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Transfer Pricing by the Multinational Companies: The Case of Egypt

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This paper mainly investigated the effect of Electronic Commerce (EC) on Multinational Enterprises (MNEs) transfer price. Not long ago, transfer pricing was a subject for tax administrators. But recently, politicians, economists and business men, as well as tax authorities, are realizing the importance of who pays taxes on international business transactions between different arms of the same corporation. The reasons of this importance are globalization, the growth of MNEs, and the emergence of EC. The research studied MNE characteristics and transfer price strategies and the influence of EC on both the MNE and transfer price. Also, it investigates EC effects on taxes and whether tax regulations and transfer price methods are applicable for EC transactions or not. The theoretical and empirical study verifies that there are problems in the application of current transfer price methods for EC transactions and MNEs use transfer price to reduce its tax liability. In addition to, there are some legal loops in taxing EC transactions that have negative effect on tax revenue. The researcher distribute a questionnaire to 80 MNEs operating in Egypt, conducting interviews with some tax inspectors to show EC impact on tax proceeds as well as transfer price problems. Also, the paper studies the Egyptian environment concerning transfer price and EC.

Keywords: Transfer price, Multinational Enterprises, Electronic Commerce, Tax problems.

1. Introduction

The structure of modern business process has significantly changed in the last decades, especially for cross-border transactions. Also, MNEs have significantly changed the contractual structure of doing business. OECD recognizes that the role of MNEs in world trade has increased dramatically over the last 20 years. For instance, changes in manufacturing processes, increased data communications and networking, as well as the increasing role of services and valuable intangibles in the economy. More than 60% of the world trade takes place within MNEs. As a result, the related trade parties are growing both in volume and scope (Turner, 1996).

Today, MNEs are facing two major issues. The first issue is that internationally accepted transfer pricing methods are no longer applicable to EC cross-border activities. The second issue is that the Corporate Financial Officers (CFO) and accountants, in these multinationals, must help in reducing the risk of transfer pricing tax audits of either Internal Revenue Service (IRS) or host countries' tax authorities (Abdallah, 2002). Transfer prices are relevant for both tax payers and

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tax administrations because they determine the income and expenses of the business and therefore, taxable profits of associated enterprises in different tax jurisdictions (Turner, 1996). However, the importance of intangible assets transfers have become currently recognized as one of the most important and controversial components of international business activity. The subject of EC, however, grows to be more complicated because of the controversy that has emerged over the cost of intangible assets transfers. The pricing decision for intangibles transfers, whether domestic or international, can be complex.

Subsequently, MNE must have a global comprehension of different national tax regulations in addition tax authorities should be prepared for different MNEs transfer price strategies. A survey of national government reactions shows that many countries have not passed any significant tax legislation or administrative guidance with respect to the taxation of global EC. Although there are no connection between the two (i.e. transfer price and EC), transfer pricing has been identified as one of the crucial challenges that EC poses to tax systems.

The emergence of EC has complicated the rules for transfer price strategies for MNEs. The OECD noticed that one of the most difficult issues is establishing an appropriate transfer prices for tax purposes. In principle, EC offers no new problems, no fundamentally or categorically different dimensions, for transfer pricing. It may, however, increase the complexity of transfer pricing analysis. The development of private intranets within MNEs puts pressure on the traditional application of the arm’s length principle by stimulating the integration of multinational operations, particularly in the provision of services. This makes it even more difficult than it is already for tax authorities to determine what a given transaction actually is, and how to find a transaction between independent enterprises that it may be considered a comparable transaction to that undertaken between related enterprises.

When an MNE is engaged in EC, traditional transfer pricing methods may be more difficult to apply to reduce their worldwide tax liabilities and globally integrate their production and marketing strategies. The difficulty lies in the application of internationally accepted methods to the special circumstances created by EC activities such as, the increased orientation towards specialization, integration of common functions, and cooperation between different locations and legal entities.

The main issues in digital products or services transferred through the EC are three issues: (1) web-based services that are unique to EC; (2) the ability to deliver products electronically; and (3) the ability to operate a web-based business remotely. Services and digitized products, such as software, can be delivered over the internet to customers around the world. Customers can pay the price electronically, and internet providers make sure to secure all transactions completely. Tax rules and regulations governing EC transactions and electronic delivery of products are, however virtually nonexistent.

It is important to know whether or not a MNE has created a taxable presence in a country. This requires understanding of the three items; (1) the web server (hardware), (2) the web site (software), and (3) the Internet Service Provider (ISP); to decide which one will be an indicator of the Permanent Establishment

(PE) and determine the taxability of the income generated by EC transactions (Abdallah, 2002).

This research studies transfer price problems of MNEs as well as the effect of using EC on MNEs. EC benefits MNEs in different ways but it also creates different problems and complicates applying traditional transfer pricing rules especially to intangible assets and calculating taxes for both tax payer and tax administrator. This is because tax legislation does not state tax rules that govern EC transactions. This research addresses both the problem of MNEs transfer pricing and problems faced by MNEs and tax authorities as a result of using EC.

The research reviews the main global transfer price methods for tangible and intangible assets and assesses the problems of EC for both MNEs and tax authorities. In addition the paper evaluates the recent legislations for transfer price of estimating EC transactions and finally it assess the current tax regulations applied in Egypt related to EC and transfer pricing.

The research objectives were reviewing the main global transfer price methods for tangible and intangible assets. Assess the problems of EC for both MNEs and tax authorities. Evaluate the recent legislation for transfer price used in estimating EC transactions. Assess the current tax regulation applied in place in Egypt concerning EC and transfer pricing.

The research main questions were: What is the global transfer price methods used for tangible and intangible assets? How does the EC influence MNC's strategies? What are the problems faced by tax authorities as a result of applying EC? Are the current legislations valid in assessing tax bases for EC transactions and setting transfer prices? What is the most appropriate framework for applying global transfer price methodologies for intangible assets?

The following sections of the research will cover transfer pricing in Egypt, the literature review, EC Impact on MNE Policies, Tax Complexity for EC, Challenges that Face Egypt in EC Era, research hypotheses and methodology, and finally the research conclusions and results.

1.1 Transfer Pricing in Egypt: An Overview

Planning transfer pricing strategies, working to limit tax exposures and defending the company's return position and transfer pricing practices on a global basis require knowledge of a complex issues such as country tax laws, regulations, rulings, methods and requirements. According to a survey done by the World Bank Investment in Egypt (2004), which surveyed around 1000 enterprises, tax-related issues were ranked as severe by almost 80% of the participants. A key finding of this survey was that tax administration officials exercised substantial discretion in applying rules in most areas of enterprise regulation or public service access.

In June 2005, the Egyptian parliament approved Law no 91/2005 to add and organize the transfer pricing regulations. It states that all companies are equal under the law, through paying a 20% tax on profit (instead of 32% or 40%, depending on the activity, and 2% is added as a development duty). This improves the rules for MNC's.Tax revenues increased, even though the government expected a reduction. Corporate tax revenues went from £E 22 billion in fiscal year 2004 to £E 39 billion in fiscal year 2005, despite the fall in corporate tax rates (from 32–40% to 20%). The new law brings more sophisticated concepts, such as transfer pricing rules and definitions of PE and royalties, which are more difficult to implement. Egypt's definition for PE is based on the UN convention.

Egyptian corporations are subject to corporate profits tax on their profits achieved in Egypt, as well as on profits achieved from abroad, unless the foreign activities are performed through a PE located abroad. Foreign companies resident in Egypt are subject to tax only on their profits achieved in Egypt. To bring the tax system in line with modern international tax practices and to provide domestic investors with an incentive to invest in Egypt, rather than abroad, the new law introduces residence based taxation for corporate taxpayers. Previously, Egypt levied tax only on income generated within their borders; a system known as source tax. Adoption of a residence based system coupled with credits for foreign source tax paid should help Egypt retain domestic investment.

The new residence based system is more complex than the previous source-based system, so training for tax inspectors is essential. With the self-assessment system, tax inspectors become tax auditors. Accordingly, they do not assess the tax due, they accept the estimations done by the taxpayer and audit a few taxpayers based on risk assessments (Ramalho, 2008).The transfer pricing provisions are based on the arm’s length principle. Under these provisions, the tax authorities may adjust the income of an enterprise if its taxable income in Egypt, is reduced under contractual provisions that differ from those agreed by unrelated parties. APA provides guarantees that transfer prices will not be challenged after the tax return is submitted. On the other hand, it imposes consequent penalties and interest on late paid taxes (PKF Egypt Tax Guide, 2009).

Egypt has become the first Arab and African country to sign the OECD Declaration on international investment and MNEs. Egypt has made impressive progress in reforming its investment policies in recent years. The Investment Policy Review of Egypt 2007 declare that FDI inflows increased twelve-fold between 2001 and 2006, to amount of $9 billion in the first three quarters of 2007, compared with $6.1 billion for 2006 as a whole.Moreover, the new tax law encompasses elements to increase compliance of tax administration. The Egyptian government aims by introducing a lower rate of tax and a stricter enforcement system, that tax evasions will decline (OECD, 2006).

A comparison between transfer price rules among different countries, give an indication if the Egyptian legislation need to be modified or not. The comparison chooses countries approve transfer price rule before Egypt as U.K, U.S. and countries approve transfer price rules after Egypt as China. Table (1) in the appendix shows the transfer price rules for China, India, Egypt, U.K, and U.S and compare between them from different criteria. The analysis of the legislation of each country shows that transfer price rules of Egypt need to be more specific, clear, detailed, and enforceable. The law needs to be modified concerning certain points such as:

- Required transfer pricing documentation for Egypt statutory required and has not been defined by tax authority until now, although in China which approve rule in 2008 the regulation specify detailed documentation requirement.
- Deadline for documentation preparation for Egypt not applicable although other countries either developed or developing specify preparation deadline with tax return according to each tax authority.
- Specific categories of documentation required for Egypt have not been defined although these categories of documentation help tax authority to audit carefully the company transfer pricing methods. These categories of documentation need to be mandatory.
- Transfer price penalties need to be more strict and enforceable.
- The law should be clear and justified, if tax payer ask about if transfer price penalties can be reduced, the answer is not applicable. Therefore, each question should find a clear answer as not applicable have no meaning and give no indication.

To sum up transfer price rule in Egypt need modification to be more specific and clear. Any law needs to be developed as the economic environment of the business has a continuous change. Although, tax regulations of China become effective from January 2008, China legislators enter some development for transfer price rules in 2009. Also, U.K. and India made some modifications concerning transfer price audit, adding a new risk approach to transfer price enquires, targeting high risk transactions and structures. On the other hand, Egypt legislation has not been modified from 2005.

2. Literature Review

The international operations could have both positive and negative impacts on performance. The positive impacts are originated from the MNCs’ ability to leverage scale economies, access new technologies, and arbitrage factor cost differentials across multiple locations. As well as, differences in government regulations (e.g., taxes, accounting, subsidies). Also, the motivation for diversifying internationally is to improve the reward-to-risk trade off by taking advantage of the relatively low correlation among returns on assets of different countries.

Management is able to take advantage of international tax differences and to arbitrage temporary international market imperfections by managing transfer pricing, and investors will earn a higher return on their investment from holding an internationally diversified portfolio. But restrictions on capital movements and other market imperfections make it costly for individual investors to maintain efficient international portfolios. Alternatively, although MNCs owns sources of competitive advantage that are not available to domestic firms, they are also exposed to additional costs and risks (e.g., geographic concentration risk, market and political risk).The economic impact of currency exchange rate changes is complex because such changes are often linked to variability in real growth, inflation, interest rates, governmental actions, and other factors.

MNCs, in comparison with domestic firms, may face more scrutiny from investors, more pressure to provide enhanced guidance, and increased scrutiny from policymakers on tax and earnings issues. The cultural differences, geographic constraints, differing legal systems, and language barriers increase the complexity of international operations, thus increasing the risk profile of the firm. Transfer pricing has emerged as one of the dominant sources of controversy in international taxation.

The transfer prices impact the taxable income reported in each country in which the MNE operates. MNEs wish to minimize their tax burden and tax authorities wish to ensure that the tax base of a MNE is divided fairly. Thus, both tax authorities and MNEs are interested in the way which a transfer price is determined. In the accounting literature, a transfer price is considered as a part of the Management Control System of the company with two main objectives: the promotion of goal congruence and the provision of a suitable system of performance measurement and evaluation (Letish & Barrett, 1992).

Transfer pricing refers to "the pricing of contributions (tangible & intangible assets) transferred within an organizations, e.g. goods from the production division may be sold to the marketing division, or goods from a parent company may be sold to a foreign subsidiary". Since the prices are set within an organization (i.e. controlled), the typical market mechanisms that establish prices for such transactions between third parties may not apply. According to Iqbal (2001) a transfer price is "what one segment of a company charges another segment of the same company for the transfer of a good or a service. The segments may be subsidiaries, departments, branches, or any other part of the overall MNCs".

Ernst and Young (1997) defined transfer pricing to be "the pricing of cross-border intrafirm transactions between related parties". This term used to be known only to a few international tax specialists; however, according to a survey conducted by Ernst and Young (1999) transfer pricing is the hottest issue faced by MNEs. Moreover, Ernst and Young (2009) survey stated that the world has changed. A worldwide recession and turmoil in the financial markets have brought serious, and often unforeseen, challenges to MNEs in managing their transfer pricing

MNEs view transfer pricing as problematic given the potential effect of differences in tax rates and transfer pricing policies on their reported profits. MNEs normally set their transfer prices based on either production costs or market prices; a conducted survey found that about two-thirds of transfer prices are cost based. However, there are internal and external motivations for the MNE to establish transfer prices. On one hand, a transfer pricing can be a way to motivate managers and to monitor subsidiary performance. On the other hand, it is necessary to set transfer prices for cross-border trade flows helping MNE to pay corporate income taxes on its domestic and foreign source income. In addition, transfer pricing can achieve other benefits for the MNE as: Tax and tariff reduction; Avoiding exchange controls; Increasing profits from joint ventures (Shenkar & Luo, 2004).

In addition, Shapiro (2005) states one more use for transfer price which is hiding an affiliate’s true profitability. Higher local prices are justified by hiding the true profitability of its local affiliate. Also, lower reported profits may improve a subsidiary's bargaining position in wage negotiations. For this reason several international unions have called MNEs for full disclosure of their worldwide accounting data. However, a proper transfer price would affect MNC in certain ways such as, assisting top management in evaluating and guiding divisional performance providing adequate information on divisional revenues and expenses; helping the division manager in running the division; and insuring divisional autonomy, and finally allowing each profit center to act as an independent agent. Developing a set of transfer pricing rules that can integrate the complex dimensions of an organization, insure divisional autonomy, and at the same time achieve overall corporate goals is a very difficult task. The main positive characteristics of a transfer pricing system should include insuring goal congruence, being fair to all concerned parties, and minimizing conflicts between divisions.

Ernst & Young (2005) conducted independent interviews with 348 parent companies and 128 subsidiary corporations in 22 countries. Their transfer pricing survey results clearly indicate that transfer pricing continues to be a priority tax issue for governments and MNEs around the world. Their 2005 Survey responses strongly reaffirmed previous survey findings that transfer pricing is the dominant tax issue facing MNEs. New trends have also emerged in the 2005 Survey. More than 70% of parent company respondents reported significant changes in their business operations during the last three years whether through business expansion, by M&A, or by redeployment of resources. At the same time, MNEs are constantly changing the type and the scope of their operations around the world.

Among the Ernst and Young (2005) Key global findings was that more than 90% of all survey respondents find transfer pricing important; transfer pricing is identified more than any other concern as the most important item on the agenda of their corporate tax directors. In addition, 31% of all respondents believe that transfer pricing will be absolutely critical to their organizations over the next two years. Moreover, 63% of all respondents have undergone a transfer pricing audit in the last three years; over 40% of these examinations have resulted in adjustments by the tax authorities. Also, in 2007 Ernst and Young survey MNCs concerning transfer pricing and found the following: 87% of MNEs believe that transfer pricing is a risk when managing their financial statements, as compliance requirements have increased due to developments in financial reporting. Risk mitigation is a key priority for MNEs, and transfer pricing has increasingly moved into board rooms and audit committees. MNEs want to ensure that transfer pricing is compliant with tax laws.

The degree of perceived transfer pricing related financial statement risk varied significantly by industry. In particular, 53% of parent company respondents in telecommunications, 48% in pharmaceuticals, and 45% in the biotechnology industry reported that transfer pricing posed the largest financial risk they face. Also, over half of the survey respondents (53%) said that their transfer pricing compliance costs had increased. This was a significant increase on the 2005 survey results, where only 29% of parent companies mentioned a rise in costs as a result of financial reporting and regulatory developments. Concerning tax and custom authorities’ coordination, the lack of MNEs internal customs and tax coordination has increased since 2005 survey. This is a result of general lack of appreciation of how customs and tax offices work together, domestically and internationally. The survey further showed that 19% of parent respondents have had their customs valuations challenged where they have been based on their transfer prices for the same goods, or vice versa. Transfer pricing was found to be the single most important issue for 76% of parent respondents in the pharmaceutical sector, which was an increase of 19% on the 2005 survey.

Ernst and Young (2009) survey state that transfer pricing environment has moved on rapidly. Among, the key findings and analysis are:

- Tax authorities are increasing their dedicated transfer pricing resources and improving their specialist capabilities.
- Jurisdictions seem to be gearing up not simply for more audits, but also for more transfer pricing penalties and for more disputes.
- Many companies have suffered a reduction in profits or undergone business restructuring as a result of the recession, which are cited as the two most common audit triggers. In addition, the industries that have been most affected by the downturn are the ones most actively targeted by many jurisdictions for transfer pricing audit.
- Transactions with tax haven jurisdictions and major investor jurisdictions are increasingly likely to be scrutinized.
- Substantial differences remain in the practical application and enforcement of what is supposed to be the governing and commonly accepted rule the arm’s length principle.

Analyzing the previous studies and Ernst and Young surveys since 1995 until 2009 found that transfer pricing continues to be the number one international tax issue of interest to MNEs, in addition to;

A. The intensely challenging economic climate.
B. The growing number of countries that devote attention to transfer pricing activities.
C. The increase in the number of countries introducing both documentation requirements and penalty rules.
D. The ever increasing diversity of transfer pricing issues facing MNEs. As a result of the challenges of a global economic downturn, many governments are sharpening their focus on compliance, enforcement and legislative approaches. Therefore, explaining transfer pricing regulations and legislative approaches is essential to help MNEs to meet their tax obligations, often with reduced budgets and fewer resources.

MNEs view transfer pricing as problematic given the potential effect of differences in tax rates and transfer pricing policies on their reported profits. MNEs normally set their transfer prices based on either production costs or market prices; a conducted survey found that about two-thirds of transfer prices are cost based (Tang, 1997). However, there are internal and external motivations for the MNE to establish transfer prices. On one hand, a transfer pricing can be a way to motivate managers and to monitor subsidiary performance. On the other hand, it is necessary to set transfer prices for cross-border trade flows helping MNE to pay corporate income taxes on its domestic and foreign source income. In addition, transfer pricing can achieve other benefits for the MNE as:

- ***Tax and tariff reduction;*** tax minimization is the main reason behind transfer pricing policies. When tax rates varies among countries, MNEs favor low transfer prices for goods and services bought by an affiliate in a high tax jurisdiction and high transfer prices for goods and services sold by, an affiliate in a low tax jurisdiction. Also, transfer price can be used similarly to minimize import duties. Tariffs could be reduced if the selling companies under price the goods it exports to the buying unit. For example, a product that sells for $100 has an import price of $120 because of a 20% tariff. But if the invoice price were listed as $80 rather than $100; it would be imported for $96 (Shenkar & Luo, 2004).
- ***Avoiding exchange controls;*** transfer pricing may be used to offset the volume effects of foreign exchange quotas. If a government allocates a limited amount of foreign exchange for importing particular goods, a parent company may under price products shipped to its subsidiary, by doing so it allows a greater volume of imports. When MNE wants to move funds out of one country, it may consider charging higher prices on goods sold to its local affiliates. Similarly, MNE may indirectly finance an affiliate by lowering the prices of goods sold to it.
- ***Increasing profits from joint ventures;*** transfer pricing enables the party to gain unilateral profit from controlling the joint venture's import and export activities. For example, Hong Kong investors are not concerned with the reporting profits in their joint ventures in Mainland China. This is because they have already made returns from over pricing materials imported for the joint ventures and by under pricing joint venture outputs exported to headquarters (Shenkar & Luo, 2004).

In addition, Shapiro (2005) states one more use for transfer price which is hiding an affiliate’s true profitability. Higher local prices are justified by hiding the true profitability of its local affiliate. Also, lower reported profits may improve a subsidiary's bargaining position in wage negotiations. For this reason several international unions have called MNEs for full disclosure of their worldwide accounting data.

However, a proper transfer price would affect MNC in certain ways such as, assisting top management in evaluating and guiding divisional performance providing adequate information on divisional revenues and expenses; helping the division manager in running the division; and insuring divisional autonomy, and finally allowing each profit center to act as an independent agent. Developing a set of transfer pricing rules that can integrate the complex dimensions of an organization, insure divisional autonomy, and at the same time achieve overall corporate goals is a very difficult task. The main positive characteristics of a transfer pricing system should include insuring goal congruence, being fair to all concerned parties, and minimizing conflicts between divisions (Belkaoui, 2002).

2.1 EC Impact on MNE Policies

The Internet is provoking a number of issues that are laying the foundation for a new global economy, in which production and consumption become more mobile, dynamic, intangible, and multinational. First, the shift from a manufacturing based economy to a service based economy has been reinforced by the explosive growth of the IT industry. Second, the sharply falling costs of both transportation and communications which have lead to the development of an integrated global market place in which intermediate inputs and final products move more freely among states and nations. Finally, the growth of direct marketing and distance selling through mail order, telemarketing, television shopping networks, and most recently, internet retailing has fastly expanded the proportion of remote commerce that can be conducted almost instantaneously between vendors based in one location and consumers in another.

Issuing new transfer pricing regulations to meet these challenges is a source of conflict among objectives for MNCs. Transfer pricing systems, of both tangible and intangible assets including EC cross-border business transactions should be designed to meet the new business and tax challenges more effectively than before. The nature of intangible assets vary widely and include IP such as brands, customer lists, technical, designs, databases, in addition to the more traditional product and process formulations (Walsh, 2001). The new economy has created an increase in new technology based IP. For accounting purposes, the Financial Accounting Standards Board (FASB) defines technology-based IP as patented technology, trade secrets, databases, and software (Wiederhold et al., 2009).

The real measure of a company's value is now seems to rest in its people and technology-software ideas rather than in its hardware equipment and real estate. Financial Executive Officers (FEOs) of MNCs can make valuable tax savings for their companies by making the most relevant and objective transfer pricing tax strategies (Collardin & Alexander, 2002). Several issues have increased the importance of transfer pricing of intangible assets for MNCs, for example:

1) The growing globalization of markets and a consolidation of some markets structures, particularly the restructuring of the telecommunications, electronics, pharmaceutical, and other industries in EU marketplace.
2) The requirements of Sec. 482 of the U.S. IRC (1) which in 1986 was amended to satisfy the Commensurate With the Income (CWI) standard. It was a response to the IRS's allegation that MNCs were not paying their fair share of taxes. Instead, MNCs direct their income to tax haven countries.
3) The increased concern of national tax authorities to protect their country's share of the taxable income earned by MNEs. Recently, every MNC has become aware of its responsibility and obligation to have a sound documented transfer pricing system. This documentation has become the focus point in all transfer pricing tax audits. MNC's success in audit and its ability to maintain reasonable reserves for financial reporting purposes is directly proportionate to the quality of the analysis. These benchmarks are also the key to success in any strategic tax planning program used by an MNC. Therefore, understanding the intangible assets in details is important to design an appropriate transfer price system for transfers of intangibles through EC.

The problem of calculating the price of goods and services transferred between associated companies is not new, and is not exclusive to EC. What is new, however, is the level of integration between businesses operations located in different countries, which is made possible by EC (Hardesty, 2001). Thus, traditional methodologies have been challenged particularly by those MNCs whose income is mainly through services, or through the use of intangibles.

For example, WebCo.com Inc. is a U.S. corporation, and an online global retailer. The company owns another corporation, organized and doing business in France. The WebCo.com charges the French company for certain services, such as accounting. It also licenses to the company the right to use its trademarks and copyrighted materials. France has the right to tax profits attributable to the French company. In order to calculate the profit correctly, the prices charged by WebCo.com must be taken into account. However, if WebCo.com charges too much or too little, the profits taxed by France will not be correct (Hardesty, 2002).

Although, Maguire (1999) argues that EC do not present new transfer pricing problems; it only magnifies exiting issues such as the evaluation of intangibles and services, and compliance with documentation and information reporting requirements. Also, OECD still think that current principles in dealing with EC transfer pricing transactions are adequate, and that EC has not presented any fundamentally new problems for transfer pricing. However, due to the rapid development in communications resulting in instantaneous transmission of information, tax administrations found that it become more difficult to identify, trace, quantify and verify cross border transactions. As a result there are difficulties in applying internationally accepted transfer pricing methods to EC, which creates complicated problems for MNC's, tax authorities, and international organizations in applying EC. The problems result from using EC includes 1) Evaluation of Comparability; 2) Identification of transactions; 3) Use of intangibles; 4)Web-based services; 5) Evaluating contributions of MNE group members.

2.2 Tax Complexity for EC

EC has a strong impact on taxation and tax policy. In particular, EC could result in the erosion of tax bases; specifically Consumption taxes.Tax planning for an E-business differs from tax planning for a traditional bricks-and-mortar company. Historically, the generation of income depends on the physical presence of assets and activities (OECD, 2000).

This physical presence, or PE, determines the jurisdiction needed to practice the right to tax the income generated. Because of the growth of EC, new E-business models (including digital marketplaces, on-line catalogs, virtual communities, subscription-based information services, online auctions, and portals) have emerged. Each model allows taxpayers to conduct business and generate income in a country with little or no physical presence in that country.

The separation of assets and activities from the source of the income represents a significant departure from historic business models. This change creates new tax planning challenges and opportunities (Olin, 2001). The tax challenges are to identify a place of tax payer and the responsible tax authority to collect taxes. In addition to, increase the tax evasion especially for income and sales tax.

These economic trends have a great effect on the different local, regional, and national taxation formulas used by countries throughout the world. It is easier to tax domestic business activity that involves the sale of tangible goods or property than to tax business activity that is multijurisdictional and involves the sale of services or intangible property.

The increase in jurisdictions number raises legal and political risks for MNC's (Kostova & Zaheer, 1999). Moreover, the taxation problem of MNEs increases in its complexity as a result of using EC heavily. On the other hand, governments face three types of taxation problems: jurisdiction, allocation, and evaluation because of MNC's expansion.

The first issue is jurisdiction; this problem concerns answering several questions such as which government has the right to tax the MNE's income, and if two governments both claim the same right to tax, should one government's claim have priority over the other. What if the tax base is earned in more than one country? Which government should have the right to tax this income base? Should tax exemptions be given by one of the governments in order to avoid double taxation?

EC reduce the geographic borders between countries, so EC deals take place with no need for the seller to transfer to buyer country especially in digital products as the buyer download it from the internet. As a result the problem of which country has the right to impose tax emerges, which lead to double taxation as each country imposes tax. The double taxation can prevent the spread of EC although, the WTO announce that governments should find a framework to organize the problem of double taxation. A lot of countries try to solve the problem of double taxation by developing tax treaties; but still tax treaties solve part of the problem.

A second issue is allocation; affiliates of the MNE share common overheads and resources. These resources should be allocated where they provide the greatest overall advantage to the MNE group. National trade and tax barriers distort this allocation and raise national and transactions costs for the MNE. On the other hand, the costs and income allocated among jurisdictions. Setting transfer prices for intragroup transactions in services and intangibles creates confusion among governments which leads to international disputes.

A third issue is evaluation; determining the value of intrafirm transfers. The MNE is an integrated entity, with the ability to convert international differences into integrated economy that have common control, goals, and resources. Yet, these differences complicate international allocation and evaluation of the MNE revenues and expenses, and thus international taxation creating interjurisdictional conflicts not only between MNEs and nations but also between home and host governments.

In any international tax situation, there are three parties: the MNE and the two tax authorities. When one government taxes an MNE unit (parent, subsidiary, branch), it has implications for the tax base of the other country since, in any intrafirm transaction, a higher tax base in country A implies a lower base in country B (Durst et al., 1999).

On the other hand, MNCs could face inconsistent and unfair treatment of cross-border transactions, double taxation and penalties for non-compliance. International transfer pricing of EC transactions has not been discussed to the same extent as other important strategic business and tax issues (Durst et al., 1999). The complexity of the issue might require MNCs to redefine and update their strategies to face the new challenge of the IT. EC transactions through the internet issue taxation problems for the countries which can be summarized as follows:

- Which government has the right to impose tax on income come from transaction done through EC.
- Problem of double taxation results from imposing several taxes on the same person using EC.
- Hide of important information about the buyer and seller especially in the digital products which complicate the work of tax authority in each country.
- Problem of tax treatment of costs of building web sites.
- Tax audit problem of EC transactions.
- Identification of income types (income/ royalties/ sales) come from EC transactions.

3. Challenges that Face Egypt in EC Era

In spite of the significant growth in the internet and value added services, there are still several challenges that the internet community are currently facing. These challenges are common among Arab, African, and developing countries, include:

- Securing sufficient financial resources both from the government and the private sector, in order to sustain the on-going developments.
- The inability of current legislations to convey sufficient legal enforcement and frame work for the internet services.
- Providing adequate Arabic information content on the internet in key sectors including education, business, and trade services. This will increase the societal internet penetration.
- Internet security and protecting the individual privacy.
- Increasing internet accessibility for the community at an affordable price.
- Providing adequate training and technical assistance to enable users especially professionals, to make best use of the internet technologies in their line of work (El Gawady, 2005).

4. Research Hypothesis

H1: There are problems in applying current transfer price methods for EC transactions.
H2: MNEs use transfer price to reduce its tax liability.
H3: There are some legal loops in taxing EC transactions that have negative effects on tax revenue.

5. Research Methodology

The research is conducted through the following:

First: A theoretical study through searching academic periodicals, theses, and working papers to assign the problems and methods of dealing with these problems. Second: An empirical study depend on analyzing the current situation in Egypt concerning the accounting problems facing the multinational companies by: 1-conducting an interview with tax inspectors to analyze the problems of transfers regarding the Egyptian tax law on income (91 for 2005) which to the first time state the transfer price regulations. Also, asking them if the Egyptian tax legislation comply with using EC in business. 2- Distributing a questionnaire to a sample of MNCs operating in Egypt. The questionnaire was distributed to a sample size of 80 MNC's working in Egypt only 60 MNCs answer the questionnaire. The answers of the questions are provided according to its order in the questionnaire.

The empirical part of this research is indicated by the results collected from the questionnaire and interview with tax inspector in different tax authorities. The questionnaire includes 12 questions. The questionnaire is divided into 2 sections; the first section identify companies, While, the second section certify the validity of the hypotheses of the thesis.

Concerning question no (1) the answers were classified among 3 main choices. The answers are given according to its percentage. It is found that the number of companies chooses subsidiary 33 (55%), the number of companies chooses Joint company 21 (35%) and finally the number of companies chooses branch option was 6 (10%).Question no (2) indicates the sectors to which the selected companies belong to the answers were as follows:

- 5 companies belonged to Food Industry.
- 10 companies belonged to Mining.
- 10 companies belonged to Pharmaceuticals/Medical.
- 5 companies belonged to Banking/Finance.
- 10 companies belonged to Tourism/Travel/Leisure.
- 5 companies belonged to Motor Industry.
- 10 companies belonged to IT/Computers/Software.
- 5 companies belonged to Telecoms/Communications.

The results of the questionnaire has answered the main questions of the thesis for instances, questions (1, 2, 3) of the second section indicated that the main global transfer price methods used. CPM comes in the first place as 60% (42) companies use it. In the second place comes PSM as 40% (28) companies, while, in the third place comes C+ method with 80% (8) companies respond. In the last place comes RPM with 20% (2).

However, none of the companies use CUP nor TNMM this is because of complexity of required methods which adds to complexity of using EC. Thus, the questionnaire suggests that EC have influenced MNC's strategies for transfer prices by changing the methods used and requiring more developed international regulations for transfer price in order to overcome the problems of complexity, in applicability, lack of information caused by applying EC.

Finally, this shows that current international legislation needs to be improved. Although, IRS and OECD guidelines provide the main framework for estimating transactions over EC, yet these regulations in Egypt are not followed by companies working in Egypt. This calls for updating the Egyptian law to ensure that new transactions of EC are provided for estimating by tax authorities. This will reduce tax evasion by MNEs and preserve the fair taxes of them on one hand. On the other hand, it protects the tax base estimated and collected by tax authorities.

Question no (1) intend to identifies transfer price methods preferred to be used by MNE in Egypt. It is found that although, the Egyptian tax law give the first priority to the choice of traditional transaction based method in transfer pricing, yet the results of the questionnaire indicates that 51 companies prefer to use profit based methods in estimating their transfer prices (this represents almost 85% of the sample) this means that 9 companies (15%) of the sample choose traditional based methods. However, this percentage implies that the companies prefer using profit methods because profit based methods require less effort in calculations and estimations than transaction methods. In addition, the profit methods data are most likely to be available than transaction methods as it does not need comparable transaction.

The results of the second question indicate that the highest priority among the transaction based methods is given to C+ with a percentage of (66.6%) i.e., 6 companies out of (9) the companies that choose transaction based method in the first question. However, RPM comes in the second place with a percentage of (33%) i.e., 3 companies out of (9). While, none of the companies choose CUP despite, it is the most preferred method by international regulations concerned about taxation of EC. This is due to the complexity of the requirements of applying CUP. In addition, the requirements of CUP are inapplicable in reality as it is extremely complicated to find a given transaction that is adequately comparable.

Results of question (3) shed lights about methods preferred under profit based methods. As in question one 85% (51) has chosen to use profit based methods. The answer to question three indicates that out of this percentage about 35.3% prefers to use CPM (i.e., 18 companies, while 33 companies which represent the other 64.7% choose PSM). This is because PSM is easily identifiable in terms of its simplicity, efficiency and cost.

Question no (4) asks whether the company use EC. The answers shows that the number of companies that use EC is 15 (i.e., 25% of the whole sample size), while the other 45 companies do not use EC, which represents 75% of the sample. However, 20 companies out of those who currently do not use EC (i.e., 33.3% of whole sample) have intensions to use EC in the near future.

Question no (5) intend to identifies if EC affect the applied transfer price methods. All the 15 companies that use EC (those answered the previous question with yes) i.e., the 100% of the sample has agreed that using EC have changed their transfer price methods. They stated that using EC has lead to use different method from those required in the traditional business because of the complexity of EC as no comparable transaction is readily available. Also, because of the complexities of real life business situations may put practical difficulties in the way of the application of traditional methods.

Question (6) asks if the tax payments to tax authorities change after using EC. The results of the question show that out of the 15 companies that use the EC none of them stated that their tax payment to tax authorities have changed after using EC. This means that 15 companies (25% of the sample have chosen option no) while, 75% of the sample have not answered the question as they are not using EC in the first place. However, answering this question with no in spite of using EC gives an indication that those 15 companies are using the contradiction and inapplicability of transfer price methods as an excuse for tax evasion.

Question (7) shows the current tax assessment in Egypt. The answer to this question indicates that 80% of the sample i.e., 48 companies consider the tax assessment in Egypt to be objective and applicable, while 6 companies (10%) consider tax assessment to be subjective and inapplicable. However, the last 6 companies (10%) consider the current tax assessment in Egypt to be objective and in applicable. Those last 20% proves that those using EC found difficulty in applying current transfer price methods to EC.

The results of the questions prove the validity of both hypotheses of the thesis as questions in section two (4, 5, 6, 7) indicates that the transfer prices methods are no more applicable for EC transactions. In addition, they imply that the complexity of applying global transfer price methods help MNEs to reduce its tax liability and allows tax evasion for MNEs for transactions using EC.

6. Research Conclusion and Results

The main objective of this research is to review the main global transfer price methods for tangible and intangible assets and assess the problems of EC for both MNEs and tax authorities. In addition the thesis evaluate the recent legislations for transfer price of estimating EC transactions and finally it assess the current tax regulations applied in Egypt related to EC and transfer pricing.

The results showed that current international legislations need to be improved. Although, IRS and OECD guidelines provide the main framework for estimating transactions over EC, yet these regulations in Egypt are not followed by companies working in Egypt. Companies working in Egypt need to feel that the regulations are enforceable in order to comply and reduce transfer price manipulation. This calls for updating the Egyptian law to ensure that transactions of EC are under control by tax authorities. On one hand, this will reduce tax evasion by MNEs and pay their fair share of taxes. On the other hand, it protects the tax base estimated and collected by tax authorities.

Transfer price regulations need to be modified according to the new concepts and new technologies happening in EC. Since, EC characteristics differ from traditional business so regular transfer price methods become inapplicable; therefore, changing the methods is essential. This change will prevent reducing tax revenue, which in turn affects the budget and investment projects.

Furthermore, the research concludes that:

1-EC affects MNCs strategies and policies for doing business. For instance, MNC can open subsidiaries on a lot of countries with no need to have a PE in the host countries. In addition to, it helps managers to support each others as well as each branch easily reducing costs, saving time, and efforts.

2-MNCs use transfer pricing to avoid paying taxes.

3-There is no one best method for transfer price; it depends on the surrounding circumstances of each transaction. MNCs might encounter several difficulties in maintaining the effectiveness of the transfer price method due to the fact that arm's length principle is based on the separate entity approach, whereas, MNCs are often globally integrated firms. MNCs engage in transactions that independent firms would not carry out, such as maintaining a new related business venture at a loss to create a bigger market share, transferring a valuable closely held technology to a related party foreign subsidiary or entering into specialized business contracts.

4-Traditional rules of taxation need to be modified to allow for the new concept of PE related to EC features.

5- The difficulty to indicate which government has the right to tax income, lead MNCs to sever double taxation, and the complexity of different tax treatment on different types of cross-border income (i.e., royalty, business profit).

6- Lack of cooperation between international organizations to solve problems of international taxation as double taxation and income characterization.

7-Transfer price guidelines in Egypt need to be modified (i.e., more clear, specific and updated) to include the required detailed documentations and impose enforceable penalties so as to take into consideration the new developments.

8-There is no tax regulation for EC transactions, that is why tax proceeds of the Egyptian government is affected by companies doing business using EC, without paying their fare share of taxes.

9-Traditional ways to audit bricks-and mortar companies cannot be used to audit companies using EC because of the absence of documents and the use of electronic books.

7. Research Scope and Limitations

This research focuses on:

Cross-borders transfers related to MNEs, Intangible assets and EC. The research will not take into consideration the following issues: Designing a mathematical model to identify the transfer prices, EC problems dealing with goods other than digital products, EC technical problems.

Table1: Comparison between Transfer Pricing Rules among Different Countries

Criteria	China	India	United Kingdom	United States	Egypt
1-Tax Authority Name	State Administration of Taxation	Central Board of Direct taxes (CBDT)	Her Majesty's Revenue and Customs (HMRC)	Internal Revenue Service (IRS)	Egyptian Tax Authority
2-Effective Date of Transfer Pricing Rules	From January 2008	From April 2001	From July 1999	From October 1994	From 2005
3-Required Transfer Pricing Disclosures	Required / nine forms	Required/form 3CEB contains details of all related party transactions and methods used to justify the arm's length price	Not required	Required related party transactions; forms filed with tax return	Required related party transactions
4-Required Transfer pricing documentation	The regulation specify detailed documentation requirements	Statutory requirement and is required to be filed with tax return	Statutory requirement	Documentation is required for penalty protection	Statutory requirement, however it has not been defined yet by the tax authority

Table1: Comparison between Transfer Pricing Rules among Different Countries (continued)

Criteria	China	India	United Kingdom	United States	Egypt
5-Deadlines for documentation preparation and submission	There is a grace period for the completion of documentation from (2008 until 31 December 2009). The documentation must be completed before 31 may of the year after transactions and submitted within 20 days of tax authorities request	Preparation deadline with tax return(30 September of the following year) submission deadline within 30 days of tax authorities request	Preparation deadline with tax return(12 month of the fiscal year end) No specified submission deadline. HMRC will set deadline on case by case basis, typically 45 to 90 days.	Preparation deadline with tax return(30 September of the following year) submission deadline within 30 days of Request	Preparation deadline not applicable, submission deadline: other. Tax payer is required to maintain supporting documents , which can be requested during the tax audit ; tax audit can take place at any time within five years from the date of filling the corporate tax return

Table1: Comparison between Transfer Pricing Rules among Different Countries (continued)

Criteria	China	India	United Kingdom	United States	Egypt
6-Specific categories of documentation required	The regulations specify 5 categories and 26 sub-categories	There are 13 mandatory documentation requirements, including business description/ overview, Organizational structure, functional analysis, risk analysis ,industry analysis, financial performance, intercompany agreements, description of controlled transactions, method selected, identification of comparables, economic analysis, profile of MNCs group, names, addresses, legal status and country of tax residence of associated enterprises, record of actual work carried out for determining the arm's length standard and adjustments made	There are no specific requirements set down in the legislation, but HMRC would expect to see business description/ overview, Organizational structure, functional analysis, risk analysis ,industry analysis, financial performance, intercompany agreements, description of controlled transactions, method selected, identification of comparables, economic analysis	business description/ Overview, Organizational structure, functional analysis, risk analysis, industry analysis, financial performance, intercompany agreements, description of controlled transactions, method selected, identification of comparables, economic analysis. Certain documentation are required by the regulations, including cost share arrangement	Specific categories have not been defined at this time.

Table1: Comparison between Transfer Pricing Rules among Different Countries (continued)

Criteria	China	India	United Kingdom	United States	Egypt
7-Purpose documentation serve	Meet legal requirements may reduce the risk of audit, support the transfer pricing applied, prevent the use of deemed method and waive the 5 % additional interest.	Penalty elimination and a structured presentation of the case to India's transfer pricing authority	Penalty elimination; penalty reduction, shift burden of proof.	Penalty elimination	Penalty elimination to support the transfer pricing of the company and eliminate regular interest and penalties.
8-Acceptable transfer pricing methods	Transaction methods (CUP, RPM, C+), profit based methods (PSM, TNMM) and other methods in compliance with the arm's-length principle.	Transaction methods (CUP, RPM, C+), profit based methods (PSM, TNMM).	Transaction methods (CUP, RPM, C+), profit based methods (PSM, TNMM).	Transaction methods (CUP, RPM, C+, CUT, comparable un controlled service price, gross service margin, cost of service plus, services cost), profit based methods (PSM, comparable profit methods	Transaction methods (CUP, RPM, C+), profit based methods (PSM, TNMM, comparable profits methods and any other methods discussed with and approved by the tax authority).
9-Priority among the acceptable methods	No	No	U.K follows the OECD transfer price guidelines and the guidance contained within on the determination of the most appropriate method	None	CUP, if not applicable choose between RPM, C+, if these are not applicable, any other method accepted by the OECD guidelines is generally accepted.

Table1: Comparison between Transfer Pricing Rules among Different Countries (continued)

Criteria	China	India	United Kingdom	United States	Egypt
10-Transfer price penalties	No penalties on the tax adjustment. Some non-compliance fines in line with the general tax law. However, interest will be imposed on tax adjustments which relate to transactions which occur after 1 January 2008. This interest rate equal peoples bank lending rate plus 5%. This interest would be non-deductible; however, if the company supplies relevant materials the 5% extra charge will be reduced or eliminated.	Transfer pricing penalties 100-300 % of the tax due on transfer pricing adjustments;2% of aggregate value of international transactions for failure to maintain prescribed documentation; 2% of aggregate value of international transactions for failure to furnish prescribed documentation, fixed penalty (approximately USD 2,200) for failure to furnish accountant's report in form 3 CEB.	General tax penalties only. Transfer price adjustment may lead to a penalty based on a percentage of potential tax lost, even if the result for the period is a loss. Penalties are up to 30% for a failure to take reasonable care; up to 70% for deliberate understatement aggravated by concealment. HMRC may apply lower percentage penalty where there is disclosure, the extent of mitigation depending on whether disclosure is prompted or unprompted	Compliance penalties, 20% of additional tax due if income adjustment is more than USD 5 million or 10% of gross receipts; or price is adjusted to 200 % or more or to 50% or less. 40% of additional tax due if income adjusted more than USD 20 million or 20 % of gross receipts; or price is adjusted to 400 % or more to 25% or less.	There are no special penalties for transfer pricing. However, if the transfer price adjustment has affected the taxable profits, then the normal penalties will be imposed.
11-To what extent transfer price penalties enforced	No penalties from transfer price adjustments, fines and interest rates specified in the regulation	Often	HMRC enforce penalties more strictly in recent years	Always	Not applicable

Table1: Comparison between Transfer Pricing Rules among Different Countries (continued).

Criteria	China	India	United Kingdom	United States	Egypt
12-Can transfer price penalties be reduced	No	No	Yes, penalties can be mitigated for a number of reasons, such as cooperation with HMRC	No	Not applicable
13-Advance Pricing Agreements options	Unilateral, bilateral, Multilateral. In order to be eligible for APA applicants must have over RMB 40 million in annual related party transactions and have prepared or submitted annual filing and contemporaneous documentation according to law.	No provision for APAs	Unilateral, bilateral	Unilateral, bilateral, multilateral	Unilateral, advance rulings
14-Recent developments	Regulations finalized 9 January 2009 adding clarification on documentation; audit APA, CSA, CFC, thin capitalization.	Continue to take aggressive positions, including higher mark-ups for services companies, Non-tolerance of losses in case of routine distributors, And benefit test for cross charges.	HMRC has introduced a procedure for applying for Advance Thin Capitalization Agreement (ATCA). HRMC is implementing a new risk-based approach to transfer pricing enquiries, targeting high risk transactions and structures.	None	None
15-Language of documentationfiled	Chinese	English	English	English	Arabic

Endnotes

1. Controlled transactions: transactions between two enterprises that are associated enterprises with respect to each other (OECD Guidelines 2001: Glossary of terms).
2. Related party: interaction between two parties, one of whom can exercise control or significant influence over the operating policies of the other.
3. Exchange controls: Restrictions applied by a government (or the Central Bank) to limit the convertibility of the local currency into foreign currencies.
4. Joint venture: A contractual agreement joining together two or more parties for the purpose of executing a particular business undertaking. All parties agree to share in the profits and losses of the enterprise.
5. Exchange controls: Restrictions applied by a government (or the Central Bank) to limit the convertibility of the local currency into foreign currencies.
6. Joint venture: A contractual agreement joining together two or more parties for the purpose of executing a particular business undertaking. All parties agree to share in the profits and losses of the enterprise.
7. CWI standard means that the intangible's transferor must recognize income over time that is CWI to be generated by the intangible. The U.S Congress in 1986 added a sentence to

section 482 requiring that transfers of intangibles be priced CWI from the intangibles (Abdallah & Murtuza, 2006).

8. Consumption taxes are levied on the principle of taxation at the place of consumption and according to rates set in individual countries, or in individual states in the case of federal nations.
9. PE is defined in the OECD model tax treaty as a fixed place of business through which an entity wholly or partly conducts its operations. The place of business may be a showroom, storage facilities, manufacturing operation or distribution point, but national tax rules will dictate the tax position of each type of establishment.

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