objective is to ensure that the pricing between associated entities is reasonable and consistent with what would be expected between unrelated parties in an open market, guaranteeing a fair playing field for tax purposes (1).

When companies belonging to the same group trade with each other, they set prices for these transactions (known as transfer pricing). However, if these prices do not match what independent companies would charge in the open market, it can lead to issues with how much tax these companies owe. As a result, the amount of tax revenue collected by the country is affected. To address this issue, the countries that make up the OECD (an international organization) have agreed to adjust the profits reported by these companies to ensure that taxes are fair. They do this by determining what the terms and prices of these transactions would look like if the companies were not related but were independent businesses engaged in similar deals under similar conditions. This ensures that everyone follows the arm's length principle, which aims to ensure that transfer prices among related companies are similar to prices charged between unrelated parties. Being part of a multinational enterprise (MNE) doesn't necessarily mean that companies always set prices and terms that wouldn't happen in a normal market situation. Sometimes, different parts of a large company operate independently and make deals with each other as if they were separate entities. They base these deals on the actual economic conditions of the market, just like they would with any other company. Managers in different parts of a multinational enterprise (MNE) may want to demonstrate strong profits for their section. As a result, they may not set prices for internal transactions in a way that would reduce their own profits. Tax authorities should keep this in mind when deciding where to focus their efforts on assessing whether companies are pricing their internal transactions fairly (transfer pricing examinations). It may seem like the different departments within a company are negotiating hard with each other to set prices for their transactions, but this alone does not guarantee that the prices are fair, especially if the company is a multinational enterprise (MNE). In such cases, the fact that the departments are all part of the same MNE could still influence their decisions. Therefore, tax authorities need to consider more than just whether there was tough bargaining to determine if transactions between different parts of the same company are being priced fairly (1).

Transfer pricing is a really important element in international taxation because it directly affects where profits are reported and, consequently, where taxes are paid. In a world where businesses can operate in multiple countries with different tax rates, the allocation of income and expenses between resident and non-resident entities within the same multinational enterprise (MNE) becomes a powerful tool for managing tax liabilities (Reuven Avi-yonah, 2007:102).

The arm's length principle means that the price of goods or services exchanged between related parties should be similar to the price of similar goods or services exchanged between independent parties. This is to ensure that the prices charged between related parties are in line with market conditions. The arm's length principle is based on the idea that the open market regulates the economy. This principle considers price adjustment to market conditions as the most appropriate and fairest standard. Thus, the price calculated during the transfer of goods, work and services between related parties should be in accordance with the current market price and market conditions. The arm's length principle aims to create a level playing field by using market prices as a benchmark, becoming a fair approach for all parties involved, including tax authorities, corporations themselves and other stakeholders in the global economy (1).

The arm's length principle principle states that transactions between related entities in a multinational group should be conducted as if the entities were independent businesses dealing with each other. This means the terms and conditions of their financial and commercial relationships should be the same as if they were unrelated parties.

The arm's length principle is widely accepted, especially among OECD member countries. The arm's length principle aims to create a level playing field in taxation for multinational enterprise (MNE) group members and independent businesses. This approach means neither is favored nor disadvantaged when it comes to paying taxes. By treating related and unrelated business transactions similarly for tax purposes, the arm's length principle helps to maintain fair competition. It prevents tax policies from influencing business decisions that could unfairly benefit companies with international affiliates over those that only operate domestically. When tax considerations do not distort business decisions, it's easier for companies to trade and invest across borders. This openness can lead to increased international trade and investment, driving economic growth (1).

The arm's length principle is reflected in Article 9 of the OECD Model Tax Convention. This article is the authoritative statement of the arm's length principle. It sets out the rules for how tax authorities can adjust profits if related entities in different countries set their internal prices differently than independent entities would. The analysis under Article 9 involves two main comparisons (3):

a) Conditions (not just prices) between related entities are compared with what would occur between independent entities. This is to see if an adjustment in accounting for tax purposes is warranted.

b) Profits that would have been earned at arm's length are calculated to determine how much the accounts might need to be rewritten to reflect these fair profits.

Article 9 ensures that tax authorities have a basis to review and adjust intra-group transactions to prevent companies from artificially lowering their tax liabilities by shifting profits between countries within their corporate group. The goal is to have intra-group transactions reflect the same profits as if the transactions were between completely independent companies (3).

If the related entities set conditions that differ from those expected between independent entities and this results in a shift of profits, tax authorities can adjust the profits to what they would have been under arm's length conditions and tax them accordingly.

The arm's length principle is rooted in contract law, which ensures a fair deal. Currently, the arm's length principle is recognized as the international standard for determining an appropriate transfer pricing.

According to article 14-1 of Tax Code of Republic of Azerbaijan, transfer price means the price determined during transactions between the following persons and the price determined in comparable transactions between independent persons under the same conditions (4).

1) a) between a resident of the Republic of Azerbaijan and non-resident persons who are mutually dependent on him; b) between a resident of the Republic of Azerbaijan and any representative office, branch and other division of non-resident who is mutually dependent on him located in other states (territories);

2) a) between a permanent establishment of a non-resident in the Republic of Azerbaijan and that non-resident himself; b) between a permanent establishment of a non-resident in the Republic of Azerbaijan and any representative office, branch and other department located in other states

(territories); c) between a permanent establishment of a non-resident in the Republic of Azerbaijan and any other person mutually dependent on that non-resident located in other states;

3) between a resident of the Republic of Azerbaijan and (or) non-resident's permanent establishment in the Republic of Azerbaijan and entities established (registered) in countries subject to preferential taxation;

4) except the above, between a resident of the Republic of Azerbaijan or permanent establishment of non-resident in the Republic of Azerbaijan and non-resident persons in the following cases:

a) individuals have conducted transactions on products traded on international commodity exchanges and (or);

b) During the tax year, the total income of a resident of the Republic of Azerbaijan or a non-resident's permanent representation in the Republic of Azerbaijan exceeds 30 million manats, and the volume of transactions with each non-resident person has a specific weight of more than 30 percent in the total income (expenses) (4).

According to Article 14-1.3 of the Tax Code, if the value of the goods, work, or service provided by the taxpayer is less than the value of a similar transaction between other persons, except for the persons listed above, then the tax is calculated based on the transfer price. If the value of the goods, work, service provided by the taxpayer is higher than the value of a similar transaction between other persons, except for the persons listed above, then the tax is calculated on the basis of the actual sales price (4).

Comparable uncontrolled price method. The Comparable Uncontrolled Price (CUP) method is one of the main techniques used in transfer pricing analysis to ensure that transactions between related enterprises of multinational enterprises (MNEs) are consistent with the arm's length principle. The CUP method compares the price calculated in a transaction between related parties with the price calculated in comparable circumstances in a transaction between independent parties (1).

The CUP method compares transactions that are sufficiently similar in terms of the nature of the goods or services, the terms of the transactions, and the economic and market conditions in which the transactions occur. The transactions being compared must be sufficiently similar to make a fair comparison. When comparing operations, factors such as sales conditions, volume, and market conditions should be taken into account. If between controlled and uncontrolled operations, there are differences in terms of sales, product quality, product volume, etc. If there are differences, then the price in the uncontrolled transaction should be adjusted accordingly. Transactions can be compared after adjustments are made.

The main condition of the CUP method is that there should be no significant differences between the controlled operation and the uncontrolled operation that could significantly affect the price. In the absence of such differences, an uncontrolled operation can serve as a benchmark for a directly controlled operation. When there are significant differences between transactions, the CUP method can be used, provided these differences are quantified and reasonably accurate adjustments are made to the prices in the uncontrolled transaction. Because the CUP method provides a clear, direct comparison of prices, it is considered one of the simplest and most reliable transfer pricing methods when similar transactions exist. If there are no significant and price-affecting differences between similar transactions, using the CUP method is the most convenient and reliable method (1).

The use of the CUP method is mostly applied in relation to stock market goods. Commodities are subject to less price changes than other commodities, so transactions can be easily compared. Commodity quotations from reliable sources such as international exchanges or government agencies are used as benchmarks for determining prices in similar uncontrolled transactions. The CUP method can effectively determine the transfer price for stock commodities.

When using the CUP method to determine the arm's length price for related party transactions, it is important to consider various factors such as the country of origin of the goods, terms of delivery, and the volume of the sold product. For instance, if an independent enterprise sells wine of the same type, quality, and quantity as the wine sold between related enterprises, and these sales occur under similar conditions, then the CUP method can be easily applied. However, if one of the comparable establishments sells French wine and the other sells Russian wine, adjustments may be necessary to account for any material price differences arising from the origin of the wines.

Consider the following example related to the volume of a product. Company A sold 10,000 tons of a product to its subsidiary at $800 per ton. Later, it sold 5,000 tons of the same product to an independent company at $1,000 per ton. Although there is a visible price difference in this example, it is important to note that Company A gave a discount to its subsidiary for selling more products. Hence, this case should not be considered as a price difference when selling to an independent company. These transactions are comparable. So, when the enterprises sell more products to their customers, they consider a discount in the price of the products compared to their customers who sell a smaller volume of products (1).

Resale price method. The application of the resale price method initially begins with the determination of the price at which the enterprise resells the goods purchased from another enterprise with which it is related to an unrelated enterprise. The price at which the enterprise buys the goods from a related enterprise and sells them to an unrelated party is considered “the resale price”. Gross margin (resale margin) is deducted from the resale price. After deducting resale margin, customs duties, transportation costs and other costs from the resale price, the transfer price is determined according to the arm's length principle (1).

The resale method is sometimes called "the resale minus method" because it is calculated by subtracting the gross margin from the resale price. Gross margin is expressed as a percentage of gross revenue from sales. Gross profit is sales minus cost of goods sold. For example, if the original cost of an item is $20 and the item is resold for $40, the gross profit margin is calculated as follows: ($40-$20)/$100=$20/$100, or 40 percent. The resale price is the $100 selling price, minus the $40 gross profit, or $60 total (Feinschreiber, 2004:70).

The resale method is typically used to determine the transfer price when selling tangible property. In order to apply the resale method, the goods that are the subject of resale should not differ from their previous condition and should not be subjected to any processing process. Re-sold goods must retain their original condition. Packaging and labeling of goods during resale is not considered as a change. The resale price method measures the cost of the functions performed (Feinschreiber, 2004:70).

The resale price method is particularly useful when products are resold by a distributor or marketing operation.

When applying the resale price method, two comparison methods are used: a) internal comparison and b) external comparison. İnternal comparison: An entity buys goods from a related entity and then resells them to an unrelated party with a resale margin on the goods. In this case, the resale margin applied by the entity is compared to the resale margin applied when selling the goods to other unrelated parties. External comparison: An entity buys goods from a related entity and then resells them to an unrelated party with a resale margin on the goods. The entity's resale margin on the goods is compared to the resale margin applicable between unrelated independent enterprises when the goods is resold (1).

We mentioned above that the following conditions must be observed for the application of the CUP method: a) there should be no difference between the compared transactions; b) if there are circumstances that prevent comparison, then appropriate adjustments should be made so that transactions can be compared. However, when applying the resale method, unlike the CUP method, small and insignificant differences between controlled and uncontrolled transactions are allowed. Thus, although small differences between operations directly affect prices, they do not significantly affect profit margins. When using the resale price method, the focus is on the overall profitability of the transaction rather than the exact specification of the transaction.

However, when comparing margins, important facts that cause the margin to be high should be identified and considered. Consider the following example:

Suppose Company A and Company B are both distributors. Both sell the same product under the same brand in the same market. Company A, unlike Company B, also provides warranty for the goods it sells. So, if the product breaks during the warranty period, Company A undertakes to restore the product free of charge. Company B does not provide warranty for the goods it sells. In this case, A sells the goods at a higher price because of the guarantee. Therefore, Company A's profit margin will be greater than Company B's. This feature, which affects the margin, must be taken into account when operations are compared.

Company X purchases goods from its parent Company Y and then sells them to an unrelated independent party. Company X buys 500 goods, each worth 400 AZN. The total value is 20,0000 AZN. The purchase price of the product unit is 300 AZN, and the costs related to the import of the product (customs, transport, etc.) are 100 AZN. Company X sells the goods to an independent party at a price of 500 AZN each.

The transaction conducted between 3 independent parties selling goods of the same quality and volume as the goods sold by company X is investigated and it is found that 20%, 21%, 22% margin was applied to the goods sold by the independent parties. At this time, the margin percentages applied by independent parties are collected and the numerical average is found: (20%+21%+22%)=21%. The transfer price will be calculated assuming the margin applied by Company X as 21%.500-100-(500x21%)= 400-105=395. Apparently, using the resale method, the transfer price was calculated from the resale price less import-related costs and gross margin. In the current case, the transfer price was 395 Azn (6).

The cost plus method. The application of the cost plus method begins with the calculation of the cost incurred by the supplier for the goods and services provided to the related enterprise. Then a cost plus mark-up is added to the cost and the transfer price is determined. For the application of this method, initially, the actual costs incurred by the supplier during the production of goods or the provision of services are determined. These costs include production costs, labor costs and other costs. The supplier adds a cost plus mark-up to the costs incurred in providing the goods or service. Cost plus mark-up should be determined by taking into account the functions performed by the supplier, the assets used, the risks assumed and the market conditions. The application of the cost-plus method is more often used in the sale of semi-finished goods based on long-term contracts with related enterprises (1).

When applying the cost plus method, two forms of comparison are used: a) internal comparison and b) external comparison. Internal comparison compares the cost plus mark-up applied by the same supplier for the goods and services provided to the related enterprise and to the unrelated enterprise. In case of external comparison, the cost plus mark-up applied by the supplier to the related enterprise is compared with the cost plus mark-up applied between independent parties (1).

Like the resale method, the cost plus method is comparable to the CUP method if there are no significant differences in transactions. For example, suppose Company X manufactures and sells toasters and Company Y manufactures and sells irons. Both Company X and Company Y incur the same costs for the production process. Since supply and demand for those products in the market are at the same level and production costs are approximately the same, these companies will usually have the same profit margins. So, the production costs and selling price of both products in the market are approximately the same. Therefore, both Company X and Company Y will charge roughly the same trade markup on the goods they sell. Apparently, if Company X and Company Y both sell different types of goods, the comparison of transactions is permissible. Thus, during the application of the Cost plus method, since trade allowances for the provision of goods and services are compared, the main point to pay attention to here is the profitability of enterprises. However, if Company X used a more efficient method of manufacturing the goods and the cost was lower, the comparison of transactions with Company Y would not be considered permissible for determining the appropriate transfer price. In such a case, the price must be adjusted to make the Comparison.

Transactional net margin method. The application of the transactional net margin method involves the comparison of net profit in controlled operations. The profitability method is similar to the resale method and the cost plus method. However, unlike them, the profitability method compares the net profit from the operation, not the gross margin applied to the goods and services provided (1).

When applying the cost plus and resale plus methods of profitability, two forms of comparison are used. a) internal comparison and b) external comparison. During the internal comparison, the net profit obtained as a result of the operations of the same enterprise both with the related enterprise and with the independent enterprise is compared. During the external comparison, the net profit obtained by the enterprise as a result of the transaction with the related enterprise is compared with the net profit obtained as a result of the transaction between the independent parties (1).

When applying the profitability method, a detailed functional analysis is required to ensure that controlled and uncontrolled operations are comparable. This involves comparing the functions performed, the assets used and the risks assumed in the operations. The net profit determined for the TNMM analysis must comply with comparability requirements, that is, it must take into account all relevant factors that may affect profitability, such as economic conditions, contractual terms and business strategies of the enterprises involved.

If the cost of transactions is high, that is, if both parties to the transaction are engaged in unique activities, then the application of the profitability method is not appropriate. Let's say that Company X is engaged in software development, and Company Y is engaged in film production. Company X develops and sells software to Company Y for the use of special effects in filmmaking. As seen in this transaction, both parties are engaged in a unique activity. In this case, the application of the profitability method will not be reliable, since it is difficult to find comparable operations for such specialized activities. It will be more convenient to apply the profit split method to compare this type of operation. Because it can calculate the unique value that each subsidiary gives to a transaction. If, for example, Company A provides standard advertising services for its film production parent, Company B, then the profitability method may be used. Because there are enough standard advertising companies in the market. It will not be difficult to compare transactions.

Company A provides services to its subsidiary Company B. The cost of the service is 800,000 AZN. The cost of providing the service is 600,000 AZN. The profit obtained as a result of the service is 200,000 AZN. The weight of the profit obtained in this transaction in the total cost is approximately 34%. That is, the weight of 200,000 manat profit in 600,000 manat cost is 34%. The current transaction is compared to a transaction between independent parties. In an uncontrolled transaction between independent parties, the specific weight of profit in total costs is determined at 42%. In this case, the appropriate transfer price will be calculated assuming a specific weight of 42%. If the specific weight will be 42%, the amount of profit in the controlled operation will be equal to 252,000 AZN. In such a case, the tax will be calculated not from 200,000 AZN, but from 252,000 AZN (6).

The Profit-Split Method (PSM) is one of the transfer pricing methods used in international tax practice, particularly useful for complex inter-company transactions involving intangible assets or for business operations where integrated services and goods are exchanged between related entities within a multinational enterprise (MNE). PSM is especially relevant when traditional transaction-based methods like the Comparable Uncontrolled Price (CUP) method or the Transactional Net Margin Method (TNMM) cannot be reliably applied due to the highly integrated activities of the related parties (1).

PSM starts by identifying the total profit earned from the inter-company transactions that are to be split. This could involve the combined profit from a range of integrated services, joint ventures, or transactions involving shared intangibles. The next step is to split these combined profits between the involved entities in a manner that reflects the division of profits that would have been expected had the entities been independent parties dealing at arm's length.

The profits are typically split based on the relative value of the contributions made by each party to the joint activity. These contributions might include tangible assets, intangible assets, services provided, or risks assumed.

The basis for the split should be determined by analyzing functions performed, assets used, and risks assumed by each party, often referred to as the FAR (Functions, Assets, Risks) analysis.

Company A provides services to an independent third party in the amount of 2,000,000 AZN together with its subsidiary company B located in Azerbaijan. 1,600,000 AZN is spent during the provision of the service. The income is 400,000 AZN. 240,000 AZN of the obtained income is transferred to the parent company, and the remaining 160,000 AZN remains in the subsidiary. The specific weight of the share of the subsidiary in the total income is 40%, and the weight of the share of the parent company in the total income is 60%. The specific weight was calculated as follows:

- (160,000:400,000)x100%=40% (in relation to the subsidiary)
- (240,000:400,000)x100%=60% (in relation to the parent company)

In order to determine the appropriate transfer price, relevant analyzes are carried out and it is determined that the profit is divided 50/50 between the parent company and the subsidiary company. In such a case, the special weight of the subsidiary company located in Azerbaijan in the total profit is taken not 40%, but 50%, and as a result, the profit tax is calculated from 200,000 AZN (6).

The 8-10 Action Plans of OECD, a famous global organization, deal with issues related to transfer pricing. These Action Plans try to define the rules of application of the arm's length principle (7).

Action 8 emphasizes that profits associated with the transfer and use of intangibles should be allocated in accordance with the economic activities and value contributions of the respective entities within an MNE. This means ensuring that the returns derived from controlled transactions involving intangibles are consistent with the value that is actually created by those intangibles (8). Action 9 emphasizes that profits should be aligned with the economic activities that generate them. This involves ensuring that the risks undertaken by different entities within an MNE are appropriately compensated in line with their actual economic performance and not merely contractual agreements (9). BEPS Action 10 focuses on ensuring that the transactional profit split methods and other rules are better aligned with value creation, particularly in complex global value chains (10).

Council Directive on transfer pricing No. 2023/0322 (CNS) is one of the most important directives adopted within the framework of the European Union regarding transfer pricing. This Directive lays down rules to harmonize transfer pricing rules of Member States and to ensure a common application of the arm’s length principle within the Union (11).

## Conclusion

The purpose of applying transfer pricing is to ensure equal conditions for each of the market participants and fair distribution of tax. Transfer pricing ensures that profits are appropriately distributed and taxed in different jurisdictions. This aligns tax obligations to where actual economic activity and value creation occurs, preventing profit shifting to low-tax countries. The main objective is to reflect the terms of transactions as if they were between unrelated parties, thereby preventing tax evasion and ensuring that each jurisdiction receives its fair share of tax revenues depending on where the value is actually created.

International efforts such as the OECD's Base Erosion and Profit Shifting (BEPS) project, now a powerful global organization, are trying to address these issues by tightening guidelines on how transfer pricing should be applied and ensuring it remains effective in a rapidly changing global economy. This includes increasing transparency, improving information sharing between tax authorities, and clarifying definitions of how value is created in different business models (12).

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