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Article

Transfer Pricing: What Is It and Why Does The Tax Office Monitor It?

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Abstract: This article examines the use of transfer pricing for tax evasion by related companies and enterprises, methods for its determination, and inconsistencies in the tax code.

Keywords: Transfer pricing, transaction terms, methods, foreign trade transactions, OECD — Organization for Economic Cooperation and Development, comparable market prices, resale price method, cost method, comparable profitability method, profit sharing method.

1. Introduction

In the global business world, companies often consist of many branches and divisions in different countries. When one branch sells a product or service to another within the same holding company, the question arises: at what price? This is the essence of transfer pricing (TP).[1]

That is, a transfer price is a price that is formed in transactions between related or foreign trading parties and is lower than the objectively formed (market) price that would be used in similar transactions between independent persons.

How does it work?[2]

A transfer price is a price for transactions between related parties. For example, a factory in one country supplies components to a sales office in another country, or such a process has already taken place in the same country.[3]

The main problem here is the temptation to "redistribute" profits. If taxes are high in one country and low in another, a company can artificially reduce or overstate the transaction price, so that the bulk of the profit remains in the country with low taxes.[4]

That is, any income that one of the parties to the transaction may receive, but not as a result of transfer pricing, is subject to tax control.

The “arm’s length” principle.This is the main rule of TN, recognized worldwide. The essence of the rule: Prices in transactions between related companies should be the same as prices in transactions between independent companies under similar conditions. If the price deviates from the market price, the tax authorities have the right to levy additional taxes based on market indicators.[5] Why is it important for companies to report and be informed about this? Today, transfer pricing is a high-risk area. Tax authorities in different countries actively exchange information, and errors in reporting can lead to large fines.Accordingly, when determining transfer pricing, the following are subject to tax control:

1. Controlled transactions between related parties[6]
2. Transactions under foreign trade control

2. Materials and Methods

Related parties are recognized, for example, if one person directly or indirectly participates in several companies and in each of them such participation exceeds 20%. The main methods recognized in international practice and enshrined in the tax codes of many countries (including Uzbekistan) are:

1. Comparable Market Price Method

This is the preferred method. It is considered the most direct and reliable.[7]

Basic: The transaction price is compared with the price in a similar transaction between independent companies.

When to use: When there is publicly available information about the prices of identical (or very similar) goods or services in stock exchanges, quotations, or proprietary transactions with independent customers. [8]

2. Resale Price Method

Basic: We take the price at which the seller resells the product to an independent buyer and subtract a markup (surcharge) that is customary in the industry. The remainder is the “fair” market price for the original transaction.

When to use: Often used when reselling goods without extensive processing.[9]

3. Cost Method

Basic: We take the manufacturer's costs as a basis. To them is added a profit margin that is typical for the industry.

When to use: Suitable for the service sector, the production of raw materials/semi-finished products where it is difficult to find comparable products for labor indicators or price comparisons.[10]

That is, it is the process of accounting for all costs associated with production (materials, labor, depreciation) in order to determine, plan and control the cost of the product.

4. Comparable Profitability Method

Basic: If it is difficult to compare prices or add-ons, the overall profitability (profitability) of the entire transaction is compared. Company indicators (for example, trade profitability) are compared with market averages for similar businesses.[11]

When to use: When the company performs complex functions and it is not possible to find a single comparable transaction.

The comparable profitability method (or comparison within the income approach) is a method of determining the value of assets, investment projects, or enterprises by comparing the expected income they will generate with the profitability of similar objects.[12]

3. Results and Discussion

Essence: The profit distribution method is about maintaining a balance between "today" and "tomorrow". In simple terms, this is the procedure and mechanism for distributing the net profit of the enterprise in targeted areas (dividends, reserves, reinvestment). In accordance with the Law of the Republic of Uzbekistan "On Amendments and Addenda to Certain Legislative Acts of the Republic of Uzbekistan in connection with the adoption of the main directions of tax and budget policy for 2026", starting from 2026, Article 137 of the Tax Code "Types of Tax Audits" was supplemented with paragraph 4, which established an audit on the formation of transfer prices. If violations are identified as a result of the audit, Article 226 of the Tax Code, which is mainly for the amount of tax not paid or not fully paid by the taxpayer, entails the imposition of a fine in the amount of forty percent of the unpaid tax amount.[13]

How to minimize risks?

To ensure security for publication in the business community, it is important to highlight the following stages:

1. Preparation of documents: Preliminary justification of the selected pricing method.
2. Monitoring of market indicators: Constantly monitor quotes and market ranges.

3. Agreements on prices and transactions: This includes maintaining documents in accordance with the Resolution of the Cabinet of Ministers of the Republic of Uzbekistan dated March 10, 2022 No. 111 “On approval of certain legislative acts regulating tax control in determining transfer prices and tax administration of non-residents”.[14]

Transfer pricing methods are used to verify that prices in transactions between related parties correspond to market prices (the “arm's length” principle).

The Organization for Economic Cooperation and Development is an international organization established in 1964 to promote economic growth and the development of global trade.

“Global tax transparency and international cooperation require working together to ensure that taxes are paid in full and in the correct amount. The Organization for Economic Cooperation and Development is a leader in international efforts to end bank secrecy and increase transparency and information exchange to combat tax evasion.”

Transfer Pricing Rules are international standards based on the “arm’s length” principle. They require that prices in transactions between related parties be consistent with prices in independent parties. The main principles include comparative analysis of transactions, the application of five basic valuation methods, transfer pricing documentation, and cross-country reporting.

The main areas of this work include improving tax administration, combating corruption, responsible corporate governance, financing sustainable development, and ensuring an effective transition to the digital economy.5

Transfer pricing is not a method of "tax avoidance", but a means of correctly distributing financial results within an international group. In today's reality, the transparency and reasonableness of transfer pricing is the key to the stability and reputation of any large business.

Problem:

I. Part 9 of Article 176 of the Tax Code states that “transfer pricing control on value added tax (VAT) and excise tax shall be carried out only if one of the parties to the transaction is not a payer of this tax”. This gives rise to the following problems:

1. Manipulation between VAT payers: If both companies are VAT payers, they can reduce their obligations to the budget by setting artificially low (or high) prices.

2. Chain schemes: There is an opportunity to illegally use the VAT refund (offset) mechanism from the budget through “transit” operations through VAT payer companies.

II. Also, this norm allows for the application of TN control only to the pair “taxpayer - non-taxpayer”. The pair “taxpayer - taxpayer” remains outside the scope of TN control. It is precisely this that allows interrelated VAT payers to manipulate profits and VAT burdens through prices.[15]

4. Conclusion

a. International experience: It is recommended that the VAT rules be applied uniformly to all types of taxes (including VAT). In many developed countries, VAT control on VAT is carried out not depending on the status of the parties, but on the consequences of the transaction.
b. Protecting the interests of the budget: If both companies are VAT payers and are interconnected, they can lower prices within the group, ultimately reducing the overall corporate tax burden of the group. This is directly detrimental to the budget.
c. Preventing discrimination: The current regime controls only small businesses or large companies that work with non-VAT payers. Transactions between large companies (for example, a holding company and its manufacturing subsidiary) remain uncontrolled. This leads to an unfair distribution of the tax burden.

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