L&P

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Thailand about to introduce new law on Transfer Pricing

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I. Introduction

When independent parties contract with each other, the conditions, especially the pricing, will generally be determined by market forces. This is however not necessarily the case for associated enterprises.[1] Their conditions may differ for various reasons.[2]

If the transfer pricing of multinational enterprises ("**MNE**s") does not reflect free market conditions, the tax revenues of countries may be distorted. In extreme cases, fraudulent transfer pricing may be used to artificially generate profits in low tax countries or tax havens, thereby avoiding taxation in high (or higher) tax countries. As countries try to minimize such practices, they require enterprises to comply with the "arm's length principle" ("**ALP**").

The ALP requires associated enterprises to model the pricing of internal transactions according to the pricing of independent enterprises. The application of the ALP therefore relies on the comparison of transactions.[3] Art. 9 of the OECD Model Tax Convention (hereinafter the "**Convention**") states:

"*Where […] conditions are made or imposed between [two associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.*[4]

The critics of the ALP raise the concern that transactions of associated enterprises are fundamentally different from those of independent enterprises. They regard the ALP therefore as fundamentally flawed. Nevertheless, the ALP has become a cornerstone of the transfer pricing discussion and – as far as the OECD can evaluate – has proven to be effective.[5]

Therefore enterprises need to be familiar with the basic statements of said principle and also with the various methods of assessing transfer prices arising thereof. The OECD has issued "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations" to help enterprises and tax officials with their task of determining if a specific pricing is in compliance with the ALP.[6]

II. Transfer Pricing in Thailand

Thailand, though not being a member of the OECD, models its legislation and administration of transfer pricing after the OECD guidelines. Most of the actual regulations on transfer pricing come as guidelines[7] (hereinafter the "**Guidelines**") issued by the Reve-

[1] Remark: Associated enterprises may also be referred to as "affiliated enterprises" or "related parties" in contrast to "independent parties"; a transaction between such associated enterprises is commonly referred to as "controlled transaction" in contrast to "uncontrolled transaction" between independent parties.

[2] Apart from tax-related reasons, the OECD (Organization for Economic Co-operation and Development) names governmental pressure relating to customs valuations and cash flow requirements within multinational enterprises (Transfer Pricing Guidelines, July 2010, p. 32, No. 1.4).

[3] OECD, Transfer Pricing Guidelines, p. 41, No. 1.33.

[4] http://www.oecd.org/ctp/treaties/2014-model-tax-convention-articles.pdf.

[5] OECD, Transfer Pricing Guidelines, p. 34, No. 1.9.

[6] Version 2010: http://www.oecd.org/ctp/transfer-pricing/45763692.pdf.

[7] Departmental Instructions No. Paw. 113/2545, http://www.rd.go.th/publish/fileadmin/download/TransferPricing_en.pdf.

nue Department ("**RD**"). However, on 7 May 2015, the cabinet approved the draft of a new law on transfer pricing. The draft is currently in the legislative process and will need final approval by the National Legislative Assembly. Thus, the final law may (and hopefully will) differ from the current draft, particularly in terms of documentation. However, it can be assumed that it will basically put into law what is until now only regulated by internal guidelines. Further, it can be assumed that the Transfer Pricing as such will be put more into focus of the Revenue Department once the law is enacted. It is therefore advisable for (particularly foreign) companies to start reviewing their intercompany transactions and building up some transfer pricing documentation based on the below guidelines.

1. The Legal Basis

The Revenue Code ("**RC**") gives tax officials authority to assess the intercompany pricing of companies. Regulations can be found in Sec. 65 bis (4) and (7), Sec. 65 ter and Sec. 70 ter RC.

Especially relevant is Sec. 65 bis (4) RC:

"In the case of transfer of assets, provisions of service or lending of money without remuneration, fee or interest that is lower than the market price without reasonable cause, an ***assessment official shall have the power to assess*** *such remuneration, fee or interest in accordance with the market price on the date of transfer, provision or lending."*

This means: If the assessment official finds that the transfer price differs from the ALP, the transfer price may be adjusted accordingly and enterprises are liable to additional taxation as well as fines.

2. The Guidelines

The Departmental Instruction No. Paw 113/2545 shall assist assessment officials and enterprises in determining arm's length prices (named "market price" in the Guidelines). In case of a transfer price assessment the officials will conduct their task according to the Guidelines.

The RD defines Transfer Pricing as "price set between related contracting parties for goods or services which may deviate from the market price".

The Guidelines also include information on necessary documentation enterprises should keep and on how to enter into **Advance Pricing Agreements** (APA) with the RD.

III. Methods Described in the Guidelines

The guidelines explicitly propose three methods to determine arm's length prices, all of which are referred to by the OECD as "traditional transaction methods":

- Comparable Uncontrolled Price Method ("**CUPM**");
- Resale Price Method ("**RPM**");
- Cost Plus Method ("**CPM**").

While the Guidelines do not expressively mention "transactional profit methods" [8], they generally still allow enterprises to use such methods.[9]

The RD does not recommend a certain method but leaves it to the enterprises to choose a method that is best suited to determine arm's length prices.

1. Comparable Uncontrolled Price Method ("CUPM")[10]

The CUPM compares the pricing of associated parties (assessed transaction) with the pricing of a similar transaction of **independent parties** (similar transaction). Dif-

[8] OECD, Transfer Pricing Guidelines, p. 77 et. seqq.
[9] Clause 3 (4) Departmental Instructions No. Paw. 113/2545.
[10] Clause 3 (1) Departmental Instructions No. Paw. 113/2545.

ferences may indicate a deviation from the ALP.

a) Difficulties and Area of Application

Enterprises using the CUPM face the challenge of finding a transaction that is actually comparable with the assessed transaction.[11] Minor differences may have a big influence on the final pricing.

However, the OECD finds that in case a comparable transaction is found, the CUPM applies the ALP in the "most direct and reliable way". Therefore, "in such cases the CUPM method is preferable over all other methods."[12] However, the Thai RD does not give such preference and all methods are applicable.

b) Example

Company A sells a good to the associated company B for USD 50 (assessed transaction).

Company C (not related) sells a similar good under similar circumstances to an independent company D for USD 80 (similar transaction).

The price of the assessed transaction differs from the price of the similar transaction. This may indicate that the transfer price of the assessed transaction (A to B) is not an arm's length price (please note that such conclusion is not compulsory).

Under Sec. 65 bis (4) RC tax officials have the authority to assess the price between A and B according to the arm's length price.

2. Resale Price Method ("RPM")[13]

The RPM determines the arm's length price by assessing the resale price of a good. It compares the transfer price of an assessed transaction with the resale price of the same good.

First, the method notes the price of a sold product between two associated parties (Transaction 1 – Transfer Price A to B). Then, the RPM notes the resale price of the same good (Transaction 2 B to C **or** a totally different transaction with the same good, e.g. D to Z – Resale Price). An assumed profit margin is calculated by comparing the price B to C or D to Z. The result is the arm's length price which is compared to the transfer price A to B.

a) Proposed Area of Application

The OECD sees the RPM most useful when "applied to marketing operations".[14]

The RD does not offer a recommendation regarding the area of application for the RPM.

b) Example

Company A buys a good for 40 and sells it to the associated company B (Transaction 1). The price is USD 50 (Transfer Price). Company B resells the same good to the independent company C (Transaction 2). The price is USD 100 (Resale Price). The **gross profit margin is 100%, while the gross profit of the first transaction is only 25%.** The gross profit generated by Company A seems unreasonably low compared to the gross profit of Company B. The officer has the right to adjust the selling price of party A (probably to 70, so that the profit is equally shared) and thus generating more profit and higher corporate income tax for party A, unless there is a reasonable cause to explain the difference, Sec 65. bis (4) RC.

3. Cost Plus Method ("CPM")[15]

To determine the arm's length price, the CPM takes the costs of a good and adds an

[11] OECD, Transfer Pricing Guidelines, p. 24, No. 2.15.
[12] OECD, Transfer Pricing Guidelines, p. 24, No. 2.15.
[13] Clause 3 (2) Departmental Instructions No. Paw. 113/2545.
[14] OECD, Transfer Pricing Guidelines, p. 25. No. 2.21.
[15] Clause 3 (3) Departmental Instructions No. Paw. 113/2545.

appropriate "cost plus mark up". The CPM is based on the idea that enterprises can only sustain themselves if they cover their costs and create a certain profit. (Usually, a profit margin between 3 to 10 % is accepted, depending on the industry and transaction).

a) Proposed Area of Application

According to the OECD, the CPM is suited best for the situation when associated parties trade "semi finished goods", or associated parties have concluded "joint facility agreements" / "long-term buy and supply arrangements", or where the controlled transaction is the provision of services.[16]

The RD does not offer a recommendation regarding the area of application for the CPM but has so far widely accepted the concept, particularly in case of servicing affiliates.

b) Calculating the Mark Up

Enterprises (and tax officials) using the CPM have to calculate an appropriate cost plus mark up. Therefore, the RD proposes to determine such mark up by referencing a comparable transaction of independent parties. The OECD guidelines name this approach "external comparable".[17]

In addition to this approach, the OECD proposes a method named "internal comparable" which references the mark up the "same [enterprise] earns in a comparable uncontrolled transaction".[18] The OECD finds this approach actually preferable over an external comparison. However, the approach "internal comparable" is not being mentioned by the Guidelines.

c) Calculating Costs

The OECD divides the costs of goods in three broad categories: the direct cost of production (e.g. raw material), the indirect costs of production (e.g. the repair department that services the production process) and the operating expenses of an enterprise as a whole, i.e. administration and such.[19]

d) Example[20]

Company A sells goods to the associated company B at a price of USD 100. The total all in costs of the goods are USD 80. Accordingly, it generates a profit of 20.

Company C sells a similar kind of goods to the independent company D (this transaction is "external comparable") for USD 120. The total all in costs for party C of the goods are USD 100. Therefore the net profit is USD 20, which is 20 percent of the selling price.

This profit margin (20%) is now used to assess the transaction between A and B. The costs of the sold goods are USD 80. The appropriate profit margin (as determined by the transaction C to D) is 20% of the costs of the goods, thus USD 16. Therefore, the arm's length price is the sum of the <u>costs</u> of the goods <u>plus</u> the appropriate profit. In our example USD 80 plus USD 16 equals USD 96 and **<u>not</u>** USD 100.

Therefore, the transfer price of the transaction A to B (USD 100) is higher than the arm's length price (USD 96). Under Sec. 65 bis (4) RC tax officials have the authority to assess the actual price according to the market price, but will probably not adjust it, since the price used in the intercompany transaction is higher than the arm's length price. However, this may raise problems in the jurisdiction of company B because it pays more than the arm's length price.

[16] OECD, Transfer Pricing Guidelines, p. 29, No. 2.39.
[17] OECD, Transfer Pricing Guidelines, No. 2.40.
[18] OECD, Transfer Pricing Guidelines, No. 2.40.
[19] OECD, Transfer Pricing Guidelines, No. 2.47.
[20] A more in depth example can be found in the OECD Transfer Pricing Guidelines, No. 2.53.

4. Other Methods[21]

The Guidelines allow to use other than the above described methods under the condition that

- the method is internationally accepted and
- the method is appropriate for the transaction.

Generally all methods described in the OECD guidelines are acceptable as long as they are an appropriate instrument given the circumstances of the transaction.

5. Establishing the Arm's Length Price

The RD proposes a system of four steps to determine the arm's length price. Please note that this system is neither mandatory nor does it, if applied, limit taxpayers' liability. It remains the enterprises' duty to establish the arm's length prices.

- Step 1: Characterisation of the international dealings between the related parties
- Step 2: Selection of the most appropriate transfer pricing method
- Step 3: Application of such method
- Step 4: Review of the process.

IV. Documentation

As of now, Thailand does not (unlike Germany and other OECD member states) have a statutory filing requirement. However, the Guidelines offer an overview of documents companies should properly keep. In case of an assessment of the transfer pricing, such documentation must be presented within 7 to 15 days. Documents requested include:

- documentation on the structure and relationship between business entities within the same group
- budgets, **business plans** and financial projections
- documentation indicating the taxpayer's business strategies as well as the reasons for adopting such strategies
- documentation indicating sales and operating results and the nature of the taxpayer's transactions with business entities within the same group
- documentation indicating the reasons for entering into international transactions with business entities within the same group
- pricing policies, product profitability, relevant market information and profit sharing of each business entity (consideration should be given to functions performed, assets utilized and risks assumed of the related business entities)
- documentation supporting selection of a particular pricing method
- where several methods are considered, documentation indicating details of the method (document should be created at the same time the decision is made)
- documentation used as evidence indicating the negotiation positions taken by the taxpayer in relation to the transaction with business entities within the same group and the basis for those negotiating positions
- other related documentation in determining the transfer price (if any).

V. Advance Pricing Agreements (APA)

Taxpayers can enter into an advance pricing agreement (APA) with the RD for any transaction with its affiliated contracting parties. APAs aim to avoid any disputes or problems because of double taxation caused by transfer pricing re-assessment. The RD issued a guide for the APA process.[22]

Interested taxpayers have to submit a written document of intent (APA proposal) to the Director-General of the RD. The documents needed (the RD provides a list) have to be submitted in Thai and English lan-

[21] Clause 3 (4) Departmental Instructions No. Paw. 113/2545.

[22] Guidance on APA process (http://www.rd.go.th/publish/fileadmin/download/GUIDANCE-ON-APA-PROCESS-EN.pdf).

guage. Taxpayers may use translators or APA experts to submit the request.

After that, a pre-filing meeting[23] is held between the taxpayer and the RD. In general this meeting has to take place six months prior to the intended effective date of the APA (i.e. normally six months prior to the last day of the first accounting period for which the APA shall apply). Approval notice shall be issued within three months, but delays are common.

The RD remains the right to cancel or revoke the APA prior to its termination if the taxpayer is not fulfilling its duties with the RD (false information given, non-compliance with regulations of the APA etc.).

There is no filing fee for the APA and the RD will keep all the data strictly confidential.

VI. Transfer Pricing Law

On 7 May 2015, the cabinet approved a draft amendment of the RC. The draft is currently in the legislative process and will need final approval by the National Legislative Assembly. Thus, the final law may differ from the draft.

If approved, the law will amend the RC, establishing rules on transfer pricing between associated parties.

It basically transforms the (internal) guidelines of the RD explained above into material law.

Additionally, the current draft requires taxpayers from now on to keep necessary documentation on their transfer pricing and they will have to file such documentation together with their tax return. If taxpayers do not comply with this requirement, they may be liable to a penalty not exceeding THB 400,000. (approx. EUR 10,000)

The documentation will have to show the relation to other entities, e.g. details on management, capital and other necessary information. Furthermore, taxpayers will have to provide documentation on the methods being used to determine the pricing between related parties, e.g. details on the computing of the prices and details on the method being used.

Tax officials will have the authority to reassess the transfer pricing between related parties. If the transfer pricing assessment leads to double taxation in different countries involved, the taxpayer is entitled to claim for refunds. Taxpayers have to file their claims within 60 days after having received the assessment notification or three years after the due date of the tax return.

VII. Conclusion

So far, transfer pricing has not been closely monitored in Thailand and therefore was often a topic being raised during tax audits with no clear guidelines given and the interpretation of the Guidelines varying from audit team to audit team. The amendment of the RC now appears to turn this around implementing comparably high requirements for companies. Particularly, the requirement of submitting transfer pricing documentation together with the tax return appears rather unusual and will hopefully be revised once coming into effect.

We hope that the information provided in this newsletter was helpful for you.
If you have any further questions please do not hesitate to contact us.

LORENZ & PARTNERS Co., Ltd.
27th Floor Bangkok City Tower
179 South Sathorn Road, Bangkok 10120, Thailand
Tel.: +66 (0) 2-287 1882
E-Mail: info@lorenz-partners.com