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**TRANSFER PRICING AND
ITS IMPLEMENTATION IN THAILAND**

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Title Transfer pricing and its implementation in Thailand			
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Abstract <p>This paper studies how transfer pricing practice is actually taken in Thailand. Though there has been researched on transfer pricing in Thailand, we have found that such research are focused on related law and regulation not on its practice, itself. Therefore, this research aims to focus on the practice of transfer pricing and its related facts. Our research finds that many taxpayers are still unaware of transfer pricing as the result of no legal enforcement on such practice. Furthermore, we find that businesses with persistent loss and profit margin lower than industry average, assuming there is substantial related-party transaction, will catch the tax officers' attention. Similar to other researches, we find that TNMM is mainly used to test the arm's length price when it comes to transfer pricing audit. Not surprisingly, we find that compliance risk is biggest concern when implementing transfer pricing as the result of stiff penalty imposed by tax authorities. Such penalty can be greatly affect shareholders' value; therefore, to mitigate such risk, it is recommended that MNEs shall have a good transfer pricing documentation on hand or enter APA program when necessary.</p>			
Keywords Transfer pricing, arm's length principle (ALP), multinational enterprises (MNEs), advanced price agreement (APA), shareholders' value, economic value added (EVA), Thai tax law, double taxation agreement, Organization for Economic Co-Operation and Development (OECD).			
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As a former tax consultant, transfer pricing has always caught my attention as it concerns with international tax issue. Since it can be considered as the cost of doing business, which good management should always take it into consideration when operating their businesses, it becomes the area in which I want to gain more insight. It has always been challenging me throughout my research since the availability of information is limited, especially in Thailand. Therefore, it would not have been possible to write this thesis paper without the supports of people around me.

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1. INTRODUCTION

1.1. Background

Transfer pricing has long been taught in accounting area as the method for cost and revenue allocation among divisions in decentralized enterprises (Sikka & Willmott 2010). However, transfer pricing starts getting its attention in wider areas such as tax and economics as enterprises expand its businesses across the borders, where difference in tax rates may arise. Transfer pricing has gained its importance since it does not only enable businesses to avoid double taxation (OECD 2010a: 18), but it can be used to relocate corporate profit and facilitate tax avoidance, flight of capital (Sikka & Willmott 2010) and repatriation of profit (Tebogo 2011). Through its roles of facilitating the flow of capital and tax avoidance, transfer pricing has contributed to economic inequalities (Kuschnik 2008) by enhancing shareholders' wealth and deteriorating social welfare (Sikka 2009, Sikka & Willmott 2010).

Many researchers such as Urquidi and Thompson (2010) and Sikka and Willmott (2010) claim that loss of tax revenue from the aggressive use of transfer pricing by multinational enterprises (MNEs) has lead tax authorities to scrutinize its tax audit. They point out that the tax authorities around the world begin to challenge the enterprises' income tax computation, especially on those related-party transactions. Furthermore, they cite that tax authorities may impose high tax penalties and transfer pricing documentation requirement to discourage the use of aggressive transfer pricing practice and increase the transparency of related-party transactions, respectively. According to KPMG (2011: 5), transfer pricing documentation required by tax authorities may contain detailed information describing the nature of related-party transaction, method and reason for choosing particular arm's length method for its related-party transaction and detail on its comparability analysis. Wong, Nassiripour, Mir and Healy (2011) argue that to protect their tax base governments in many countries often give their tax authorities the rights to audit and adjust the corporate income tax on the related-party transactions and penalize those result in tax shortfall.

Transfer pricing, as learned in accounting textbook, can affect the divisional manager's performance. Thus, the management might be unwilling to set the transfer price that will maximize the enterprise's profit but hurt their division's performance, which in turn is used to determine their incentives or bonus (Drury 2004: 885). According to Wong et al. (2011), this conflict of interest of transfer pricing objectives can be resolved by applying the two sets of books system, which is the system of decoupling of transfer pricing for managerial and tax purposes. However, Steven (2008) and Wong et al. (2011) have found that MNEs are hesitated to use such dual system since tax authorities may challenge them for maintaining the separate set of books for internal and external purposes. Eden (2009) also finds that maintaining two sets of books have not gain popularity due to its complexity and time consuming.

In this thesis paper, the paper is divided into eight main sections. The first two sections are motivation of this study and literature reviews on various perspective of transfer pricing. Section III provides the overview of what transfer pricing is and its methods. Section IV provides the overview of comparability analysis and the studies of its importance. Section V provides the overview on how transfer pricing can affect the shareholders' value, and why it shall be considered as one of the risk management area. Section VI provides the related tax law and regulation that shall be taken into consideration when practicing transfer pricing in Thailand. Section VII is the highlight of this research; it provides the empirical research result on transfer pricing practice in Thailand. Lastly, Section VIII will conclude our studies of this paper.

1.2. Motivation of this study

As we are approaching the world of internationalization, enterprises begin to expand its businesses around the world. By doing so, many enterprises begin to realize one potential operational risk, which is known as tax audit risk, especially in case where there are related-party transactions. Since each tax jurisdiction has its own tax regulation and tax rate, many enterprises try to take advantage from such differences by shifting income from one country to other in order to pay least tax as possible.

Some enterprises use such transfer pricing practice to escape from the currency restriction or facilitate the capital flight. Such action causes nations to lose billions of dollars of its tax revenue, which is the important fund for government to use in investment for their public goods thus enhancing the social wealth. Therefore, tax authorities begin to increase their scrutiny in their tax audits, especially on those related-party transactions, to discourage any businesses from using aggressive transfer pricing practice. Governments around the world also start to give their tax authorities the rights to audit, adjust and penalize those businesses with transfer pricing manipulation.

Since transfer pricing practice often associates with several countries' jurisdictions, multinational enterprises (MNEs) may find it difficult to comply with every country's regulation. Therefore, the double taxation on single source of income is possible. Furthermore, the tax authorities usually impose the high tax penalty on any transfer pricing activities if tax adjustment has been made and resulted in tax shortfall. As what we have mentioned, transfer pricing is the area that can potentially be needed in the near future, especially in Asia when the Asean Economic Community (AEC) become effective where the free flow of investment between Contracting States is possible.

1.3. Purpose of this study

This study is to enhance the understanding of transfer pricing from various perspectives. In order to meet this objectives, several literature reviews regarding various perspectives of transfer pricing will be provided briefly. Furthermore, this paper will provide the overview of what is transfer pricing and its comparability analysis in accordance with OECD guideline which is the international standard for implementation of transfer pricing. To gain the insight of transfer pricing practice in Thailand, the research done through the interviews of transfer pricing experts--both transfer pricing consultants and tax officer--has been made. This aims to enhance our understanding on such practice in Thailand and helps to predict the future trend of it. Furthermore, this study also tries to determine how transfer pricing can actually have

the impact on shareholders' value, and why it shall be considered as one of the enterprise's risk management when implementing transfer pricing strategy.

This research will be conducted in accordance with Thai tax law; however, in cases where such source is insufficient, the OECD Guideline will be used and implemented. Any tax law of other jurisdictions will be not taken into consideration in this research.

2. LITERATURE REVIEW

2.1. Literature review regarding tax perspective

In the world of competition today, businesses need to find the ways to increase its competitiveness either through cost cutting or economic of scales. Eden and Smith (2011) point out that MNEs can take advantages from cheap labor cost, knowledge know-how and market penetration by expanding its businesses globally. Since such MNEs usually produce its supplies in one country, assembly and market its products in other countries, they find that by choosing appropriate locations for each purpose can offer the MNEs the greatest value added.

Since MNEs operate in different tax jurisdictions where tax rate can be varied, Tebogo (2011) claims that these enterprises may use transfer pricing to manipulate gain or loss of the enterprise to minimize its global tax expenses. In doing so, the enterprises will shift income from high tax jurisdictions to low tax jurisdictions lessening its total taxable income and thus its tax expenses. According to Borkowski (1997) such transfer pricing practice has gained increasing concern to tax authorities around the world since it can distort the competitiveness among businesses and facilitate the capital flight of MNEs. The capital flight as the result of tax avoidance can deteriorate social welfare, especially in those developing countries where highly need funds for investment in infrastructure and public goods (Borkowski 1997, Sikka & Willmott 2010). Therefore, it is no surprise if the tax authorities will dislike such transfer pricing practice and increase its scrutiny in tax audit on related-party transactions to discourage MNEs from using aggressive transfer pricing practice.

As the result of its role in tax avoidance, many tax authorities have adopted the transfer pricing guideline from Organization for Economic Co-Operation and Development (OECD) to counter-react to transfer pricing problem (Kuschnik, 2008). The OECD guideline states that transfer price of the related-party shall be based on the arm's length principle. Under the arm's length principle, the transfer pricing set

by related-party shall be the same with price of the comparable transaction under the comparable circumstances of independent parties (OECD 2010a: 31-35).

OECD (2010a: 59-62) has provided various methods used to determine such arm's length price; they are transaction-based methods and profit based methods. Transaction-based methods consist of comparable uncontrolled price (CUP), resale price method (RPM) and cost plus method (CPM). In case where the traditional transaction methods cannot be used, the profit based methods will be used as the alternative. Profit based methods consist of profit split method (PSM) and transactional net margin method (TNMM).

Drtina and Reimers (2009) argue that comparability analysis, not the method of transfer pricing, is the most important thing to be considered when applying arm's length principle. They find that when tax law allows the MNEs to choose its own transfer pricing method that best approximate the arm's length price, it is necessary for MNEs to be able to demonstrate that such method has produced the most reliable results. The OECD (2010a: 41-51) has provided guideline on how to apply the comparability analysis and factors needed to consider when making such analysis.

2.2. Literature review regarding management perspective

Transfer pricing has long been studied in management as the method of profit allocation among the profit centers of the decentralized enterprise (Sikka & Willmott 2010). Such transfer price has often seen in the decentralized enterprise involving with the vertical integration, where one division sells products or renders services to other division (Antić & Jablanovic 2000). Divisional profitability can be directly influenced by the transfer price being used since such price will be revenue of the selling division and cost of the buying division (Merchant & Van der Stede 2007: 227).

Transfer price has been set up to meet several objectives as following: it is used as the management control system in which helps coordinate the workflow among

divisions and motivates divisional managers to make good economic decision that is in the best interest of the enterprise as a whole (Cools & Slagmulder 2009); it provides the information necessary for evaluating performance of divisional managers to correctly reward them for their contributions to the company's profit (Merchant & Van der Stede 2007: 227); it promotes divisional autonomy by allowing managers to make decision on what price to charge and what amount to trade to maximize their divisional profit (Malik 2011); lastly, it allows the enterprise to move profit between divisions of the enterprise (Drury 2004: 884). Several researchers, for example Steven (2008) and Wong et al. (2011), argue that transfer pricing objectives are often conflict and no single transfer pricing method can best serve all objectives. Therefore, Drury (2004: 885) suggests that managers often need to trade-off among these objectives when deciding which method to be used.

There are several transfer pricing methods available for enterprise to price their internal transferred goods or services. Market based transfer price use existing market price less the marketing and selling expenses for their goods or services transferred internally. This method is best used in the perfectly competitive market since such price can best represent the true economic value of the transactions. This method can only lead to the optimal decision making in the competitive market for transferred goods or services while in the imperfect market the price can be distorted by market competition, thus, leading to the suboptimal decision (Drury 2004; 885-890).

Marginal cost transfer price is the price set equal to the marginal cost--also known as variable cost--of the selling division. This method is used in the imperfect or even non-exist market of the transferred goods or services. By using this method, the optimal decision can be made since buying divisions will purchase internally for all units it is expected to be sold in finished goods market. However, it can provide poor performance evaluation by under-stating and over-stating profit of selling and buying divisions, respectively. This is the result that no fixed cost has been covered and no profit margin has been realized by the selling division. Therefore, it can damage

autonomy of the selling division if it was forced to sell goods internally (e.g. Antić & Jablanovic 2000, Drury 2004: 885, 890-891).

Full cost transfer price is the price set equal to full cost of production of the selling division. Though both variable and fixed costs of production have been recovered, it still discourages selling division to sell internally since no profit margin has been realized. Hence, it weakens the selling division's autonomy and provides the poor the performance evaluation for both selling and buying divisions (e.g. Antić & Jablanovic 2000, Drury, 2004: 885, 891-892).

Since the previous two methods damage both divisional autonomy and performance evaluation, Antić and Jablanovic (2000) suggest that cost plus a mark up transfer price can be used to overcome such problems. In this method, the mark up will be added into the cost base--either variable or full cost--to provide selling division some profit margin from the transferred transactions. However, they claim that this method can lead to optimal output level only when the transfer price is less than the market price encouraging the buying division to purchase the intermediate goods internally.

Lastly, managers of selling and buying divisions can exercise their autonomy by negotiating with each other on the transfer price. This method--so called negotiated transfer price--will only work best when there is the imperfect market for the intermediate goods and managers of both selling and buying divisions have equal bargaining power. By using this method, the performance evaluation can be most likely satisfied, and it can lead to the optimal decision if the transfer price is less than the market price but still offer sufficient profit to selling division. However, there are several drawbacks to consider: first, conflict among divisions can arise, and it may need central management involvement to resolve such problem which eventually cause the loss of divisional autonomy; second, the unequal bargaining power and negotiation skill of the divisional managers can cause the suboptimal outcome and profitability of each division; lastly, it is time consuming and requires lots of data analysis for negotiations (Antić & Jablanovic 2000, Drury, 2004: 893-894).

Since transfer price objectives are often conflicted and none of the pricing methodology can be best serve all objectives, two methods has been introduced to resolve such problems which are dual rate transfer pricing and marginal cost plus a fixed lump sum fee. Dual rate transfer pricing is the system in which two divisions will use different transfer price for a particular transaction. This system can lead divisional managers to make the optimal decision. However, this method hasn't gained much attention as the result of its complexity. Furthermore, it double counts the internal profit, which eventually can distort the real picture of company's profit and thus misleads management decision (Antić & Jablanovic 2000, Drury 2004: 898-900).

Marginal cost plus a fixed lump sum fee--also known as two-part transfer pricing system--is the system in which selling division will charge a marginal cost for each unit being transferred plus a lump sum amount for fixed cost and some profit margin charged for each period. By using this method, goal congruence of the company can be achieved since both divisions are willing to trade internally at the optimal output level. It enhances the workflow among divisions since both divisions have to negotiate and agree on the amount of fixed lump sum selling division will charge for the transactions. Moreover, it can provide a fair measurement for performance evaluation since the selling division can recover full cost of production and realize some profit from the transaction (Merchant & Van der Stede 2007: 282-283, Drury 2004: 900).

2.3. Literature review on the integration of tax and management of transfer pricing

Transfer pricing is the process of charging price of goods and services trade within the enterprises. It is often used to serve several objectives such as evaluating divisional performance, coordinating workflow among divisions and minimizing global tax expenses. However, conflict of interest among objectives often arises. Managers consequently need to decide on the transfer price that would come up with the optimal trade off among these transfer pricing objectives (Wong et al. 2011).

Several researchers have studied and tried to come up with the best solution to solve such conflict of interest by adopting either a single set of book or two sets of books system. In the earlier researches, the researchers such as Halpirin and Srinidhi (1999 via Cools & Slagmulder 2009) argue that under specific circumstance the optimal transfer price that will meet both managerial and tax compliance objectives can be set. Dürr and Göx (2008) have come up with a research result that the use of one set of book will be most appropriate to the enterprise only if there is product similarity and small number of competitors in the industry.

Hiemann and Reichelstein (2012) recently argue that enterprise can reach an optimal result only if the two sets of books, so called decoupling of transfer pricing, have been implemented. They say that tax compliance transfer price may provide the information that doesn't reflect the current economic condition of the internal transfer, which in turn gives the improper economic signal to management leading them to make the suboptimal decision making. Therefore, different transfer price for managerial and tax compliance purpose can help management to make the optimal decision regarding the current economic condition of internal transfer and concurrently complying with the tax regulation. Though, the decoupling of transfer pricing can help avoid the conflict of interest among objectives, Ernst & Young (2003 via Hiemann & Reichelstein) cites that one set of book is still widely used in the business world. According to their research, they find that single set of book has provided them several advantages as following: it is simple to understand and implement; it consumes less time and cost in maintaining one set of book; it prevents the potential tax disputes with the tax authorities that can be associated with the use of decoupling of transfer pricing.

Nielsen and Raimondos-Møller (2012) have found that even though when the enterprise has two different transfer prices for different purposes, the two transfer prices are seemed to be interdependent. Moreover, they find that when the enterprise use one transfer price for both managerial and tax purposes, it will subsequently produce the negative value to the firm as the whole. Furthermore, Choe and Hyde (2004) study the relationship between the managerial and tax transfer price when the

two sets of books are being kept. They find that under the separate entity approach both prices are interdependent. Since both of transfer price can be affected by the change in tax and cost structure, they also suggest that by keeping two sets of books the enterprise can thoroughly respond to the change in business and economic environment.

3. TRANSFER PRICING

With the help of technology development, the costs of communication and transportation have become less expensive. Such decreasing in costs has motivated enterprises to expand its businesses across the borders to take advantages of cheap labor cost, knowledge know how, and market penetration (Eden & Smith 2011). When businesses have operated in several countries, it is referred as multinational enterprises (MNEs). Companies within these MNEs may trade goods, services, and intangible assets with each other, which activities are called related-party transactions. When related-party transactions are done cross-borders, it may involved with the tax issues on transfer pricing (United Nations 2013: 1-2). Therefore, this chapter aims to provide the overview of what is transfer pricing and what are transfer pricing methods under OECD Guideline.

3.1. What is transfer pricing?

Recent study from United Nations (2013: 1) has found about thirty percents of international trade are estimated to be the transfer of goods, services and intangible assets within the enterprises. From this study, it can be noticed that transfer pricing, the setting of price charged for goods, services and intangible assets being transferred between the related-party, is increasing its importance in today's world trade.

When independent companies are traded together, the price is generally determined by the market force. However, the transfer price set between related-party can be determined by a combination of market and group driven forces, such as commercial and financial conditions (OECD 2010a: 31, Urquidi 2008). Through its special character, it is no wonder why transfer pricing is increasing its importance to both tax authorities and taxpayers. Since transfer price can differ from the market price, Organisation for Economic Co-Operation and Development (2010a: 31-32) has stated that when transfer price doesn't reflect the true market force of the transaction, the income tax base--and therefore tax expenses--can be significantly distorted. Thus,

they claim that the appropriate adjustment shall be made to the transaction to reflect the true economic condition and thus the correct taxable income bases.

Borkowski (1997) claims that transfer pricing when involving with the cross-border transfers is often used as the method to minimize global tax expenses and facilitate the income shifting between tax jurisdictions. Therefore, Drtina and Reimers (2009) discover that tax authorities around the world begin to increase its control on transfer pricing practice of MNEs as the way to protect its tax bases and thus generate its tax revenues. They find that MNEs increasingly face the difficulty to comply with tax laws and regulations of countries in which they have their businesses reside at once since different jurisdictions have its own tax laws and regulations. Thus, it is possible for the MNEs to be put at risk of double taxation on the same income, which arises when MNEs have made the income adjustment in one jurisdiction and such change has not being agreed on the other jurisdiction (OECD 2010a: 19-20, Steven 2008)

To mitigate the double taxation and to protect the nation's tax base, there is the need of methods use to determine the correct transfer price. Hence, Organisation for Economic Co-Operation and Development (OECD) has provided guideline uses to determine the correct transfer price. According to this guideline, it requires MNEs to follow the arm's length principle, which requires the price of goods, services or intangible assets being transferred between related-party to be similar as those were traded in the opened market under the similar circumstance. If the transfer price set by MNEs does not followed the arm's length principle, it can be deemed as inappropriate or mispriced by the tax authorities, which can be subjected to the price adjustment and tax penalty imposed by the tax authorities (KPMG 2011: 4, Sikka & Willmott 2010, United Nations 2013: 2).

3.2. Arm's length principle

Ernst & Young (2008 via Eden 2009) finds that transfer pricing is currently recognized as the international tax issue by both MNEs and tax authorities. Several researchers, for example Sikka and Willmott (2010) and Kuschnik (2008), cite that

tax authorities around the world increase scrutiny in their tax audits especially on those related-party transactions as the result of their increasing concerns on transfer pricing role in tax avoidance. In their studies, they find that the unfair assessment of the transfer of goods, services and intangible assets between MNEs can enhance the private gain while deteriorating the social welfare. To achieve the appropriate assessment of transfer price, OECD has come up with the internationally accepted principle calls arm's length principle, which states that the price of the related-party transactions shall be similar as those transactions taken in the opened market (KPMG 2011: 4, Kuschnik 2008).

According to OECD and many nation's legislations, if the transfer price does not represent true market condition, the income adjustment made by tax authorities is likely to be taken place (KPMG 2011: 4-6). Such adjustment can be done by establishing the commercial and financial conditions that are expected to be incurred in the transactions between the independent parties. In order to adjust the price in accordance with the arm's length principle, separate entity approach shall be applied. The separate entity approach will treat the members of MNEs as if they are separate independent parties. Therefore, all companies within the jurisdiction will be treated similarly for tax purposes. This is to prevent the MNEs from taking tax advantages of tax break through mergers, acquisitions or even tax holidays, thus, promote the competition in business environment (OECD 2010a: 31-36).

To apply the arm's length principle, nature of the transactions between enterprises will be focused. It is necessary to establish the comparability of the transaction between the related-party with the independent parties. In order to be comparable, the OECD states that there shall be no significant difference between the transactions being compared; otherwise, the appropriate adjustment shall be made to eliminate such difference (KPMG 2011: 5).

It is sometimes difficult for tax authorities and taxpayers to implement the arm's length principle since the MNEs may engage in the businesses where the adequacy of data may not be available. Therefore, it requires lots of judgement on both parts of

tax authorities and taxpayers when it comes to setting the appropriate transfer price, the price at which can be accepted by both tax authorities and taxpayers (OECD 2010a: 34-36).

3.3. Methods of transfer pricing

OECD (OECD 2010a: 59) has provided guideline listing methods use to determine the appropriate transfer price. This guideline aims at searching the method that is most appropriate for the transactions in question. In choosing the best method, the tax authorities and taxpayers need to consider a) strength and weakness of the methods b) the reliability of the data c) sufficiency of comparable transactions and d) the reliability and accuracy of the adjustment made to eliminate the significant differences between the transactions.

In order to choose the most appropriate method, it is not necessary to analyze every method for the transactions in question. However, taxpayers are recommended to keep the transfer pricing documentation on hands. Transfer pricing documentation may contain information regarding the establishment of the transfer price, such reason support for choosing and rejecting particular transfer pricing method, basis information on the business industry, and reason for entering the related-party transactions, for example (OECD 2010a: 59-61 & 181-189).

It is important to notice that there is no method that is suitable to every transaction in every circumstance. Therefore, the taxpayers shall choose the method that can best estimate the transfer price of particular transaction under particular circumstance. The reliability of the method chosen will depend on the accuracy of the adjustment make to establish the comparability of the transaction (OECD 2010a: 41-43 & 59-61).

3.3.1. Traditional transaction method

3.3.1.1. *Comparable uncontrolled price method*

The comparable uncontrolled price (CUP) method compares price charged for goods or services by related-party to price charged for comparable transaction by independent parties in comparable circumstance (Eden & Smith, 2001).

The transaction of-/with the independent parties will be comparable to the related-party transaction for the purpose of comparable uncontrolled price method if one of the following conditions is met:

- i. There is no difference that can significantly affect the arm's length price; or
- ii. If such difference does exist, the accurate adjustment shall be made to the transaction to eliminate any significant effect of such difference (OECD 2010a: 63).

This method is considered to be the most direct way for determining the arm's length price since it involves with direct price comparison. As the result of minor difference on goods or services being transferred can significantly affect the price of the transaction, it may be difficult to find the comparables under this method. Therefore, the CUP is most readily used in transactions involving commodity products where degree of similarity of goods is high (OECD 2010a: 63-65 & 81, United Nations 2013: 192-199).

In order to apply this method, taxpayers and tax authorities can search for either external or internal comparables. When the comparable transaction is transacted between one of the related-party and independent party, it is called internal comparable. In contrast, external comparable will incur when the comparable transaction is transacted between two independent companies (United Nations 2013: 193).

The comparable uncontrolled price method illustrated by United Nations (2013: 193) have been replicated in Figure 1 as below:

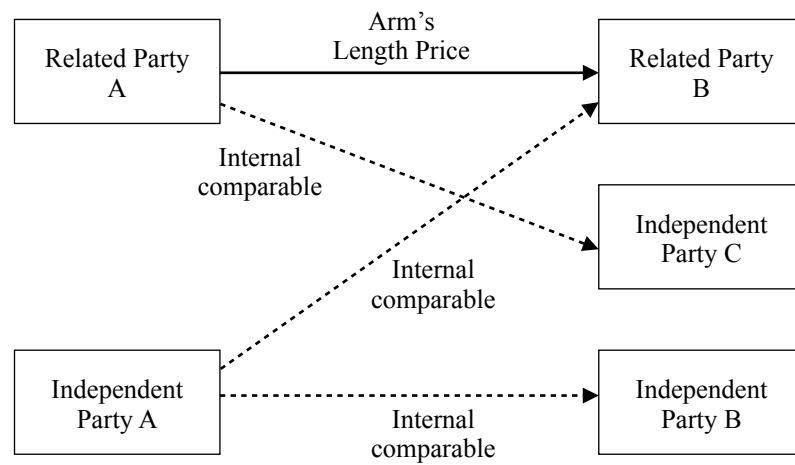


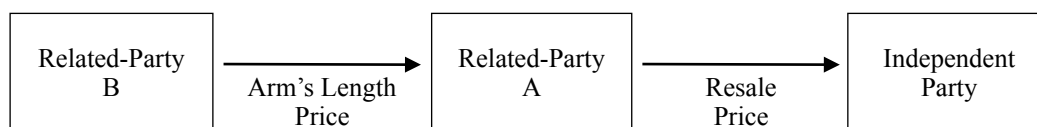
Figure 1: Comparable Uncontrolled Price (CUP) Method

To apply this method, the tax authorities and taxpayers must determine how the transaction in question is differed from the comparable transaction of-/with the independent parties. If there is any difference that significantly affect on the arm's length price, the appropriate adjustment shall be made to eliminate such difference. In case where reasonably accurate adjustment cannot be made, the alternative method shall be taken into consideration (OECD 2010a: 63-64).

3.3.1.2. Resale price method

Resale price method compares gross profit margin percentage of the related-party to those of the independent parties performing the comparable transaction under comparable circumstance. It will then deduct the appropriate gross profit margin from the resale price to determine the arm's length price. The gross profit margin shall be high enough to cover expenses and earns sufficient profit (OECD 2010a: 65).

The resale price method illustrated by United Nations (2013: 201) have been replicated in Figure 2 as below:



Arm's length price = Resale price - (Resale price x Gross profit margin)

For example:

Resale price	\$10.00
Gross profit margin (25%)	<u>2.50</u>
Arm's length price	\$ 7.50

Figure 2: Resale Price Method

The gross profit margin can be determined by reference to either internal comparable or external comparable. When the gross profit margin is obtained from the comparable transaction between a related-party and independent party, it is called internal comparable while those obtained from the comparable transaction between independent parties are called external comparable (OECD 2010a: 65-66).

The transaction of-/with independent parties will be comparable to the related-party transaction for the purpose of resale price method if one of the following conditions is met:

- i. There is no difference that can significantly affect the arm's length price; or
- ii. If such difference does exist, the accurate adjustment shall be made to the transaction to eliminate any significant effect of such difference (OECD 2010a: 66).

According to OECD (2010a: 65-69), resale price method is probably most useful for marketing operation carried by distributors (or resellers) where no unique intangible assets were added to goods or services before resale. They also claim that when the product difference exists, fewer adjustment is needed under this method since gross profit is less likely to be affected by the product difference. In contrast, resale price method is more concerned with functional comparability; therefore, the tax authorities and taxpayers need to take the functions performed, risks assumed and assets used by resellers into account when determining the gross profit--the profit after the cost of goods (United Nations 2013: 200-209).

Since this method compares the gross profit of the related-party with those of independent parties, it is important to ensure the accounting consistency. Tax authorities and taxpayers shall keep in mind that gross profit will not be comparable if there is the difference in accounting practice between the related-party and independent parties; therefore, the appropriate accounting adjustment is needed to achieve the data consistency for calculating the appropriate gross profit margin (OECD 2010a: 65-69, United Nations 2013: 200-209).

As the result of its dependence on comparability of functions between transactions of related-party and independent parties, there must be no difference that significantly affect the attribute being used to measure the arm's length condition of the transaction. Whenever such difference does exist, the reasonably accurate adjustment is needed to eliminate the significant effect of such difference. It is recommended that the alternative methods shall be taken into consideration if the reasonably accurate adjustment cannot be made (OECD 2010a: 65-69).

3.3.1.3. Cost plus method

Cost plus method compares mark-up of the related-party to those of the independent parties performing the comparable transaction under comparable circumstance. It will then add the appropriate mark-up to the transaction cost of related-party to determine the transfer price (Eden & Smith 2001). According to OECD (2010a: 70-75), the mark-up will be computed after the computation of direct and indirect costs of production but before the operating expenses. Furthermore, the mark-up added to these costs shall be high enough to earn sufficient profit for the function performed, risks assumed and assets used.

The cost plus method illustrated by United Nations (2013: 213) have been replicated in Figure 3 as below:

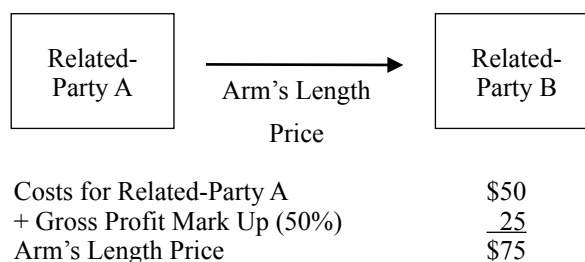


Figure 3: Cost Plus Method

The mark-up can be determined by reference to either internal comparable or external comparable. When the mark-up is obtained from the comparable transaction between a related-party and independent party, it is called internal comparable. On the other hand, the mark-up obtained from the comparable transaction between independent parties is called external comparable (OECD 2010b).

Similarly to the previous methods, the transaction of-/with independent parties will be comparable to the related-party transaction for the purpose of cost plus method if one of the following conditions is met:

- i. There is no difference that can significantly affect the arm's length price; or
- ii. If such difference does exist, the accurate adjustment shall be made to the transaction to eliminate any significant effect of such difference (OECD 2010a: 71).

According to OECD (2010a: 70-75) and United Nations (2013: 212-220), this method is similar to resale price method in the way that it is less sensitive to product comparability but is more sensitive to functional comparability. This means that anything significantly affect the gross profit mark-up as a result of differences in functions performed, risks assumed and assets used must be taken into account, and necessary adjustments shall be made to eliminate such difference.

This method is most useful for manufacturers or service providers, where no valuable or unique intangible asset is added to goods being sold or services being rendered (OECD 2012b). Similarly to the resale price method, the accounting consistency has played vital role in calculating the appropriate gross profit mark-up

under cost plus method. Tax authorities and taxpayers shall keep in mind that the appropriate gross profit mark up will not be able to determine if there is a difference in accounting practice between the related-party and independent parties. Hence, the appropriate accounting adjustment is needed to achieve the data consistency for calculating the appropriate gross profit mark-up (United Nations 2013: 212-220).

As with other methods, the reliability of the cost plus method depends on the comparability of the tested transaction with those of-/with independent parties. When there is a difference that can significantly affect the arm's length price of the transaction, the appropriate adjustment shall be made to eliminate such difference. Alternative methods shall be taken into consideration if such adjustment cannot be made (OECD 2010a: 67-69).

3.3.2. Transactional profit methods

In cases where traditional transaction methods are not appropriate for setting transfer price due to its lack of comparability or reliability, OECD (2010a: 60) recommends the use of transactional profit methods. The transactional profit methods examine the profit that arises from a particular transaction among related-party to those independent parties. Two transactional profit methods that are accepted under OECD Guideline are (1) profit split method and (2) transactional net margin methods (OECD 2010a: 77). This section aims to provide the overview of such two methods.

3.3.2.1. Profit split method

The profit split method is often used in cases when comparability doesn't exist due to the transaction of related-party is too interrelated that it is not possible to evaluate the transactions independently (United Nations 2013: 250) or in cases where both related-party have contributed unique or valuable intangible assets to the transaction(s) (OECD 2010a: 93). Such unique conditions can be eliminated by determining the profit of each related-party that will be expected to earn from

engaging in the comparable transactions of the independent parties (OECD 2010a: 93).

To apply this method, it is necessary for tax authorities and taxpayers to identify the combined profit. Then such combined profit will be divided among related-party based on their relative contributions to the transaction(s) by taking the account of functions performed, risks assumed and assets used. In cases where the comparable market data are available, it is possible for the tax authorities and taxpayers to divide the combined profit based on such comparable data. By doing so, the division of profit will be most likely reflected what will be expected from the comparable transaction(s) of the independent parties. This method will be equally applied in case of losses (OECD 2010a: 93-95, United Nations 2013: 247).

There are two approaches used to split the profit among related-party, which are discussed below:

- i. Contribution analysis: The main idea of this approach is to allocate the combined profit among related-party as if it is expected to be split among independent parties. In cases where the external market data is available, such combined profit shall be allocated by reference to the market data to reflect the division of profit in the comparable transactions of independent parties. However, in cases where such external market data is not available, the profit shall be split based on the value of their relative contributions by taking the account of functions performed, risks assumed and assets used (OECD 2010a: 96-97, United Nations 2013: 247).
- ii. Residual profit split analysis: According to OECD (2010a: 97-98), there are two stages of profit division under this approach. In the first stage, after the combined profit has been identified, the sufficient profit will be split among the related-party based on their functions performed. In this stage, the profit being allocated will account for the routine functions performed by each related-party. Practically, this part of profit can be determined by using either

traditional transaction methods or transactional net profit margin (TNMM). In the second stage, the residual profit will be split among the related-party based on the facts and circumstances of the transactions; therefore, the treatment of this part of profit division will be varied case-by-case. The division of profit in this stage will account for the unique or valuable assets used in the transactions. The residual profit split analysis is often used in cases where the unique or valuable assets are contributed by both (or all) parties of the transaction. On the other hand, resale price method, cost plus method or TNMM will be used where the unique or valuable assets are contributed by only one party of the transaction ([United Nations 2013: 247-250](#)).

In order to determine the combined profit under this method, it is necessary for the tax authorities and taxpayers to find the relevant transactions needed to be covered and all parties involved in the transactions. The combined profit used to split among the related-party under this method is usually operating profit(loss), however, gross profit can be used if it deems appropriated ([OECD 2010a: 98-100](#)).

To apply the profit split method, it is essential to take reliability of the method into account. Since the implementation of this method generally depends on fact and circumstance of cases and the availability of information, tax authorities and taxpayers must allocate profit that will be most likely expected in the comparable transactions of independent parties. To be able to approximate such division of profit, the functional analysis, the determination of combined profit and splitting factors and the approach used for determining the division of profit of the related-party shall be consistent with those used by independent parties. Moreover, accounting practice can be varied among businesses, hence, the adjustment of the accounting data is needed to maintain the accounting consistency. Without this consistency, the appropriated division of profit--and thus arm's length price--cannot be made ([OECD 2010a: 93-104](#)).

3.3.2.2. *Transactional net margin method*

Transaction net margin method--so called TNMM-- is the indirect method used to find the arm's length price of the related-party transactions by comparing the level of profitability of related-party transaction with those of independent parties. It is generally used to compare the net profit margin acquired by related-party transaction with those acquired by independent parties. By determining the net profit margin, the appropriate base--which can be cost, sale or asset--must be chosen carefully ([United Nations 2013: 223-224](#)).

Similar to resale price and cost-plus methods, the net profit indicator of TNMM can be determined by reference to either internal or external comparables. When the net profit indicator of related-party are reference to the net profit indicator obtained in the transactions between related-party and independent parties, it is called internal comparable. On the other hand, the external comparable is obtained in the transactions between independent parties. To implement this method, the tax authorities and taxpayers need to identify the tested party, the participant of the related-party transaction used to apply transfer pricing. Basically, the least complex party with no valuable or unique asset will be chosen since it has more reliable information available and less adjustment needed to establish the comparability ([OECD 2010a & 2012b](#), [United Nations 2013: 223-224](#)).

Unlike the resale price and cost-plus methods, TNMM uses the net profit instead of gross profit. Therefore, TNMM is more appropriate in cases where two previous methods cannot be used due to the inaccurate adjustment of gross profit. The net profit used to determine the transfer price under this method is generally the operating profit, the profit before interest and income tax expenses. Operating profit under TNMM will only include incomes and expenses from normal operating activities that are related to the transactions in question into transfer pricing calculation; any extraordinary items, such as nonrecurring activities, shall be excluded from such calculation ([OECD 2010a: 77-92](#)).

The comparability analysis is also required in applying the TNMM. Where price and gross profit margin can be significantly affected by product and function differences, respectively, net profit margin under TNMM are less likely to be affected by such differences. However, net profit margin can be significantly affected by factors--such as difference in cost of capital, degree of business experience and management efficiency--that are unrelated to transfer pricing. To mitigate the impact of the inaccuracy of comparative information due to the effect of such factors, TNMM has established the arm's length range for the transfer price instance of one single transfer price. Furthermore, the accounting adjustment is needed to maintain the accounting consistency and thus comparability between parties. Without the accounting consistency, the reliability of comparables will not be established. Similar to other methods, the reasonable adjustment shall be made to eliminate any differences between the tested party and comparables that are significantly affect the the comparability of the transactions ([OECD 2010a: 77-92](#)).

The appropriateness of profit level indicator (PLI) to be used for comparing the level of profitability between comparables and tested party depends on the fact and circumstance of the cases. The PLIs that are commonly used in practice are return on equity employed (ROEC), return on equity (ROE) and operating profit margin (OM). According to various studies, it was found that when the assets have played a significant role in generating income--for example in manufacturing businesses--it is recommended to use the ROEC or ROE, in which denominators come from balance sheet. On the other hand, the businesses--such as service providers and distributors--that are not relied on fixed assets to generate income will use the PLIs with income statement figure as denominator. Sometimes, it may be useful to examine several profit level indicators for particular transaction. If the multiple PLIs are used and such indicators yield the consistent results, it will be reassure the reliability of the examination. Whereas, the inconsistent results may inform that additional functional analysis may be needed ([United Nations 2013: 234-237](#)).

4. COMPARABILITY ANALYSIS

To establish the transfer price that will be justifiable for the tax purpose, it is important to find the arm's length price of the comparable transactions under comparable circumstances of the independent parties. Since such arm's length price relies on the reliability and comparability of the transaction, the comparability analysis comes into play. The purpose of this comparability analysis is to obtain the highest degree of comparability of the transactions. It shall be kept in mind that reliability and availability of the data are needed to take into consideration when searching for the comparables to establish the closest approximation of arm's length price (OECD 2010a: 41-51; United Nations 2012).

As mentioned earlier, the transactions will be comparable if there is no difference that can significantly affect on the arm's length price or such difference can be eliminated by the appropriate adjustments. To establish the comparability and make any appropriate adjustments as needed to achieve the arm's length conditions, the attributes of transactions--characteristic of goods and services, functional analysis, contractual terms, economic circumstances, and business strategies--that can significantly affect the arm's length price must be compared. The degree of importance of such attributes to the comparability depends on the nature of transactions and transfer pricing methods being used. (OECD 2010a: 43).

(1) Characteristics of assets and services

It has been long known that difference in characteristic of assets and services can end up with difference in value of assets and services. Therefore, tax authorities and taxpayers need to consider this feature when evaluating the comparability of the transactions. There are several important characteristics need to be considered when making comparison--for example, in case of transfer of tangible assets are physical features, quality of the assets, volume and availability of supply and demand. Nature and extent of service shall be taken into account when determining the transfer price

for services transferred. In case of intangible asset, the duration and form of assets, for example, will be taken into account (OECD 2010a: 44).

Different transfer pricing method will give different weight to this feature. Since CUP is the direct transfer pricing method, it gives the highest weight to this features. Any difference in this feature can lead to the price difference, therefore, the appropriate adjustment shall be made to establish the comparability. In contrast, there are few characteristic of assets and services that can significantly affect gross profit margin under resale price and cost-plus methods; it is even less likely to affect the net profit margin in TNMM (OECD 2010a: 44-45).

(2) Functional analysis

In the opened market, the compensation of the transaction between independent parties will reflect the functions performed, assets used and risk assumed that are undertaken by each party to the transaction. The functional analysis will compare economic activities and responsibilities, which can significantly affect the arm's length price, undertaken by the parties to the transaction. When making the comparison, the activities that need to be considered are, for example, research and development, marketing and distribution, manufacturing and production process. Furthermore, the consideration in assets used and risk assumed shall also be included in this comparability analysis. The assets mentioned here can be either tangible assets--such as research and development equipment, vehicle and property, plants and equipments--or intangible assets such as patents or trademarks. Furthermore, tax authorities and taxpayers are required to identify who bears the risks--for example, financial risk, market risk and production risk--assumed in the transaction since such risks can also reflect in the arm's length price (OECD 2010a: 45-46).

(3) Contractual terms

The contract generally will consist of the sections that state how responsibilities, risks and benefits will be divided among the involved parties in the transactions. The

term of transactions can be found in either written or verbal arrangement. However, where such arrangement is impossible, the terms of transaction can be evaluated from the economic substances or functions performed by the involved parties. The tax authorities shall examine whether the arrangement made between the related-party has been implemented since the incompliance can mislead the tax authorities in evaluating the appropriated transfer price. Furthermore, it shall be noted that difference in contractual terms between those of related-party and independent parties can significantly affect the price or margin of the transactions; therefore, the appropriate adjustment is required as necessary (OECD 2010a: 47-48 United Nations 2013: 136-139).

(4) Economic circumstances

Since price of the transactions can be varied across the markets even though the products sold or services rendered are similar, there is a need to identify the relevant market when finding the comparables. Furthermore, there are additional several economic circumstances--for example, the business cycle, extent of competition, nature of government regulation and time of transactions--that shall be taken into considerations when making the comparability analysis. Depending on the fact and circumstance of the cases, the difference in economic circumstance that can significantly affect the price of the transactions shall be identified and appropriate adjustment shall be made to eliminate such effect (OECD 2010a: 48-49, United Nations 2013: 139-145).

(5) Business strategies

This feature is to compare the factors that are relating to the daily operations of the businesses, such factors are--for example--diversification of businesses, launching of new products, and market penetration. If the taxpayers have implemented the business strategy for market penetration, for example, by setting low transfer price with the hope to earn higher income in the future, there are several things tax authorities shall do when evaluating the transfer price of related-party transaction.

The tax authorities shall investigate the conducts of the related-party to ensure that they are in consistent with the business strategy. Furthermore, the nature of relationship between the involved parties shall reflect the taxpayers who bear the cost of such business strategy. Tax authorities, sometimes, can challenge the MNEs on the transfer pricing issue if the implementation of business strategy hasn't earned sufficient profit over several years (OECD 2010a: 49-51 United Nations 2013: 145-148).

5. TRANSFER PRICING AND SHAREHOLDERS' VALUE

Transfer pricing, currently, is recognized as the most important international tax issue by both MNEs and tax authorities around the world (Ernst & Young 2006 via Sikka & Willmott 2010). The recent research by United Nations (2013: 1) has found that related-party transactions are accounted for about thirty percents of international trade. From this research, it can be noticed that transfer pricing is increasing its importance in today's world trade.

Since MNEs operate its businesses in several jurisdictions where tax rate may be differed, it is possible that such MNEs will take the advantage of such tax difference through transfer pricing to reduce its global tax expenses. Baker (via Morais 2009) claims that by mispricing the related-party transactions the MNEs can facilitate tax avoidance and capital flight from developing countries to developed countries, thus deteriorating the social welfare. Furthermore, he cites that more than sixty percents of illicit flow of capital around the world are accounted for tax evasion through transfer pricing, which is two times more than criminal activities, bribery and theft.

As the result of the loss of tax revenue from the aggressive transfer pricing by MNEs together with the budget deficit, tax authorities around the world have come up with several methods to protect their tax bases and meanwhile increasing their tax revenue. They are increasing their scrutiny in tax audit by tighten up the transfer pricing regulation and legislation, train more tax officials in transfer pricing area, enforce a high documentation requirement and impose a high financial penalties. There are evidences shown that by increasing their scrutiny in tax audit, especially in the area of transfer pricing, the governments can collect additional tax payment from millions of dollar to billions of dollar each year (Cools 2005, Sikka & Willmott 2010).

MNEs shall notice that different country may adopt and apply their transfer pricing laws and regulations differently; and by not complying with countries' legislations, it can put the MNEs at risk of additional income tax adjustment, penalties and even

double taxation ([Sanschagrin & Isensee 2013](#)). As the result of such undesirable consequences which can eventually increase the effective tax rate and thus hurts the shareholders' value, several transfer pricing experts have suggested that transfer pricing shall be taken into risk management issue; the board of directors and top management shall be aware of their corporate transfer pricing practice and take it into consideration when making a strategic planning that can affect their tax structure and their tax position ([Kobel 2009](#), [Loh 2013](#), [PricewaterhouseCoopers 2010](#)).

According to [Kobel \(2009\)](#), there are several risk factors that MNEs shall consider when setting their transfer pricing strategy: tax audit risk (so called cashflow risk), accounting risk, reputation risk, and regime risk. Tax audit risk is the risk of being audited by one or more tax authorities which can end up with the unexpected cash outflow relating to previous accounting period as the result of tax incompliance. Accounting risk is the risk associated with the unexpected change in company's financial position as the result of unexpected accounting adjustments. Reputation risk is the risk that company will loss its reputation from having negative headline news. Regime risk is the risk of unexpected change of future cashflow due to the change in governmental legislations.

These risk factors can significantly affect shareholders' value, and it can be seen from several cases; the most recent and famous cases are Starbucks, Amazon and Google operating its businesses in United Kingdom. These MNEs have been challenged by Her Majesty's Revenue & Customs (HMRC) for not paying taxes or less taxes than their competitors through the use of transfer pricing strategy ([British Broadcasting Corporation 2013](#), [Neville & Treanor 2012](#)). However, in this paper, we will use Starbucks as a demonstration on how such risks can affect the shareholders' value.

It has been known for more than decades that businesses have obligation to maximize its shareholders' value. However, as the corporate governance is increasing its importance in today's business world, businesses need to take other stakeholders' interest, especially tax authorities, into account when doing their businesses

(PricewaterhouseCoopers 2010, Sikka & Willmott 2010). According to Cadbury (via Cools 2005), good corporate governance shall provide the transparency and accountability of the fair income distribution between shareholders and society and, thus, between tax jurisdictions.

Starbucks, through the use of transfer pricing, has paid its corporate income tax to HMRC only once--or just about £8.6 millions--over the past fifteen years during its operation in United Kingdom. Starbucks avoids its tax payment over the past three years by making payments to its related-party in Netherlands and Switzerland for its royalty fee and coffee bean, respectively. Since Reuters has exposed its complex tax arrangement, the UK public has demanded Starbucks to make tax payment to HMRC. Likewise, some of coffee drinkers have boycotted Starbucks and shifted their preference to Costa coffee. According to the preference survey by YouGov, they find that Starbucks coffee drinkers have dropped from 22.7% to 15.4% after its tax arrangement has been exposed, while the Costa coffee drinkers have risen from 31.8% to 39.4%. To protect its reputation, Starbucks has announced that it will claim no tax deduction on related-party transactions fee in 2013 and 2014. Furthermore, it will voluntarily pay £10 millions in corporate income tax each year in 2013 and 2014, which amount is two times more than taxes it has been paid to HMRC over fifteen years it has its operation in UK (British Broadcasting Corporation 2012, Bowers 2013, Neville & Treanor 2012).

From the Starbucks case, we can see that the associated cost of transfer pricing shall be considered as the tax expenses, which will eventually reflect in the global effective tax rate of the MNEs. Kobel (2009) has demonstrated on how effective tax rate can have the impact on shareholders' value by simply computing economic value added (EVA) of the MNEs. EVA is the tool used to evaluate whether the management has created or destroyed the shareholders' value by evaluating the true business profit after accounting for the cost of capital.

Economic Value Added (EVA) is calculated as:

$$EVA = (ROIC - WACC) \times Invested\ Capital \quad (1)$$

or

$$EVA = \frac{NOPAT - (WACC \times Invested\ Capital)}{Invested\ Capital} \quad (2)$$

because ROIC in equation (1) can simply computed as:

$$ROIC = \frac{NOPBT}{Sales} \times \frac{Sales}{Invested\ Capital} \quad (3)$$

Furthermore, the ROIC can be calculated as:

$$ROIC = \left(\frac{Total\ tax\ expenses}{NOPBT} \right) \times (1 - ETR) \quad (4)$$

where

$$ETR = \quad (5)$$

where $ROIC$ = Return on invested capital

$WACC$ = Weighted average cost of capital

$Invested\ Capital$ = Total cash invested in firm, net of depreciation

$NOPAT$ = Net operating profit after taxes

$NOPBT$ = Net operating profit before taxes

ETR = Effective tax rate

From the above formula, it can be advised that MNEs can simply create the shareholders' value by following: (1) minimizing the effective tax rate of the enterprise, (2) increase its efficiency in generating revenue from invested capital (or capital turnover), and (3) increase profitability by reducing cost and improving its production efficiency (or operating profit margin) (Kobel 2009).

Since transfer pricing is considered as one of the potential way to minimize MNEs' global effective tax rate and vice versa, it is essential for top management and even board of directors to involve transfer pricing issue into risk management (Loh 2013, PricewaterhouseCoopers 2010). As Angeline Ziouclas (via Financial Post 2013), a transfer pricing expert, claims that transfer pricing is the art not science, the MNEs can be put at risk when implementing transfer pricing as it is in the grey area of the interpretation of fair share of taxes between tax jurisdictions. Therefore, to prevent tax dispute with tax authorities, several researchers and transfer pricing experts have suggested MNEs to use the proactive approach to minimize risks associated with transfer pricing practice. The proactive approach includes the establishment of transfer pricing policy, improvement of tax department efficiency, acquiring the experts or their advice in setting their transfer pricing strategy, and entering into advanced price agreement (APA) (Financial Post 2013, Sikka & Willmott 2010). According to Kobel (2009), Ziouclas (via Financial Post 2013), Sanschangrin and Isensee (2013), they find that such proactive approach can improve the shareholders' value as a good proactive approach will provide the MNEs with spare time, effort and money necessary for managing its businesses.

5.1. Shareholders' value with the use of transfer pricing

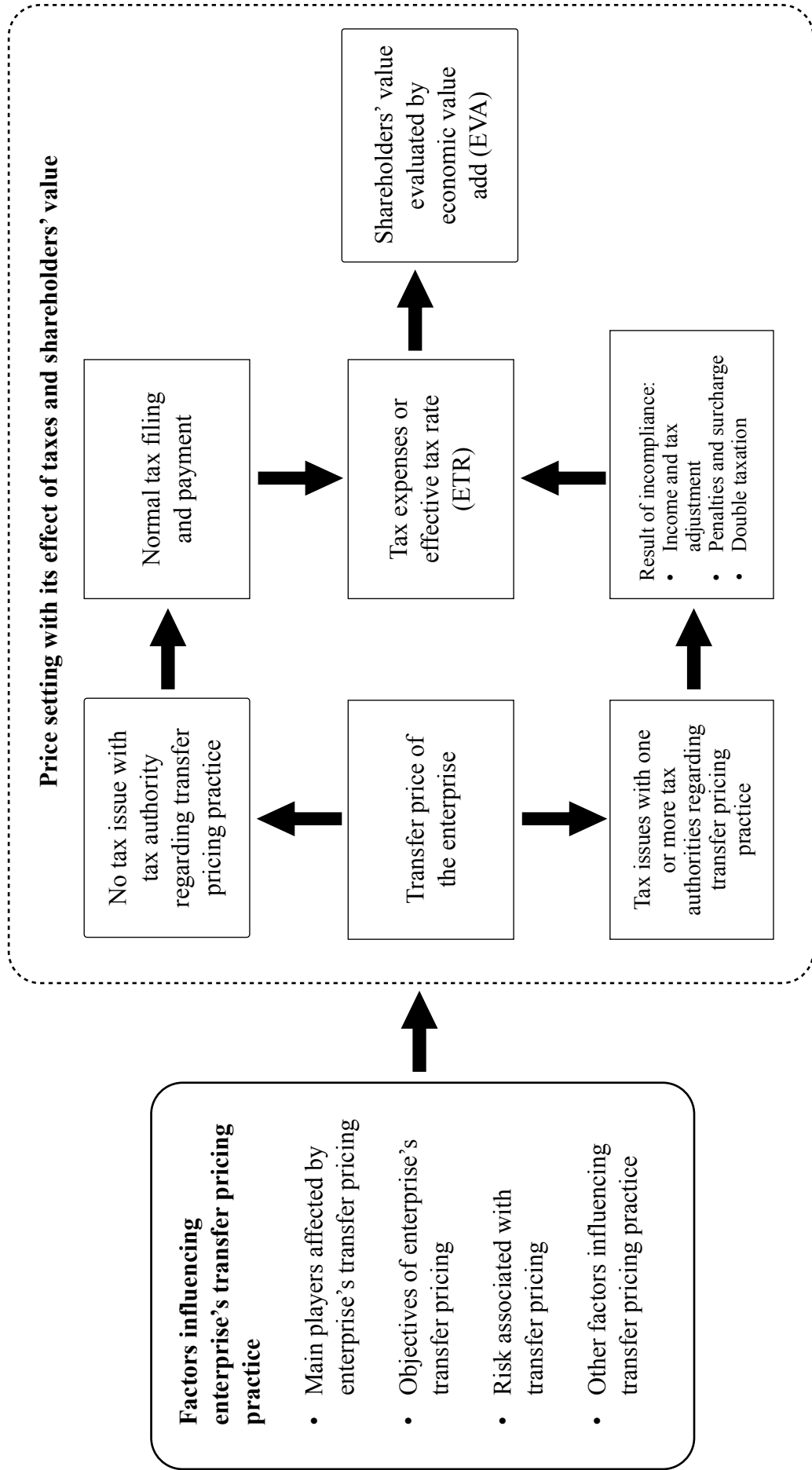
As the result of this paper, the framework used for analyzing the relationship of transfer pricing and shareholders' value can be established as seen in Figure 4. Furthermore, Table 1 summarizes the detail of factors affecting transfer pricing of the enterprises.

Table 1. List of factors affecting enterprises' transfer pricing.

Factors	Sub-factors	Authors
Main players affected by transfer pricing	- Management - Tax authorities - Shareholders	Cools (2005)

Factors	Sub-factors	Authors
Objectives of transfer pricing	<ul style="list-style-type: none"> - Tax compliance - Tax minimization - Performance evaluation - Facilitate the flow of capital 	Borkowski (1997), Drury (2004), Tebogo (2010), Merchant & Van der Stede (2007), etc.
Risks associated with transfer pricing	<ul style="list-style-type: none"> - Tax audit (so called cash flow risk) - Reputation risk - Accounting risk - Regime risk 	Kobel (2009)
Other factors affecting transfer pricing practice	<ul style="list-style-type: none"> - Proactive approach of the enterprise 	Financial Post (2013), Sikka & Willmotte (2010)

Figure 4. A framework analyzing the transfer pricing establishment and its relationship with tax expenses and shareholders' value



6. LAW AND REGULATIONS IN THAILAND

As it has mentioned in previous sections, transfer pricing can be used to maximize the enterprises' global profit at the expenses of public welfare. Many tax authorities around the world find themselves in the need of tools to counteract those aggressive transfer pricing practices. Therefore, the law has come into play. It is used as the tool to empower tax authorities to make income adjustment on related-party transactions and penalize those in compliance with tax law. In Thailand, currently, there is no specific provision for transfer pricing; however, the general provisions under Thai tax law can be used to guard against the tax avoidance through transfer pricing practice (Poshyanonda 2013). In this section, tools used for income assessment on the related-party transaction under Thai tax law will be discussed in detail.

6.1. Provisions under Thai tax law

To prevent the tax avoidance through transfer pricing, there are several provisions under Thai tax law that empower tax authorities to assess the market price of the related-party transactions. The relevant provisions will be provided below.

Provisions that give Thai tax authorities the rights to assess additional income on related-party transactions are Section 65 bis (4) and (7) and Section 70 ter of the Revenue Code, B.E. 2481 (Ernst & Young 2012: 172, KPMG 2011: 176).

Section 65 bis (4) of Revenue Code (1938) empowers the tax authorities the rights make income adjustment in case where there is no compensation or with compensation lower than the market price without justifiable reason for goods transferred, services rendered and money lent.

Section 65 bis (7) of Revenue Code (1938) allows the tax authorities to assess the cost of goods imported by comparing with the cost of goods of the same type and kind imported to other countries.

Section 70 ter of Revenue Code (1938) provides that the exporting goods to or by the order of related-party is deemed to be sale within Thailand, and the market price of such goods on the exporting day is deemed to be income of the company in that accounting period.

On the other hand, tax authorities also have a rights to disallow some expenses of the company if it deems appropriated; the relevant provisions under the Revenue Code (1938) are Section 65 ter (13), (14), (15) and (19) (Ernst & Young 2012: 172, KPMG 2011: 176).

Section 65 ter (13) and (14) of Revenue Code (1938) empower tax authorities to disallow any expenses that are not used for the purpose of generating profit or not for purpose of business within Thailand, respectively.

Section 65 ter (15) of Revenue Code (1938) provides that tax authorities has a rights to disallow any costs or expenses used in *acquiring assets* only those in excess of normal amount without justifiable reason. However, it shall be noted that this section is only applicable for acquiring asset in excess of normal amount; it is not included the case of having cost in acquiring service or loan in excess of normal amount (Chokboontiyanon, Ruengrithdech & Jaruvatee 2009).

Section 65 ter (19) of Revenue Code (1938) empowers the tax authorities to disallow any expenses that are determined on and payable from the profit after the accounting period has ended.

6.2. Double Tax Agreements between Thailand and other countries

When it comes to tax avoidance defense through transfer pricing manipulation, Double Tax Agreements (DTAs) between Thailand and other countries can come into play. Currently, Thailand has such DTAs with 56 countries worldwide. Each of DTAs of Thailand has adopted from Model Tax Convention on Income and on Capital issued by Organization for Economic and Development (OECD) (Chokboontiyanon

[et al. 2009](#)). There are several articles under Model Tax Convention on Income and on Capital that are relevant to transfer pricing and are adopted by DTAs of Thailand, and they will be discussed below.

Business Profit, which was model on Article 7 of the OECD Model, provides the Contracting States a rights to make the profit adjustment of the permanent establishment if profit of such enterprise hasn't reflected the true contribution of such permanent establishment. Furthermore, if the profit adjustment made by one of the Contracting States results in the change of income taxes, the corresponding adjustment shall also be made in another Contracting State. Article 9 on Associated Enterprises of OECD Model has provided tax authorities of Contracting States the rights to make price adjustment on the related-party transaction to truly reflect the arm's length of unrelated-party transaction under the comparable circumstance. The persons are deemed to be related if: a party directly or indirectly manages, controls or capitalizes another party; or a third party directly or indirectly manages, controls or capitalizes both parties ([OECD 2010c: 26 - 27, Chokboontiyanon et al. 2009](#)).

Interest and Royalties Articles, which are model on Article 11 and 12 of the OECD Model, provide the Contracting State the rights to adjust the interest rate and royalties charged between related-party in the amount excess of the normal market price. Article 25 on Mutual Agreement Procedure of OECD Model provides that tax authorities of the Contracting States may communicate with each other for the purpose of unresolved issue arising in the misinterpretation of agreement or unsolved issue on double taxation that does not enforce in the agreement, for example. Lastly, Article 26 on Exchange of Information of OECD Model states that tax authorities of the Contracting States shall exchange any information necessary for implementing the provision of DTAs or for the enforcement of domestic law of the Contracting States. The information shall be kept secretly and given only to the responsible persons concerned with the enforcement of such DTAs ([OECD 2010c: 29-30 & 36-38, Chokboontiyanon et al. 2009](#)).

6.3. Transfer pricing guideline

As the result of its loss of tax revenue through transfer pricing manipulation of MNEs, the Revenue Department of Thailand (TRD) becomes aware of such activities and increases its scrutiny in its tax audit of related-party transactions. Therefore, TRD has released Departmental Instruction (DI) No. Paw. 113/2545 as a guideline for the determination of market price of related-party transaction in 2002. The purpose of this guideline (2002) is to assist taxpayers in establishing their transfer price and to assist tax authorities in reviewing taxpayers' transfer price whether such price are being compliance with arm's length principle.

This guideline has adopted from OECD Transfer Pricing for Multinational Enterprise and Tax Administration (Ernst & Young 2012: 172). This DI. Paw. No. 113/2545 (2002) can divided into five clauses which can be summarized as followed:

Clause 1 provides that all companies operated within Thailand are obliged to calculate the taxable income in accordance with Section 65 of Revenue Code.

Clause 2 empowers the tax authorities to make price adjustment on the related-party transaction if such transaction is charged below or above the market price without justifiable reason. Furthermore, it also defines the market price as the price it will be expected to charge as the compensation for the transactions by independent parties, the parties in which there is no direct or indirect relationship between them regarding the management, control or capital.

Clause 3 provides the acceptable methods for setting transfer price. The acceptable methods are comparable uncontrolled price, resale price and cost price methods. However, in case where such methods are inapplicable, other internationally accepted methods can be used if appropriated.

Clause 4 provides that taxpayers are obliged to prepare transfer pricing documentation, and it shall be kept at taxpayer's office. Furthermore, it provides that, in case

where sufficient information has provided that taxpayer's transfer pricing method is best approximated the market price, the tax authorities are obliged to adopt such method for determining market price of such related-party transaction.

Lastly, Clause 5 provides that if taxpayers wish to enter into the advance pricing agreement (APA) for their related-party transactions with TRD, they can submit request to Director-General of the Revenue Department along with a relevant documents for further discussion.

6.4. Advance Pricing Agreement

As the result of unresolved issue on double taxation and its uncertainty of tax liability, advance pricing agreement (APA) has increased its importance as the tool used to eliminate double taxation and to ascertain the taxpayers their tax liabilities. APA is the agreement between tax authorities and taxpayers on the transfer pricing methodologies, its benchmarks and the agreed accounting period ([Guidance on APA Process 2010](#)). In 2010, Thai Revenue Department (TRD) has finally issued Guidance on APA process as the guideline for those taxpayers who wish to enter APA with TRD ([Ernst & Young 2012: 174](#)). According to this guideline, only businesses incorporated under Thai law who enter the related-party transaction with affiliate who are residents of Thailand's treaty partners can apply for APA with TRD. Furthermore, TRD is willing to enter in bilateral APA only. Once the APA has been accepted and decided by the tax authorities, it will be effective for three to five years accounting period depending on the agreement. Such APA will include the taxpayers' information, APA's term and conditions such as covered transaction, arm's length range or price, covered period and transfer pricing methodology the taxpayer need to be complied with ([Guidance on APA Process 2010](#)).

7. EMPIRICAL RESEARCH ON TRANSFER PRICING IN THAILAND

7.1. Transfer pricing practice in Thailand

7.1.1. Research Methodology

This research is conducted through the interview of five transfer pricing consultants, who are working in the most well-known advisory firms, and one tax officer who formerly worked in transfer pricing team of TRD. Under this research, the information gathered from these respondents are deemed to be a reliable benchmark for the transfer pricing practice of MNEs in Thailand. The table below lists the name, position, and company or organization of the respondents under this research.

Table 2. List of respondents under this research

Name	Position	Company or Organization
Anthony Visate Loh	Tax Partner, International Tax Services	Ernst & Young, Thailand
Benjamas Kullakattimas	Tax Partner, Head of Transfer Pricing Services	KPMG, Thailand
Peerapat Poshyanonda	Tax Partner, Transfer Pricing Services	PricewaterhouseCoopers, Thailand
Phongnarin Ratanarangsikul	Transfer Pricing Specialist	Dherakupt International Law Office Ltd.
Stuart Simons	Tax Partner	Deloitte Touche Tohmatsu Limited, Thailand
Krida Kritiyachotipakorn	Legal Officer (Specialist)	Thailand's Revenue Department, (Temporary Duty at Office of the Director, State Enterprise Policy Office (SEPO))

The data gathered here are best suited for the qualitative research since our data are collected from just six transfer pricing experts, and none of quantitative data can be gathered from these respondents. However, such data are deemed to be most reliable for our research since these transfer pricing experts have worked in transfer pricing area for years and have experienced various transfer pricing cases regarding

industries, sizes of transaction and transfer pricing methods. They are most likely to understand the terms and methodologies used in this research. Furthermore, as the transfer pricing experts in Thailand, they can provide us the most recent and most useful information regarding the current situation of transfer pricing practice in Thailand.

The research aims to deepen our understanding on transfer pricing practice in Thailand. In this research, the survey can be divided into two different sets, which one is for transfer pricing consultants and another is for tax officer. These two sets will have slightly different questions regarding transfer pricing practice in Thailand; this is to gain different perspective on transfer pricing practice from both taxpayers and tax authorities. This survey is used to gather informations as follow:

- Level of knowledge of taxpayers regarding tax and transfer pricing issues,
- Transfer pricing methods implemented by taxpayers,
- Arm's length method implemented by taxpayers,
- Motivation of taxpayers for using transfer pricing strategy,
- Other facts related to current situation of transfer pricing practice in Thailand,
- Transfer pricing and its effects on shareholders' value, and
- Future trend of transfer pricing in Thailand.

Some questions of this survey are acquired from Pedersen's research survey (2011), and they are as following: level of knowledge of taxpayers regarding tax and transfer pricing issue, transfer pricing methods implemented by taxpayers, arm's length method implemented by taxpayers, and motivation of taxpayers for using transfer pricing strategy. The surveys of this research will be listed in Appendix 1 and Appendix 2 at the end of this thesis paper.

7.1.2. Research Result

Question 1 tries to determine the level of knowledge of taxpayers regarding the tax issues in Thailand. From our research, we find that when it comes to general tax

issue such as corporate income tax (CIT), withholding tax (WHT) or value-added tax (VAT), the taxpayers--basically MNEs in this case--will generally have good knowledge in such area. However, when it comes to transfer pricing issue, the answers from respondents are more detail. According to Loh (2013), Poshyanonda (2013) and Kullakattimas (2013), the level of knowledge of transfer pricing advisory clients is hard to determine since it depends on the person whom they are dealing with; whether they, the representatives from MNE in question, are sent from local branch, regional branch or headquarter, and what position do the representatives hold. According to information gathered from our respondents, we can conclude that if the representatives are sent directly from regional branch or headquarter, they are likely to have good knowledge on transfer pricing, especially those representatives who hold transfer pricing (TP) director position. In contrast, if the representatives are sent from local branch, they are likely to have low or even no knowledge on transfer pricing since transfer pricing is still a new area in Thailand.

Question 2 examines the methods used by taxpayers for setting their transfer price, and whether taxpayers use different sets of books for their tax and management purpose. From our research, we find that most of the companies in Thailand will use either full cost plus a mark up or resale price (or market price) minus profit margin method, in which method chosen will depend on type of businesses itself. The full cost plus mark up will generally use in manufacturing business while the resale price will be used in distribution business.

When it comes to the sensitive question regarding the booking system of clients, all of our respondents replied that all of their clients use only one set of book for both tax and management purposes. As it is illegal for maintaining two sets of books in Thailand, all of the respondents are unwilling to provide any transfer pricing service if they do know that their clients have maintained two different sets of books for different purposes.

Question 3 examines the arm's length method used by Thai taxpayers to test the price of their related-party transaction. From our research, we can conclude that transfer

pricing can be divided into two different processes, which are setting and testing. To establish the appropriate transfer price, businesses need to consider the business model of the transaction in question; this basically means that businesses need to take the functions performed, risks assumed and assets used into their consideration when establishing their transfer price. For example, in Thailand, the cost plus and resale price methods are commonly used for manufacturing (or service) and for trading (or distributing) industries, respectively.

In contrast, when it comes to test transfer price of the related-party transaction, the most widely used method in Thailand is transactional net margin method (TNMM). As the result of the availability of information needed for determining the arm's length price, TNMM has been most widely used since it uses the net profit margin for determining the appropriate transfer price. Therefore, this method is likely to provide the most reliable result since the accounting consistency can be ensured. Testing the transfer price under this research means to verify TRD that transfer price of the related-party transaction is at arm's length (or market price), and vice versa.

From our research, we have noticed that there are few database available in Thailand currently. For TRD, they have the rights to access the database available within their organization, which consists of all company's corporate income tax returns, audited financial statements and statement of directors. The tax authorities will use this available information to find the appropriate comparables for testing the transfer price of the tested transactions. Unfortunately, this database will not be publicly available; therefore, many consulting firms--and taxpayers themselves--have to turn to other database. For example, the taxpayers can have electronically accessed of other business information through subscription of Business Online (so called BOL) for the brief description of the businesses--such as type of business, percentage of shareholding, and name of auditor--and financial summaries. It shall be noted that BOL has operated its businesses by cooperating with Department of Business Development, Ministry of Commerce, to provide basic information on registered companies in Thailand. Since this database provides just a basic information needed for comparables selection, taxpayers may need to obtain the photocopy of audited

financial statement along with note to financial statement at Department of Business Development once the potential comparables have been selected for further comparability analysis.

Question 4 examines the main motivations and objectives of taxpayers for implementing transfer pricing strategy. Based on our research, we have come up with the same result from all five respondents that main motivations and objectives of their clients to engage in transfer pricing strategy will be either tax minimization or tax compliance.

Tax compliance under this research, somehow, can be referred as either proactive approach or defensive approach. From this research, we can simply conclude that any MNEs that originally come from countries with good corporate governance concern will have primary objective as tax compliance. These MNEs will prepare transfer pricing documentation as one of the company's policy. This is to provide the proof to tax authorities that their transfer price has been established at arm's length and to mitigate the risk of income adjustment by tax authorities as stated in DI No. Paw. 113/2545. On contrary, there are MNEs that seek for transfer pricing service after they have been audited by tax authorities. In such case, these MNEs will seek transfer pricing documentation to defense any income adjustment or penalty that can be arisen from transfer pricing audit.

Tax minimization, on the other hand, is more concern with tax planning or risk management in our respondents' perspective. This means that it is not only involved with transfer pricing documentation but also the resources allocation between tax jurisdictions. Since transfer price shall reflect the functions performed, risks assumed and assets used, it is essential to keep in mind that when MNEs want to implement transfer pricing strategy, they also need to change their business structure such as off-shore, eliminate or merge department(s) between branches in question. Once the strategy has implemented, MNEs also need to prepare transfer pricing documentation illustrating the establishment of their transfer price.

Furthermore, we find that the main objective of serving clients of these respondents is to help their client to minimize their tax expense and its related exposure. This can be simply said that they view transfer pricing as one of the risk management area, in which a good management can help increase the company's value and minimize the negative surprise that can possibly incur.

Question 5 studies the facts related to transfer pricing practice in Thailand, such as the red-flags of being audited by TRD, the industry or even nationality of the MNEs that will be focused by TRD. This study can help us to easily understand the current situation of transfer pricing practice in Thailand, and it will be discussed in detail below.

(1) Preparation of transfer pricing documentation by taxpayers

Since transfer pricing is still a new area in Thailand, therefore, there may be some MNEs that do not prepare transfer pricing documentation. Furthermore, there are companies that may not be aware of this since DI Paw. No. 113/2545 is not a law but just an instruction released by TRD in 2002. We find that, from transfer pricing consultants' perspective, there are companies that do prepare transfer pricing documentation on the regular basis--in this case, yearly--and there are companies that never prepare such documentation.

The companies that prepare transfer pricing documentation on regular basis usually are large MNEs that may originally come from countries with good corporate governance concern or developed countries with transfer pricing provisions incorporated in its laws. These companies usually have transfer pricing documentation, but it may be kept in regional branch or headquarter instead. Such documentation may refer as regional or global documentation, which can satisfy TRD by some degree. However, TRD will eventually ask taxpayers to prepare the local transfer pricing documentation, which consists of functional analysis, company analysis, industry analysis, and economic analysis. Out of these analyses, the economic analysis is the most important one in which TRD will accept only Thai

comparables as their benchmark. Transfer pricing consultants, nevertheless, will recommend taxpayers to prepare other analyses using the local information; this can help explain TRD the reasons for the appropriateness of their transfer price.

When it comes to tax officer's point of view, on contrary, we find that taxpayers have always prepared their transfer pricing documentation. However, the respondent gives the comment that such documentation has been maintained as the result of good accounting control which may be suggested by advisory firms or as the part of the head quarter's order or the company's policy itself. This outcome is conflict from those received from transfer pricing consultants, which can result from taxpayers seeking transfer pricing service right after the tax authorities' request of transfer pricing documentation.

(2) Factors causing tax audit by TRD regarding transfer pricing

When talking about factors causing transfer pricing audit by TRD, we yield the same result from all respondents--both transfer pricing consultants and tax officer. The main factors causing transfer pricing audit will be loss and profit margin lower than industry average assuming there are substantial related-party transactions. Though choice listed in our survey are all potential red-flags for being audited by tax authorities, loss and low profit seem to be the most important factors in transfer pricing experts' perspective. On contrary, lack of transfer pricing documentation does not play such an important role as it has previously mentioned that it is just a new area in Thailand. Furthermore, there are few tax officers who have been trained in the field of transfer pricing. It is no wonder that the audit for this issue may not occur in general.

(3) Primary industry that will be focused by TRD in case of transfer pricing audit

We find that, currently, there is no focused industry for TRD when it comes to transfer pricing audit. However, it seems that automotive, electronic and consumer goods are often audited by TRD. This is, however, not a result of being focused by

TRD, but they are just among largest industries that have high foreign investments in Thailand. Hence, when it comes to transfer pricing audit, these industries will generally have such issue.

(4) Nationality of parent of MNEs and the tax audit

From our research, we find that there is no preference over the nationality of parent company of MNEs when it comes to transfer pricing audit. Japanese companies, nevertheless, have been audited by TRD most. But this is not the result of tax authorities' preference, but it is just a result that Japanese holds the largest foreign investment in Thailand comparing to other nationalities. We do find that Thai companies are less likely to be audited by TRD for their related-party transactions assuming there are businesses received tax holidays, such as Board of Investment of Thailand (BOI). We can conclude that domestic transfer pricing is not focused by TRD as it will be expected from those international transfer pricing practice.

(5) Mitigation of transfer pricing audit by TRD

There are two ways that can be used to mitigate the risk of being audited by TRD, which are preparing of good transfer pricing documentation and entering advance price agreement (APA). Based on our research, we find that all our respondents--including tax officer--will suggest taxpayers to prepare transfer pricing documentation as the first alternative and enter APA as the last resort. The good transfer pricing documentation can help mitigate the risk of income adjustment by tax authorities as provided in Clause 4 of DI Paw. No. 113/2545. Furthermore, transfer pricing documentation is the first thing tax authorities will ask for when they suspect of the transfer pricing practice; thus, by having a good documentation can somehow prove the tax authorities that you at least have followed DI Paw. No. 113/2545.

Since there are at least four parties--two tax authorities and two taxpayers, in case of bilateral APA--involved in APA, it is costly and time consuming. It shall be noted

that APA process can take from months to years before reaching the conclusion. However, it does provide the taxpayers with several advantages: first, it provides taxpayers certainty for their establishment of transfer price; second, it can eliminate the problem of double taxation and tax dispute with relevant tax authorities. Therefore, transfer pricing experts will only suggest taxpayers to enter APA if they have significant related-party transaction, double taxation or tax dispute with two or more tax authorities on certain related-party transaction. As the result of its large investment requirement and time consuming, it is therefore important for taxpayers to do the cost-benefit analysis when they take APA into their consideration.

(6) Principle of comparables selections of TRD

From this research, we also try to find the possibility of comparables rejections by TRD and its principle of comparables selection of TRD. From our research, we do find that there are many cases that tax authorities have rejected the economic analysis or comparables selected by taxpayers. It shall be noted that by having transfer pricing documentation does not mean that taxpayers will not be audited by tax authorities. In contrast, it is just a proof to tax authorities that taxpayers have complied with DI Paw. No. 113/2545. The reason for the tax authorities' rejections of taxpayer's comparable can be due to several reasons, such as foreign comparables and comparables in different industries. We find that the basis of comparables selection will be mainly relied on sufficiency and reliability of information, which can be, for example, financial information from financial reports and industrial or economic information from external sources such as news. It, sometimes, is likely that it will end up in the negotiation between tax authorities and taxpayers on the appropriated comparables since transfer pricing is much like an art of interpretation rather than science.

Question 6 uses to determine how important transfer pricing is to the shareholders' value in transfer pricing consultants' point of view. From our research, we find that all our respondents think that transfer pricing can significantly affect cost of doing business--in this case taxes--and, thus, shareholders' value. Therefore, good transfer

pricing strategy can help reduce such cost and increase the shareholders' value, and vice versa. However, it is difficult to say whether transfer pricing in Thailand can significantly affect the MNEs as the whole since it depends on the significance of the transactions and size of the penalty to the whole organization, too. It, nevertheless, does have a significant impact on the shareholders' value of the local branch at least.

We do find that compliance risk holds the most concern when talking about transfer pricing since the incompliance can lead to large income adjustment and stiff penalty, which can eventually lower the shareholders' value. Since transfer pricing practice is in the gray area of judgement, it can put taxpayers at risk when transfer pricing audit takes place; it is likely to end up that taxpayers may have to make small income adjustment or even encounter with some penalty in Thailand. We also find that reputation risk, on the other hand, is not the concern for the transfer pricing consultants. This can be result that transfer pricing is still unaware by most of Thais, and it is rarely published in press when there is transfer pricing case in Thailand.

Question 7 tries to discover the trend of transfer pricing practice in Thailand from transfer pricing experts. Based on our research, we can conclude that transfer pricing practice will be more severe and more complex in the near future as the result of tax competition. Currently, Thailand has reduced its corporate income tax rate--from 30 percent to 20 percent--and may be expected to reduce further if the Asean Economics Community (AEC) becomes effective in 2015; this is to encourage the foreign direct investment (FDI) to the country.

As the result of these changes, transfer pricing is expected to be more severe in Thailand, which can be seen that transfer pricing audit has arisen since more and more tax officers have been trained in this area. Furthermore, it is expected that TRD will soon incorporate transfer pricing provision(s) into its tax law. By having specific transfer pricing provision(s), it can provide several advantages to both taxpayers and tax authorities. It provides taxpayers transparency on the establishment of transfer price, and it eases the tax officers on the transfer pricing audit. It shall be noted that currently there is no specific provision for transfer pricing under Thai tax law;

therefore, tax authorities has adopted Section 65 bis and Section 65 ter for the income adjustment and expense disallowance, respectively. This can occasionally causes problem when adopting such sections as it uses lots of judgement for its implementation with transfer pricing and thus puts the country at disadvantages. By having such law, the country can possibly attract more foreign investment due to its transparency and, meanwhile, proves to other tax authorities that they do have specific regulations for anti-tax avoidance.

7.2. Research analysis and discussion

Transfer pricing, as previously mentioned, has increased its importance around the world as its aggressive practice can be deemed as the tax avoidance or tax evasion. Therefore, tax authorities around the world, including Thailand, have taken its actions to prevent such aggressive used of transfer pricing. This thesis paper aims at deepen our understanding on the transfer pricing practices in Thailand through the interviews of six transfer pricing experts, who have been worked in this field for years and experienced in various transfer pricing cases. From our research, we find that many Thai taxpayers have very low or even no knowledge in transfer pricing, and there are reasons behind this. First, transfer pricing, though has long been taught in accounting school, is still a very new area to Thais. Second, DI Paw. No. 113/2545 is just a guideline released by TRD which practically has no legal enforcement (KPMG 2011:176) ; thus, it is possible that many taxpayers will be unaware of this guideline.

When it comes to the establishment of transfer price in Thailand, all of respondents do give the consistent result, which they are all referred to the arm's length price. Though we do find that there is only single set of book is used for different purposes, transfer pricing can be divided into two process--which is basically setting and testing. Practically, when businesses want to set up their transfer price, they will choose those methods that best suit to their business model by taking functions performed, risks assumed and assets used into their consideration. Under this research, we do find that the most commonly used methods are cost-plus a mark up

and resale (or market) price plus profit margin methods. Our result is consistent with those recent empirical findings listed in Table 3 that most of the MNEs use cost-based transfer price. However, we do find that resale price is the other method used in Thailand, which does not exist in other empirical findings except those found in Pedersen's research. This can be a result that it is illegal to use two sets of books in Thailand, therefore, when businesses set their transfer price they will immediately choose those methods accepted by OECD and best estimate the arm's length price of the transaction.

Table 3. Empirical findings on multinational transfer pricing practices (in percentage)

	U.S. Tang (1992)	U.S. Cravens (1997)	U.S. Tang (1998)	Norway Pedersen (2011)
Cost-based	41.0	42.0	43.0	55.1
Market-based	46.0	33.0	36.0	17.6
Negotiated	13.0	18.0	14.0	20.0
Dual	-	7.0	-	2.5
Resale price	-	-	-	5.0
Other	-	-	7.0	-

Sources: Pedersen 2011

From our research, we find that about (or even more than) 99% of transfer pricing cases in Thailand will use TNMM to test the arm's length price to and by tax authorities. This result is consistent with statistics collected by tax authorities in several countries--which will be listed in Table 4--where TNMM is mainly used for their transfer price establishment either in unilateral or bilateral APA. As the result of availability and reliability of information together with accounting consistency, it is expected that TNMM will be widely used since it helps eliminate such problems.

Table 4. Statistical result for the use of transfer pricing methods in APA of Japan, South Korea and United States of business year 2011 (in percentage)

	Japan	South Korea	United States
CUP methods	3.30	-	6.45
Resale price method	0.83	4.17	-
Cost plus method	4.13	-	6.45
Profit split method	21.49	4.17	6.45
TNMM	57.85	91.66	64.52
Other	12.40	-	16.13

Source: National Tax Agency (NTA), Japan 2012; National Tax Service (NTS), Republic of Korea 2013, Internal Revenue Service (IRS), United States 2012.

As previously mentioned, we do find that companies in Thailand use only one set of book when setting their transfer price for various purposes. Though in the previous studies such as those by Hiemann and Reichelstein (2012) argue that company can reach an optimal result if two sets of books have implemented. However, we find that our result is consistent with survey done by Ernst & Young (2003 via Hiemann & Reichelstein) that one set of book is widely used. However, the reason for the use of one set of book in Thailand may not lie on its simplicity alone but also the legal restriction on the use of two sets of books.

MNEs shall be kept in mind that there are several legal consequences--both civil and criminal--that can be encountered in case where two sets of books are used. For example, the company can be sued by the tax authorities for the *offence of tax evasion* if the use of two sets of books deems to be used for tax evasion. Since the use of two sets of books might result in accounting inconsistency between management and tax books, therefore, it can be deemed as false statement to tax authorities, which results in the *offence against officer*. The company can also be sued for the *offence of cheating the public revenue* if the use of such booking system result in tax refund from tax authorities (Matichon 2009). The law--and its consequences--related to the use of two sets of books will be summarized in Table 5 below.

Table 5. Offences, related law and consequences of the use of two sets of book in Thailand

Offences	Code of Law & Sections	Consequence
Offence of Tax Evasion	Revenue Code, B.E. 2481 (1938): Section 37	Imprisonment from six month to seven year and fine from 2,000 Baht up to 200,000 Baht
Offence of Cheating the Public Revenue	Criminal Code, B.E. 2499 (1956): Section 80, Section 83 and Section 341	Imprisonment not exceeding three years or fine not exceeding 6,000 Baht, or both
Offence against Officer	Criminal Code, B.E. 2499 (1956): Section 137	Imprisonment not exceeding six month or fine not exceeding 1,000 Baht, or both

Source: Matichon 2009

Based on our research, we conclude that the main motivations and objectives of taxpayers implementing transfer pricing are tax related goal, which are tax compliance and tax minimization. Since tax--also its penalty and surcharge--is considered as cost of doing businesses, it can eventually affect shareholders' value. Not surprisingly, we find that most of MNEs in Thailand prioritize tax compliance and tax minimization as the very first objectives and motivations when implementing transfer pricing strategy. Our research yields the consistent result as those researches by Craven (1997 via Eden 2011) and Tang (2002 via Eden 2011), which survey on MNEs about their international transfer pricing objective. They find that among the three highest ranks of their transfer pricing objectives are to manage tax burden and maximize company's profit as the whole.

To minimize tax exposures meanwhile maximizing shareholders' value, we find that it is best to consider transfer pricing as one of the company's risk management. Furthermore, the management shall take transfer pricing into their account whenever their strategic planning has affected the business model or substances of the transaction. As the result of its impact from business model, it can cause MNEs a large amount of income adjustment, penalties and surcharges if transfer price does not reflect the new business model. In Thailand, if the income assessment result in tax shortfall, the penalty of 100% to 200% of the tax shortfall and surcharge of 1.5% per month may be imposed. Such surcharge can be capped up to the amount of tax

shortfall (Ernst & Young 2012: 172). Therefore, to prevent any possible negative surprise, such as additional income adjustment, penalties and surcharges, it is recommended the top management to take the proactive action by considering transfer pricing into their strategic planning (Loh 2013); otherwise, MNEs may face with those negative surprises as those encountered by GlaxoSmithKline (Morais 2009) and Starbuck (British Broadcasting Corporation 2012).

As previously mentioned, transfer pricing is a new area in Thailand and DI. Paw. No. 113/2545 has no legal enforcement (KPMG 2011: 176); therefore, unsurprisingly, many MNEs still have not aware of it and prepare no transfer pricing documentation as provided in DI Paw. No. 113/2545. Furthermore, the law does not specify the due date for the submission of transfer pricing document neither nor the penalty and surcharge for not being submitting such documentation. It, practically, provides the taxpayers to submit transfer pricing document whenever it is requested by TRD (KPMG 2011: 176-177). Unsurprisingly, there may be some MNEs that start to prepare their transfer pricing documentation right after requested by TRD; these enterprises often search for transfer pricing service as their defensive action of possible income adjustment, penalties and surcharges. Some MNEs, on the other hand, do prepare such documentation but not because of such instruction. However, it is prepared as a part of the company's policy, and such MNEs are usually come from countries with good corporate governance concern in which financial transparency must be provided to shareholders and other stakeholders. This is consistent with the research result find in Jost (2009) and Jost, Pfaffermayr and Winner (2010); according to their researches, they find that transfer pricing risk awareness is most exposed to companies with its parent operating either in Anglo-Saxon countries or countries with early incorporation of transfer pricing regulation into its tax law in which tax authorities are likely to be well-trained and have more sophisticated transfer pricing investigation and transfer pricing audit experience. Additionally, Jost et al. (2010) do find that transfer pricing awareness is also related to previous tax audit experienced by MNEs.

Chan and Chow (1997) argue that main factors causing the transfer pricing audit in China are losses or low profitability, in which account for 35% of all cases. Our research also draws the same conclusion. It shall be noted that in Thailand transfer pricing audit will initiate from the normal tax audit, and the companies with losses and lower profitability will be given focused by TRD than other companies. Basically, TRD--and even tax authorities around the globe--are willing to know why these enterprises persistently operate its businesses if they do have persistent loss and lower profit than industry average. Based on our research, we find that there is no nationality preference when transfer pricing audit are initiated. However, since Japanese is the largest investors in Thailand, it is most likely to have transfer pricing issue. Similarly to those research found by Chan and Chow (1997), the transfer pricing audit of about 70% are initiated to Hong Kong venture; however, this shall be the result of highest foreign direct investment in China are Hong Kong venture that accounts for 70.1% of total foreign investment. We also find that Thai companies though with its partial investment in tax holiday zone, it is not the focus of TRD. We can see that domestic transfer pricing is not the main concern of Thai tax authorities. There are two possible answer to this such as following: there are limited staffs and resources needed for audit; and tax authorities may view domestic transfer pricing does not do much harm since money still circulates with countries.

Lall (1979 via Chan & Chow 1997) argues that transfer pricing manipulation will be more severe in those industries where advanced technology are used and products are highly specialized. Such industries are considered as the danger area where the tax authorities shall be focused. Additionally, Ernst & Young (2010) suggests that tax authorities will generally target on industries with highly value intangibles with high profit margin. They do find that MNEs operating in pharmaceutical industry seems to be aware of transfer pricing risk the most. Furthermore, the recent studies by Jost (2009) and Jost et al. (2010) have also found that companies operating in telecommunication and pharmaceutical industries are aware to transfer pricing risk the most. This can be the result of recently significant transfer pricing case of GlaxoSmithKline in which IRS of United States has imposed a significant penalty for their complex transfer pricing practice of \$3.4 billions (Jost et al. 2010; Morais

2009). Though such industries may have transfer pricing expose as suggested from previous researches, we find that such industries are less likely to be audited on transfer pricing by TRD comparing to automotive, electronic and consumer goods industries. There are several possible answers that may support such actions as follow: automotive, electronic and consumer goods industries are amongst the largest industries with foreign investment in Thailand; the price for intangible assets, such as intellectual property, employed in pharmaceutical and telecommunication industries are difficult to determine as the result of information insufficiency; there are limited administrative resources, such as officers and facilities; lastly, it is time consuming since the local comparables are rare. This is consistent with the recent studies of Jost et al. (2010) in which stated that certain industries are less likely to be exposed to transfer pricing risk because of its requirement of in-depth knowledge of transfer pricing technique, well-trained expertise, experience and sophisticated transfer pricing investigation. Since Thailand is still in the elementary stage of transfer pricing practice, it is, somehow, difficult for tax authorities to audit industries with high technology and high amount of intangible assets which eventually requires a great amount of experience and time.

Though our research suggested that advance pricing agreement (APA) has been suggested to taxpayers as the last alternative for the mitigation of transfer pricing risk, we still find that the popularity of APA applications is increasing constantly (Guidance on APA Process 2010). Since APA provides taxpayers certainty for their transfer price establishment and helps resolve double taxation and tax disputes between tax authorities and taxpayers, it may overweight the cost required in such agreement. MNEs shall be noted that currently Thai tax authorities will only accept the bilateral APA as provided in Advance Pricing Agreement Guideline issued by TRD in 2010. Since there is no publicly statistical result regarding the APA program in Thailand, it is difficult for taxpayers to keep themselves update on such process unlikely those countries with strict transfer pricing regulations such as Japan, United States and South Korea. Taxpayers, however, can keep themselves update on transfer pricing issue through press released by big consulting firms, such as those released

by PwC or Ernst & Young. From the author's opinion, these consulting firms are most active in researching and updating on transfer pricing issue in Thailand.

Table 6 will listed the statistics of APA concluded and its average processing time as it was listed in mutual agreement procedure (MAP) report, annual report, or annual APA statutory reports released by the tax authorities of Japan, South Korea and United States, respectively.

Table 6.1. Numbers of APAs concluded in Japan, United States and South Korea

Business Year	Japan		South Korea		United States	
	Unilateral APA	Bilateral APA	Unilateral APA	Bilateral APA	Unilateral APA	Bilateral APA
2008	N/A	91	16	14	14	51
2009	N/A	105	20	7	21	42
2010	N/A	128	15	10	20	49
2011	N/A	135	11	13	8	34

Source: National Tax Agency (NTA), Japan (2009, 2010, 2011 & 2012); National Tax Service (NTS), Republic of Korea (2011 & 2013); Internal Revenue Service (IRS), United States (2009, 2010, 2011 & 2012).

Table 6.2. Average processing time of APAs in Japan, United States and South Korea (in months)

Business Year	Japan		South Korea		United States	
	Unilateral APA	Bilateral APA	Unilateral APA	Bilateral APA	Unilateral APA	Bilateral APA
2008	N/A	23.7	N/A	N/A	21.5	38.1
2009	N/A	24.7	N/A	N/A	23.6	45.1
2010	N/A	25.6	19.0	27.0	24.1	42.5
2011	N/A	23.6	20.0	27.0	27.0	44.0

Source: National Tax Agency (NTA), Japan (2009, 2010, 2011 & 2012); National Tax Service (NTS), Republic of Korea (2011 & 2013); Internal Revenue Service (IRS), United States (2009, 2010, 2011 & 2012).

As it has been argued by several transfer pricing experts that transfer pricing is an art not science, it is always in the grey area of interpretation (Loh 2013; Kullakattimas 2013). It is, undoubtedly, common for tax authorities to reject the comparables selection of taxpayers since such analysis does heavily rely on personal judgement. Thus, it is likely that such analysis will end up with the negotiation between tax

authorities and taxpayers since both parties need to discuss and share information with each other to decide the most appropriate comparables. This is the result that basis of comparability analysis is lie on the availability and reliability of data; the more information gather, the more likely the appropriate comparables will be selected (Kritiyachotipakorn 2013; Poshyanonda 2013; Ratanarangsikul 2013).

Consistent with the result survey by Ernst & Young (2010) of increasing significant tax penalties on transfer pricing practice around the world, we find that compliance risk is the risk affecting shareholders' value most concerned by tax experts in Thailand. Furthermore, recently significant transfer pricing cases of Starbuck and GlaxoSmithKline have evidenced us that the amount of penalty can be even higher than the total amount of taxes the companies have even paid. This can significantly affect the shareholders' value of MNEs as the whole (Morais 2009; British Broadcasting Corporation 2012; Neville & Treanor 2012). However, we do find that penalty on aggressive transfer pricing practice imposed by TRD may have no significant impact on the MNEs as the whole since MNEs may only operate minor branches in Thailand comparing to the organization as the whole. Therefore, it is possible that transfer pricing risks do have a significant impact on shareholders' value at the small scale--in this case, Thai or/and regional branches--but may not have any significant impact in the larger scale.

Lastly, we do think that Thai tax authorities need to take more active actions on transfer pricing since the tax competition is increasing in our region, especially when the AEC is expected to become effective in 2015. The specific provisions do need to be released to provide taxpayers and other tax authorities transparency on such area. It also eases tax officers at work since the legal enforcement can guide them on what exactly needs to be done. By having transfer pricing law, nevertheless, it can protect taxpayers from other tax authorities at some degree by proving that their transfer price establishment has been made in accordance with Thai tax law, where the anti-tax avoidance is effective. Furthermore, it possibly helps attract more foreign investment to due to the transparency of law regarding to transfer pricing practice. Lastly, with the legal enforcement, the TRD will have higher possibility to win the

court's ruling since TRD sometimes can lose the case as the result that status of Departmental Instruction of Revenue Department has no legal effect. With the legal enforcement, it can be a very important tool for TRD to counter-act against any tax evasion through transfer pricing practice and thus effectively protect the national tax base.

8. CONCLUSION

Transfer pricing is a growing important area for both tax authorities and MNEs around the world. However, this research finds that though transfer pricing guideline has been released for more than decade, it is still a very new area to many Thai taxpayers. This mainly results that it has no legal enforcement in Thailand; thus, many Thai taxpayers still pay no attention to it. It is essential for Thai tax authorities to take a serious action in this area since this aggressive activity of MNEs can cause Thailand loss its tax income which amount can range from millions to billions of dollars each year. They shall keep in mind that two top objectives of MNEs when implementing transfer pricing is either tax compliance or tax minimization. Therefore, by issuance of transfer pricing law, Thailand can have a tool that can effectively use to protect its tax bases.

The research also finds that when it comes to transfer pricing audit, the tax officers will draw their attention to those businesses with persistent loss or profit margin lower than industry average assuming there is substantial related-party transaction. Aside from such indicators, either type of industry or nationality of parent company plays no important role in the selection of transfer pricing audit. Similarly to statistic of arm's length method use in other countries, TNMM has gained its popularity when it comes to test the arm's length price by Thai tax authority.

Since MNEs can be penalized at the great financial amount where income adjustment is expected, compliance risk becomes the major concern for many transfer pricing specialists in Thailand as it can greatly affect the shareholders' value of the company. Furthermore, we find that it is recommended to MNEs to prepare transfer pricing documentation as the way to mitigate the risk of possible income adjustment just only in case where transaction is not substantial. However, where there is significant related-party transaction, double taxation or dispute with two tax jurisdictions, MNEs shall take APA into their consideration to eliminate such problem.

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Appendix 1

OUTLINE OF THE INTERVIEW QUESTIONS FOR TRANSFER PRICING CONSULTANTS

1. Knowledge of TP advisory client regarding tax and other related issues

a. What is TP advisory client's level of knowledge regarding transfer pricing? (Distributes a total of 10 points according to percentage of TP advisory client at each level)	
High (Client has extensive knowledge on transfer pricing)	
Medium (Client has good knowledge in some area of transfer pricing)	
Low (Client has little knowledge on transfer pricing)	

b. What is TP advisory client's level of knowledge on tax and other tax-related issues? (Distributes a total of 10 points according to percentage of TP advisory client at each level)	
High (Client has extensive knowledge on taxation)	
Medium (Client has good knowledge in some area of taxation)	
Low (Client has little knowledge on taxation)	

2. Transfer pricing method implemented by TP advisory client

a. What is the primary transfer pricing method used by your TP advisory client? (Distributes a total of 10 points according to percentage of TP advisory client at each level)	
Market price less selling and marketing expenses	
Cost based method:	
Marginal (or variable) cost	
Full cost	
Cost plus a mark up	
Marginal cost plus lump sum fee	
Other methods:	
Negotiated transfer price	
Dual rate transfer price	
(If they use other method than those mentioned above, please specify)	

b. How many of your clients use two sets of books, one for tax purpose and one for management purposes?

(Distributes a total of 10 points according to percentage of TP advisory client at each level)

One set of book is used for different purposes	
Two sets of book is used for different purposes	

3. Arm's length method implemented by TP advisory clients

a. What is the primary arm's length method used by your clients?

(Distributes a total of 10 points according to percentage of TP advisory client at each level)

Traditional transaction method	
Comparable uncontrolled price (CUP)	
Resale price	
Cost plus	
Transactional profit method	
Transactional net margin method (TNMM)	
Profit split	
(If they use other method than those mentioned above, please specify)	

4. Motivation of your TP advisory client for using transfer pricing strategy

a. What is the primary motivation of your TP advisory client for using transfer pricing?

(Distributes a total of 10 points according to percentage of TP advisory client at each level)

Tax minimization	
Tax compliance	
Fair performance evaluation	
Goal congruence (efficiency resource allocation)	
Facilitate the flow of capital	
Maintain business competitive position	

b. What is your client's main objective of transfer pricing?

(Distributes a total of 10 points according to percentage of TP advisory client at each level)

Tax compliance and minization	
Efficiency resource allocation and fair performance evaluation	
Both of the above	

c. What is your primary objective when serving your clients?

(Distributes a total of 10 points according to percentage of TP advisory client at each level)

Tax minimization	
Tax compliance	
Fair performance evaluation	
Goal congruence (efficiency resource allocation)	
Facilitate the flow of capital	
Maintain business competitive position	

5. Other facts related to current situation of transfer pricing practice in Thailand

a. Does client usually maintain “transaction pricing documentation” when first ask for your advice?

(Distributes a total of 10 points according to percentage of TP advisory client at each level)

Always (yearly)	
Never	

b. What is the main factor causing transfer pricing audit by Revenue Department?

(Distributes a total of 10 points according to percentage of TP advisory client at each level)

Persistent loss	
Substantial related-party transaction	
Inconsistent profit (loss)	
Profit margin lower than industry average	
Sudden drop of profit after tax holiday	
Significant year-end related-party price adjustment	
Significant management fee, intangible and royalties fees	
Lack of transfer pricing documentation	
(If there is other factor than those mentioned above, please specify)	

c. In case of transfer pricing audit, which industry do you think is the primary focus of Revenue Department?

(Distributes a total of 10 points according to percentage of TP advisory client at each level)

Pharmaceutical	
Telecommunication	
Technology or software	

Consumer goods	
Automotives	
(If there is other industry than those mentioned above, please specify)	

d. Does the nationality of “parent” of MNEs increase the likelihood of being audited by Revenue Department?

YES	
NO	

e. In case of yes, does the foreign company have higher probability of being audited by Revenue Department?

YES	
NO	

f. What are the primary advice given to client to mitigate the risk of being audited by Revenue Department?

(Distributes a total of 10 points according to percentage of TP advisory client at each level)

Prepare good transfer pricing document	
Enter the advance pricing agreement with tax authorities	
(If there is other method than those mentioned above, please specify)	

6. Transfer pricing and its effect on shareholders' value

a. In your opinion, what is the primary risk encounter with your clients when implementing transfer pricing strategy?

(Distributes a total of 10 points according to percentage of TP advisory client at each level)

Compliance (or tax audit risk)	
Reputation risk	
Accounting risk	
Regime risk	
(If there is other risk than those mentioned above, please specify)	

b. From the risk listed above, to what extent do you think can transfer pricing affect shareholders' value?

High (transfer pricing can significantly affect shareholders' value)	
Medium (transfer pricing can fairly affect shareholders' value)	
Low (transfer pricing can hardly affect shareholders' value)	

7. Future trend of transfer pricing in Thailand

a. In your opinion, what is the trend of transfer pricing in Thailand in the near future?

Appendix 2

OUTLINE OF THE INTERVIEW QUESTIONS FOR TAX OFFICER

1. Knowledge of taxpayers regarding tax and other related issues

a. What is taxpayer's level of knowledge regarding transfer pricing? (Distributes a total of 10 points according to percentage of taxpayers at each level)	
High (taxpayer has extensive knowledge on transfer pricing)	
Medium (taxpayer has good knowledge in some area of transfer pricing)	
Low (taxpayer has little knowledge on transfer pricing)	

b. What is taxpayer's level of knowledge on tax and other tax-related issues? (Distributes a total of 10 points according to percentage of taxpayers client at each level)	
High (taxpayer has extensive knowledge on taxation)	
Medium (taxpayer has good knowledge in some area of taxation)	
Low (taxpayer has little knowledge on taxation)	

2. Arm's length method implemented by taxpayers

a. What is the primary arm's length method used by taxpayers? (Distributes a total of 10 points according to percentage of taxpayers at each level)	
Traditional transaction method	
Comparable uncontrolled price (CUP)	
Resale price	
Cost plus	
Transactional profit method	
Transactional net margin method (TNMM)	
Profit split	
(If they use other method than those mentioned above, please specify)	

3. Other facts related to current situation of transfer pricing practice in Thailand

a. Does taxpayer usually maintain “transaction pricing documentation” when first ask for your advice?

(Distributes a total of 10 points according to percentage of taxpayers at each level)

Always (yearly)	
Never	

b. What is the main factor causing transfer pricing audit by Revenue Department?

(Distributes a total of 10 points according to percentage of taxpayers at each level)

Persistent loss	
Substantial related-party transaction	
Inconsistent profit (loss)	
Profit margin lower than industry average	
Sudden drop of profit after tax holiday	
Significant year-end related-party price adjustment	
Significant management fee, intangible and royalties fees	
Lack of transfer pricing documentation	
(If there is other factor than those mentioned above, please specify)	

c. In case of transfer pricing audit, which industry do you think is the primary focus of Revenue Department?

(Distributes a total of 10 points according to percentage of taxpayers at each level)

Pharmaceutical	
Telecommunication	
Technology or software	
Consumer goods	
Automotives	
(If there is other industry than those mentioned above, please specify)	

d. Does the nationality of “parent” of MNEs increase the likelihood of being audited by Revenue Department?

YES	
NO	

e. In case of yes, does the foreign company have higher probability of being audited by Revenue Department?

YES	
NO	

f. What are the primary advice given to client to mitigate the risk of being audited by Revenue Department?

(Distributes a total of 10 points according to percentage of TP advisory client at each level)

Prepare good transfer pricing document	
Enter the advance pricing agreement with tax authorities	
(If there is other method than those mentioned above, please specify)	

g. Is it possible for the tax officer to reject transfer price set by taxpayers even though he / she prepared all the requested TP documentation and has shown that his/her transfer price is at arm's length? If so, why?

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h. What are the principle in selecting the comparables of Revenue Department?

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4. Future trend of transfer pricing in Thailand

a. In your opinion, what is the trend of transfer pricing in Thailand in the near future?

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b. According to Revenue Code of Thailand, there is no specific law regarding to transfer pricing but just a general provision under corporate income taxes. Therefore, in your opinion, is there a need to issue such specific law to empower tax officers auditing such transfer pricing activities.