

Training Material  
HRM Wing (FBR) - GIZ

# Transfer Pricing – Concepts and Issues

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## **BROAD TRANSFER PRICING ISSUES**

- Transfer Price and Transfer Pricing?
- Transfer Pricing in Intra-group Transactions
- Arm's Length Principle?
- Transfer Pricing Law in Pakistan
- Tax Treaty Law as in Pakistan DTAs
- Judicial Practice in Pakistan on Transfer Pricing
- OECD Guidelines on Transfer Pricing
- OECD Guidelines' Focus?
- Guidance for Applying Arm's length Principle
- Methods of Arriving at Arm's Length Prices
- Transfer pricing in ethical pharmaceutical industry

# Transfer Pricing?

- **Transfer prices** are the prices charged for sale of physical goods and intangible property and/or provision of services.
- **Transfer pricing** refers to establishing arm's length prices charged or paid upon the transfer of physical goods and intangible property or supply of services in transactions undertaken between associated enterprises located in the same or different tax jurisdictions.
- **Transfer prices and Transfer Pricing** are neutral terms. To regard them as describing solely mal-practices is inappropriate / unhelpful. The assumption that the 'transfer prices' charged in the intra-group transactions are necessarily a device to divert profits to non-resident affiliates to avoid taxation in purchaser's country is a **biased/inaccurate view** of the matter
- **Transfer prices** in case of intra-group transactions, **include payments for intra-group services and intra-Group transfers of technology** e.g. in the pharmaceutical industry, such payments are largely subsumed into the transfer prices for drugs

# Transfer Pricing?

- For a multinational Group, transfer pricing is a means whereby the receipts from end-sales of Group products are directed to provide a contribution to the constituent members of the Group in compensation for the contributions made by their activities to the sale value of the product to independent third parties.
- Group center funding the Group's R and D; bearing the ultimate risk of failure to discover, make or sell a profitable product; and carrying out several support functions for the Group illustrate some of the contributions requiring compensation by affiliates
- Tax Consequences
  - In case the two entities transacting business with each other are located in the same country or they are independent enterprises, the tax consequences of the transaction value are mostly neutral to the government.
  - On the contrary, if these entities are in separate countries and are members of a group, in that case, the tax administration may attempt to correct the adverse effects of these transactions if it considers the 'transfer price' as unreasonable

# Transfer Pricing in Intra-group Transactions

- A large share of world trade consists of transfers of goods, intangibles and services within the multinational enterprises. Therefore, by considering Transfer Pricing practices carefully, multinational businesses can manage risk while improving operational and financial performance based on a long term view of sustainable growth.
- The TP policies are determined by the business needs and must be defensible and consistent with the overall corporate strategy. For a multinational Group, transfer pricing is a major tax planning opportunity as well as an important consideration when streamlining and remodeling business structures

# Transfer Pricing in Intra-group Transactions

- Commercial transactions between different parts of a multinational group may not be subject to the same market forces shaping relations between independent firms.
- Transfer prices may diverge from market prices for reasons of marketing or financial policy, or to minimize tax. To ensure that the tax base of a multinational enterprise is divided fairly, it is important that transfers within a group should approximate those which would be negotiated between independent firms i.e. the arm's length price.
- Cross-border intra-group transactions may lead to economic double taxation unless 'right price' (the arm's length price) has been put on them.

# Arm's Length Principle?

- The international standard for determining transfer prices for tax purposes i.e. **using the prices which would be paid if the transactions were between independent persons acting at arm's length.**
- Arm's length standard is set forth in Article 9 of the OECD/UN Model Tax Convention.
- **Arm's length principle works effectively in vast majority of cases** e.g. sale/purchase of commodities and lending of money. It may be difficult to apply in MNE groups dealing in integrated production of highly specialized goods, in unique intangibles, and/or in provision of specialized services.
- Arm's length principle is also viewed as inherently flawed because 'separate entity' approach may not always account for the economies of scale and inter-relation of diverse activities created by integrated businesses.

# Arm's Length Principle?

- Arm's length principle may be difficult to apply to associated enterprises engage in transactions that independent enterprises would not undertake.
- Arm's length principle, in some cases, may result in an administrative burden for taxpayers./tax admin. of evaluating significant number / type of cross border transactions
- There are **difficulties in finding and interpreting evidence from which arm's length prices can be deduced**. There may be no, or very little, evidence on which to base a determination of an arm's length price, and what evidence there is may be difficult to interpret or may indicate only that the arm's length price is within a certain range of prices. A flexible approach is, thus the requirement.
- Notwithstanding the above, this is **superior to any other approach** because it is essentially simple, aligns the comparatively exceptional kind of transaction with the normal kind, is equitable between taxpayers of different kinds, and, unlike other approaches, is widely accepted.

# OECD Guidelines on Transfer Pricing

## Article 9

*“Where an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State; or the same persons participate directly or indirectly in the management, control or capital of an enterprise of Contracting State and an enterprise of the other Contracting State;*

*and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would have been made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprise, but, by reason of those conditions, have not accrued, may be included in the profits of that enterprise and taxed accordingly.”*

**OECD Commentary** on Article 9 emphasizes that

*“the provisions apply only if special conditions have been made or imposed between the two enterprises. No re-writing of the accounts of associated enterprises is authorized, if the transactions between such enterprises have taken place on normal open market commercial terms (on arm’s length basis).”*

# OECD Guidelines on Transfer Pricing

## OECD Transfer Pricing Guidelines for Multinational Enterprise and Tax Administrations (1994/95)

- Provide **comprehensive guidelines on the relevant issues and adjustment of profits in controlled transactions**. These Guidelines reconfirm OECD commitments to the arm's length principle as a means for establishing pricing in a manner consistent with Article 9 of the OECD/UN Model Tax Convention on Income.
- They clearly provide that “it should not be assumed that the conditions established in the commercial and financial relations between associated enterprises will invariably deviate from what the open market would demand. Associated enterprises in MNEs commonly have considerable amount of autonomy and often bargain with each other as they were independent enterprises. ----- MNEs from a managerial point of view have an incentive to use arm's length prices to be able to judge the real performance of their different profit centers (paragraph 21 of the Guidelines).

# OECD Guidelines' Focus?

- Guidance on how to apply the general provisions to complex situations
- Monitoring the practical implementation of Guidelines, updating/amending in the light of monitoring
- Improvement of administrative procedures i.e. APAs, MAP.
- Encouraging countries outside OECD to associate themselves with the Guidelines

# Guidance for Applying Arm's length Principle

- Comparability Analysis
  - Reasons for examining comparability
  - Factors determining comparability
    - the characteristics (including physical features, quality and reliability, availability and volume of supplies) of the materials and services being transferred;
    - the economically significant activities and functions performed by enterprises subject of enquiry such as R &D, servicing, purchasing, distribution, marketing, type and level of risks assumed, and many more;
    - contractual terms of transactions and economic circumstances across different markets including the geographical location and size of the markets, the extent of competition in the market and relative competitive position of buyers and sellers, availability and associated risks of substitutes, level of supply and demand in the market as a whole and in relevant regions, nature and extent of Government controls and regulation of market, cost of production, timing of transactions; and
    - the business strategies followed by various enterprises including several aspects of enterprises such as innovation and new product development, degree of diversification, risks aversion, and other factors bearing upon the conduct of business, market penetration schemes temporarily charging lower prices charged for an otherwise comparable product and the timing of transactions between affiliates and independent enterprises.

# Guidance for Applying Arm's length Principle

- **Recognition of actual transactions undertaken**
- **Evaluation of separate and combined transactions**
- **Use of an arm's length range**
- **Use of multiple year data**
- **Losses**
- **Effect of governmental policies**
- **Intentional set-offs**
- **Use of custom's valuations**
- **Use of transfer pricing methods**

# Methods of Arriving at Arm's Length Prices

- the "comparable uncontrolled price method" - the comparison with prices charged in comparable transactions between independent parties;
- the "resale" or "resale-minus method" the subtraction of a margin from the end-selling price to an independent third party;
- the 'cost-based methods', including the "cost-plus" method - the addition of a margin to the costs of producing the relevant goods or services, etc.
- the "Fourth methods known a 'Transactional Profit Methods'".
  - Profit split method
  - Transactional net margin method

## Alternative to Arm's Length Approach

- Global formulary apportionment

# Methods of Arriving at Arm's Length Prices:

## Comparable Uncontrolled Price Method (CUP)

- Compares prices for property or services transferred in a controlled transaction to those in a comparable uncontrolled transaction in comparable circumstances.
- An uncontrolled transaction is comparable to a controlled transaction if:
  - None of the differences (if any) between the transactions being compared or between the firms undertaking the transactions could materially effect the price in the open market, or
  - Reasonably accurate adjustments can be made to eliminate the material effects of such differences.
- In real life, it may be difficult to find sufficiently similar transactions. For example,
  - Minor difference in the property transferred under controlled and uncontrolled transactions could materially effect the price notwithstanding sufficiently similar business conditions.

# Methods of Arriving at Arm's Length Prices: Comparable Uncontrolled Price Method (CUP)

- Products alone should not be considered in comparing the transactions.
- Also consider broader business functions effecting the prices such as characteristics of property or service, economically significant activities and functions performed by enterprises subject of enquiry, contractual terms of transactions and economic circumstances across different markets, and business strategies followed by various enterprises
- CUP is particularly reliable method where independent enterprises sell the same product as sold between two associate firms.

# Methods of Arriving at Arm's Length Prices:

## Resale Price Method

- **Arm's length price under RPM:**  
*Resale Price – Resale Price Margin (i.e. costs associated with purchase/sale of product and other operating costs).*
- RPM most useful where it is applied to marketing operations.
- Resale Price Margin of the reseller in controlled transactions may be determined by reference to the Resale Price Margin that same reseller (or an independent firm) earns on items purchased/sold in comparable uncontrolled transactions.
- An uncontrolled transaction is comparable to a controlled transaction if
  - None of the differences (if any) between the transactions being compared or firms undertaking these transactions materially effect the resale price margin in open market, or
  - Reasonably accurate adjustments can be made to eliminate material effects of such differences.
- Compensation for performing similar functions tend to equalize across different activities as against prices of different products tend to equalize only to the extent they are substitutes for each other. Because 'gross profit margin' represents 'gross compensation', after cost of sales for specific functions performed, product differences are less significant.

# Methods of Arriving at Arm's Length Prices:

## Resale Price Method

- Notwithstanding above, **property transferred in controlled transactions should be comparable with that transferred in the uncontrolled transaction.**
- Where resale price margin used is that of an independent firm, the reliability of RPM may be effected if its ways of carrying business materially differ from those of associated firms.
- RPM also depends on **comparability of functions performed** taking into account assets used and risks assumed; differences between controlled/uncontrolled transactions with material effect on attribute being used to measure arm's length conditions, i.e. resale price margin realized.
- Resale price margin easiest to determine where reseller add substantially to the value of the product.
- **Resale price margin is more accurate where it is realized within short time of the reseller's purchase of goods.**
- Amount of resale price margin influenced by the **level of activities** performed by the seller.
- Amount of resale price margin expected to **vary according to whether reseller has exclusive right to resell goods.**
- Where **accounting practices differ** from controlled to uncontrolled transactions, appropriate adjustments in the data are necessary in calculating resale price margin.

# Methods of Arriving at Arm's Length Prices: Cost Plus Method (CPM)

- **Arm's length price under CPM:**

*Cost incurred by the supplier in a controlled transaction + Markup to make appropriate profit in the light of functions performed and market conditions*

- **CPM most useful where semi-finished goods are sold to related firms;** where related firms have concluded joint facility agreements or long term buy-and-supply arrangements; or controlled transaction is provision of services.
- Ideally, cost plus markup of supplier in controlled transaction should be established by reference to cost plus markup that same supplier earns in comparable uncontrolled transaction.
- Cost plus markup earned in comparable transaction by an independent firm may serve as a guide.

# Methods of Arriving at Arm's Length Prices: Cost Plus Method (CPM)

- The rule concerning 'comparability' of controlled and uncontrolled transactions is the same as discussed for CUP and RPM.
- Differences that materially effect the cost plus mark ups earned in controlled and uncontrolled transactions require adjustment; the reliability of adjustments effecting relative reliability of the analysis.
- CPM presents difficulties in application, particularly in determination of costs which are necessarily not determinant of appropriate profits.
- While applying CPM, apply comparable markup to comparable cost basis.
- An important aspect of comparability is **accounting consistency**.
- The **costs** that may be considered in applying RPM **are limited to those of the supplier**.

# Establishing Arm's Length Prices: Intangible Property

- **Intangible Property?**

*Patents, trade marks, trade names, designs or models; literary and artistic property rights; know-how and trade secrets (associated with commercial activities), computer software*

- **General guidelines applying the arm's length principle apply.**
- Difficulties in applying the principle to controlled transactions because of special character of intangibles complicating search for comparables, thus making value determination difficult.
- Arm's length pricing determination analysis must account for perspective of transferor and transferee
  - **Transferor – comparable independent firm would be willing to charge**
  - **Transferee – comparable independent firm is willing to pay**
- Usefulness of property to be considered in determining the comparability.

# Establishing Arm's Length Prices: Intangible Property

- Transfer of intangible property may be outright sale or licensing on royalty.
- Royalty ordinarily based on user's output, sale or profit.
- Compensation for use of intangible property may be charged in the price of sale of goods, e.g. unfinished drugs and active raw materials. Additional royalty payments may be inadmissible.
- Intangible property may be a package of patents, trade marks, trade secrets, and know-how – determine separate transfer pricing while keeping in view that the total transfer pricing for the package is at arm's length. Consider value of services, i.e. technical assistance / training

# Establishing Arm's Length Prices: Intangible Property

- **Special factors relevant to comparability** of controlled and uncontrolled transactions
  - Expected profit from intangible property – determined through net present value calculations
  - Limitation on the geographic area in which rights may be exercised.
  - Export restrictions on goods produced.
  - Exclusive or non-exclusive character of rights transferred.
  - Capital investment.
  - Start-up expenses and development work required in the market.
  - Possibility of sub-licensing.
  - Licensee's distribution network.
  - Licensee's right to participate in future developments of property by licensor.
  - For patents: nature of patent, degree and duration of protection, period of economic value, process of production in which it is used and value thereof

# Establishing Arm's Length Prices: Intangible Property

- CUP useful where same owner transferred/licensed comparable property under comparable circumstances to independent firms.
- Amounts charged in comparable transactions between independent firms in same industry are a guide in price determination.
- RPM useful where associated enterprise sub-licenses property to third parties,
- Both CUP/RPM useful where sale of goods incorporates intangible property.
- Where trade marks are involved, consider: value added by trade mark.
- Where highly valuable property is involved and comparable uncontrolled transactions difficult to find, consider applying 'Profit Split Method'.
- Where valuation is highly uncertain at the time of transaction, consider using any of the following to arrive at arm's length price e.g. Anticipated benefits taking into account future developments

# Establishing Arm's Length Prices: Intra-Group Services

- **Services?**
- Administrative, technical, financial, legal, accounting and commercial services, management, coordination and control functions.
- Initially, cost of these services borne by parent or 'group service centre'.
- Where services linked to arrangements for transferring goods or intangible property, it is difficult to draw the line between them.
- **Main issues in analysis of transfer pricing:**
  - Whether intra-group services have actually been provided.
  - Price charged should be at arm's length.
- Arm's length pricing determination analysis must account for perspective of service provider as well as recipient.
  - Provider – cost to service provider
  - Recipient – value of service to recipient and how much a comparable independent firm is willing to pay in comparable circumstances
- The applicable method to be selected according to guidelines discussed.
- In most cases, CUP or CPM will be used.

## Cost Contribution Arrangements (CCA): Applicability of arm's length principle

- A CCA will be considered consistent with arm's length principle
  - where each participant's proportionate share of overall contribution to the arrangement, adjusted for any balancing payments,
  - Is consistent with participant's proportionate share of overall expected benefits to be received under the arrangement
- Where this not the case, the consideration received by at least one of the participants for its contribution is inadequate, and by another is excessive relative to independent firms, an adjustment is required to establish arm's length pricing.
- Participant's contribution consistent with what an independent firm would agree to contribute in comparable circumstances.
- Contribution to CCA in proportion to the expected gains.
- Contributing parties assigned a beneficial interest in the property or service subject of CCA.
- Arm's length charge determined under general principles underlining the arm's length principle.

# Transfer Pricing Law in Pakistan

- **Income Tax Ordinance, 2001** provides that where business transactions between a resident and a non-resident person are not on arm's length basis and such transactions result in diversion of business profits to the non-resident, the tax authorities are empowered to re-compute the profits in a manner that these reflect the correct profits due to the resident person.
- Before invoking the legal provisions, the tax authorities are required to ensure that the business dealings between the resident and non-resident persons are on a basis other than arm's length. To establish that the dealings have been not on an arm's length basis, following conditions must be met:
  - Financial and commercial conditions have been made or imposed between the resident and non-resident persons which differ from those which would have been made between two independent persons,
  - That due to these conditions, profits which would have accrued to the resident person have not so accrued.

# Transfer Pricing Law in Pakistan

- As the law creates a fiction of deeming income, the relevant provisions must be strictly construed before action is taken under these provisions. They would be applicable only if all the ingredients and transactions, particularly amongst the members of a transnational group. Equally important is to very clearly understand the internationally acceptable approach for determination of arm's length price in the event a set of transactions is found to be at non-arm's length.
- Income Tax Rules prescribe the methods for determination of arm's length price.

*Whether the determination of ‘arm’s length price’ through the ‘Comparable Uncontrolled Price Method’ without carrying the systematic analysis based on the internationally accepted ‘Guidelines on Adjustment of Transfer Pricing’ is contrary to the bilateral treaty arrangements?*

- Under the relevant provisions of income tax law, it is incumbent upon the Taxation Officer to clearly establish that the intra-group transfer price were not on arm’s length prior to invoking the law.
- In determining the arm’s length price under ‘Comparable Uncontrolled Price Method’ (generally followed in Pakistan), it is necessary for the Taxation Officer to compare the relevant ‘financial and commercial transactions’ to identify the ‘conditions’ imposed in the intra-group transactions aimed at diverting the profits otherwise due to the resident enterprise.
- In carrying out such comparison under CUP Method to establish the comparability of ‘relevant transactions’, it is imperative to compare the above stated attributes of these transactions before treating them as ‘comparable’. It is necessary to consider all aspects of the *financial and commercial conditions* rather than merely looking at the qualitative aspects of materials being procured.
- **Pakistan is a signatory to several tax treaties.** Article 9 thereof follows the wordings of the OECD Model Convention The OECD Commentary on the Model Convention is binding on Pakistan in the interpretation/application of the treaty provisions.

*Whether the determination of ‘arm’s length price’ through the ‘Comparable Uncontrolled Price Method’ without carrying the systematic analysis based on the internationally accepted ‘Guidelines on Adjustment of Transfer Pricing’ is contrary to the bilateral treaty arrangements in cases where the treaty provisions are based on the UN/OECD Model Convention for the Avoidance of Double Taxation of Income?*

- The ‘OECD Guidelines on Transfer Pricing’ provide the methods and the type of analyses to be conducted for comparability of relevant transactions for the purpose of invoking the provisions of national taxation statutes in the context of the treaty arrangements. These are internationally accepted basis for inter-company transfer pricing adjustments.
- Article 9 of the Pakistan tax treaties governs the adjustment of profits in transfer pricing issues in respect of intra-group transactions.
- It is pertinent to note that in view of the Pakistan Tax Authorities having consistently ignored the internationally accepted criteria and procedures in application of Comparable Uncontrolled Pricing Method, Pakistan and Germany through a Memorandum of the Meeting of the Competent Authorities held on 6-7 July 2004 in Berlin, Germany agreed at paragraph 5 of the Memorandum that “the most preferable method (for determining arm’s length price) is the resale price method.”

# Judicial Practice in Pakistan on Transfer Pricing

**‘Transfer pricing’**, in a negative sense, has been the subject of legal interpretation and adjudication around the globe. In Pakistan, the primary issues adjudicated by the courts include

- the qualitative comparability of raw/active materials and drugs under controlled and un-controlled transactions,
  - whether or not profits arise on purchases,
  - the level of evidence required for invoking section 79 of IT Ordinance/sec 42 of IT Act, etc.
- The question of comparability of “commercial and financial conditions” in controlled and un-controlled transactions and the type of analyses required to determine the ‘arm’s length price’ appears to have not been discussed in any of the reported cases, perhaps for the reason that this issue was never raised before the Courts in a very clear manner..
  - Thus, the case law in Pakistan/India in view of Respondent’s earlier submissions has limited relevance on this most vital issue u/s 79 of the repealed Ordinance..

# Judicial Practice in Pakistan on Transfer Pricing

**The Hon. courts**, under these circumstances, need to decide transfer pricing cases in the light of considerations concerning the fulfillment of the conditions precedent to invoking the relevant TP provisions of the Ordinance, the nature of evidence necessary for reaching the conclusion that the adjustment of transfer pricing in respect of transactions between residents and non-residents is warranted, the criteria which must be met to treat a set of transactions as non-arm's length transactions, and the type of analyses required to determine the 'arm's length price' particularly where 'Comparable Uncontrolled Price' method generally used in Pakistan

# Transfer pricing in ethical pharmaceutical industry

## General remarks

- Companies engaged in ethical pharmaceutical industry are discovering, making and selling valuable products which contribute importantly to human health care and offer the possibility of attractive financial returns. They are in consequence keenly competitive.
- Their products are highly specialized and result from discovery at the edge of scientific knowledge. Patent laws protect such discoveries to a certain extent from copying by competitors but do not, however, prevent competitors from continually discovering and marketing products, which compete without infringing patents. The period of protection is limited and effectively shortened even further by the length of time it takes to test and develop a patented compound into a marketable drug and secure Governmental approval for its use and sale. Competition from copiers of off-patent substances - "generic producers" - is already important and likely to grow.
- The extent and nature of Governmental intervention in the pharmaceutical industry is in fact a distinguishing feature of the industry. There are understandable reasons why Governments regulate a drug's entry to the market and the manner of its manufacture and sale, but such regulation undeniably adds to the costs and burdens of the companies in the industry.
- Because the industry is so competitive, it is a prime necessity for every competing company, all the time, to discover new products or improve existing products in order to meet market demands more satisfactorily than their competitors as long as possible, and especially before patent protection ends for their existing products.
- As a result, companies are increasingly compelled to spend heavily on Research and Development - more heavily than most if not all major industries in proportion to their receipts from sales. Pharmaceutical Groups tend to spend, on average, some 15 percent of their annual sales revenue on R and D.

# Transfer pricing in ethical pharmaceutical industry

## **R and D: risk and cost**

- R & D: proceeds by gradual steps, building on knowledge already gained: rarely producing sudden leap forward; a long, complex, unpredictable and expensive process; greater part of it resulting in no marketable product; all effort and money spent at considerable risk.
- Some 10,000 substances may need to be synthesized for every marketable new chemical entity, which is produced. Average cost of producing such a new chemical entity estimated around \$231 million. On average, it takes approximately ten years from the initial stages of research before the developed drug is ready to be marketed. On average, a major Group is likely to produce less than one marketable new chemical entity a year.

## **Need to recover R and D currently from sales of all products**

- The size of the amounts spent on pharmaceutical R and D, and the unpredictability of its outcome, means that current R and D must, as a commercial necessity as well as from accounting prudence, be paid for out of current receipts. All Group products, irrespective of whether they are derived from R and D or not, and irrespective of how long ago the R and D from which they emerged was carried out, must contribute to current R and D costs. To price a Group's products on the assumption that current R and D costs were relevant only to the more recently marketed products would tend to make these products much more expensive to the ultimate purchaser.

# Transfer pricing in ethical pharmaceutical industry

## **Marketing**

- The size of the R and D investment requires companies to market their products widely over the world in order to seek an adequate return to pay off the investment. Competition is therefore international.
- For various reasons, companies operate at a high level of risk, higher indeed than that of many other industries; thus entitled to seek a reward for risk and successful innovation. There is required intensive and sophisticated marketing at high cost.
- In addition, the specialized nature of ethical pharmaceuticals means that their sale needs to be accompanied by a great deal of medical information and support, especially for new products. What are being supplied are in fact not simply material goods but a package of goods and services. Moreover, what is important about a drug in this context is not the amount or manufacturing cost of the material of which it is comprised but the effect which the material produces- the curative health-preserving effect.

## **Pricing of drugs**

- Other things being equal, end-selling prices will reflect above considerations. In many countries, however, Government intervention will limit end-selling prices. This may be done directly, or it may be done indirectly by limiting profits, or the amounts, which Governmental health services will reimburse those who pay for drugs, or it may be done in other ways such as encouraging doctors to prescribe generic drugs.
- End-selling prices of drugs will tend to be determined (within the bounds imposed by Government controls) essentially by reference to the relationship perceived between the therapeutic value of the product and that of its competitors. Costs would enter into the calculation of whether a drug would be produced at all, but the costs of discovering, developing, manufacturing and marketing a drug would not be the prime determinants of its value or its end-selling price. It would not make commercial sense to use a cost based approach to such pricing. It is commercially necessary that the receipts from the sale of each drug should make a contribution to the costs and profits of the enterprise as a whole, not simply to the costs and profit, which might be attributed to each single drug by it. But, in any case, costs, particularly those of R and D and intra-Group services, could only be allocated to particular products in a relatively less precise manner.

# Transfer pricing in ethical pharmaceutical industry

## **Practice of Pharmaceutical Companies in Determining Transfer Prices**

- The high value/low-mass nature of pharmaceutical products and their ingredients enables them to be moved from country to country at different stages in the production and marketing chain in order that the Group may make the best use of its worldwide resources. These movements are thus the occasion for many transfer prices.
- Most pharmaceutical Groups aim to use transfer prices, which are consistent with the arm's length principle. They may or may not use any of the three classical methods to determine them. In using any method a Group will often be mindful of some need to provide, for the relevant subsidiary, in the long term, a fair return on its assets, or for its functions, activities or risks, or to provide whatever in the circumstances seems to be a reasonable local pre-tax profit. It may also see a need to provide some protection against severe foreign exchange loss in the long term, and to provide a framework of certainty in the pricing of supplies. This approach can be argued to be compatible with arm's length pricing.
- Transfer prices will normally be kept stable for as long as possible, but will be reviewed periodically or in certain special situations. Most companies seek to use essentially the same transfer prices over a wide area