PRACTICAL GUIDE TO U.S. TRANSFER PRICING THIRD EDITION

Highlights

• Release 12 of Practical Guide to U.S. Transfer Pricing includes a substantial revision by Professor William Byrnes to align the publication to the 2017 OECD Transfer Guidelines and the 2017 UN Practical Manual and well as the addition of five new chapters to supplement four new chapters added in 2017. He continues his in-depth coverage of the latest developments at LB&I and APMA and in federal courtrooms. The five new chapters include business restructuring and U.S. tax and transfer pricing rules; applying the arm’s length principle to performance guarantees; contemporary issues on Brazilian transfer pricing rules; Porter analysis: a business strategy of Amazon.com through a value chain and comparative advantage analysis of Amazon’s trademarks and intangibles; and M&A and transfer pricing. These complement the four new chapters that were added to this pub in 2017: contrasting the outcome of a risk analysis between the new OECD guidelines and U.S. decisions, using the Berry Ratio, State Aid’s impact on APAs, and a VCA of the Tobacco Industry to complement his VCA of the coffee industry.

The most important domestic development in transfer pricing this past year has been the enactment of the 2017 Tax Cuts and Jobs Act that substantially amended the U.S. international tax regime. This impact of the new provisions of Global Intangible Low Tax Income (GILTI), Foreign Derived Intangibles Income (FDII), Base Erosion & Anti-Abuse Tax (BEAT), the 100 percent Dividend Received Deduction (DRD), are analyzed within the various chapters where applicable. See Chapter 1.02, Chapter 7.07, and new Chapter 28A regarding the impact of these provisions on a U.S. MNEs foreign business structure of intangibles.

Moreover, the TCJA amended IRC Section 482 (and IRC Section 367) adding a sentence that the valuation of transfers of intangible property shall be made on an aggregate basis or on the basis of the realistic alternatives to such a transfer. IRC 936(h)(3)(B) was amended to clarify that intangibles includes any goodwill, going concern value, or workforce in place, or any other item the value or potential value of which is not attributable to tangible property or the services of any individual. See Chapter 1, Chapter 2, and Chapter 8 for the impact of these amendments.

The publication of the 2017 OECD Transfer Guidelines and the 2017 UN Practical Manual are both analyzed extensively in Chapters 1, 2, 28, and integrated in every chapter throughout this treatise. Of particular impact are the OECD initiatives regarding...
documentation and reporting, relation to risks and capital, and intangibles. This entire
treatise is updated to align to the new OECD guidelines and new UN Manual, contrasting
with the 2010 Guidelines where those are still potentially relevant for countries
employing a static approach. See chapter 2 for an extensive comparison of the 2017
OECD Guidelines, the 2017 UN Manual, and the U.S. IRC 482 regulation on a topic
basis.

integrates the new provisions of the Tax Cuts and Jobs Act, such as GILTI, FDII, and
BEAT, into the business structuring decision making process. This U.S. centric chapter
continues the case study of Chapter 28 and complements that chapter’s OECD centric
analysis.

New Chapter 35, “Applying the Arm’s Length Principle to Performance Guarantees,”
analyzes the issue based on the U.S. transfer pricing regulations and the 2017 OECD
Transfer Pricing Guidelines. Moreover, the chapter examines the 2018 OECD Public
Discussion Draft on Financial Transactions as informative albeit not directly addressing
performance guarantees.

New Chapter 36, “Brazilian Transfer Pricing Rules,” examines the unique approach
applied by Brazil that is often discussed as an alternative for developing countries
seeking to cope with application of the arm’s length standard but that do not want to
move out of the main stream to a formulary apportionment regime. This chapter is the
initial sample of forthcoming country chapters.

New Chapter 37, “Porter Analysis: A Business Strategy Of Amazon.Com Through A
Value Chain And Comparative Advantage Analysis Of Amazon’s Trademarks And
Intangibles,” attempts to apply a value chain analysis and industry benchmarks to the
platform segment of the technology industry. This chapter complements the previous
industry analysis chapters of coffee and tobacco.

New Chapter 38, “M&A and Transfer Pricing,” highlights a diligence checklist of factors
to be considered in an M&A transaction wherein parties will become related as a result.
This chapter reviews how M&A activity can generate transfer pricing risks and tax
planning opportunities.

On March 22, 2018, the OECD released its 2018 Additional Guidance on the Attribution
of Profits to a Permanent Establishment that provides examples on the attribution of
profits to certain types of PEs arising from the changes to the PE definition under BEPS
Action 7 such as a commissionnaire structure for the sale of goods, an online advertising
sales structure, and a procurement structure. Moreover, 2018 Additional Guidance
provides examples of implementation of the new anti-fragmentation rule drawn from the
BEPS Report on Action 7 that has been incorporated in the new paragraph 4.1 of Article
5 of the OECD Model DTA. The anti-fragmentation rule prevents paragraph 4 from
providing an exception from PE status for activities that might be viewed in isolation as
preparatory or auxiliary in nature but that constitute part of a larger set of business
activities conducted in the source country by the enterprise (whether alone or with a closely related enterprise) if the combined activities constitute complementary functions that are part of a cohesive business operation. (see Chapter 2.07[7]).

On July 21, 2018, the OECD released the Revised Guidance on the Application of the Transactional Profit Split Method (“TPS”). This revised guidance contains only minor modifications to the draft guidance issued in July 2017 and amends the OECD Guidelines Chapter II TPS guidance. In the 2018 final guidance, the OECD cautions that the TPS Method is likely to be most appropriate only when multiple parties make unique and valuable contributions, when business operations are highly integrated so that independent contribution evaluation cannot be meaningfully performed, or when multiple parties share the assumption of economically significant risks under the accurately delineated transaction. (see Chapter 10).

On July 3, 2018, the OECD issued its Discussion Draft On The Transfer Pricing Aspects Of Financial Transactions. The first part of the discussion draft provides guidance on the application of arm’s length to financial transactions. In particular, the discussion draft elaborates on how the accurate delineation analysis applies to the capital structure of an MNE within an MNE group. The discussion draft outlines the economically relevant characteristics that inform the analysis of the terms and conditions of financial transactions. The second part of the discussion draft addresses specific issues related to the pricing of financial transactions such as treasury function, intra-group loans, cash pooling, hedging, guarantees and captive insurance. (see Chapters 2, 31, and 35).

On June 21, 2018, the OECD published its Guidance for Tax Administrations on the Application of the Approach to Hard-to-Value Intangibles. The 2018 HTVI Guidance has been incorporated in Section D.4 as an Annex of the Revised 2017 Chapter VI of the Transfer Pricing Guidelines. That Section contains an approach consistent with the arm’s length principle that tax administrations can adopt to ensure that tax administrations can determine in which situations the pricing arrangements as set by the taxpayers are at arm’s length and are based on an appropriate weighting of the foreseeable developments or events that are relevant for the valuation of certain hard-to-value intangibles, and in which situations this is not the case. (see Chapter 8).

The Treasury released in 2016 the final regulations requiring that annual country by country reporting by certain U.S. ultimate parent entities of multinational enterprise groups. In June of 2017, Treasury published the final Form 8975 and its accompanying Schedule A for financial information. On March 30, 2018, the IRS released Notice 2018-31 National Security Considerations with Respect to Country-by-Country Reporting. A U.S. MNE group that is a specified national security contractor has reduced requirements for Form 8975. (see Chapter 18).

As of August 20, 2018, the OECD’s CbCR MCAA has attracted 72 countries signatories, but the U.S. is not one of them. However, the U.S. will automatically exchange country-by-country reports via its tax treaty network. As of August 31, 2018, the countries that the U.S. will provide U.S. MNEs CbCR are: Australia, Austria, Belgium, Bermuda, Brazil, Canada, Cayman Islands, Colombia, Croatia, Czech Republic, Denmark, Estonia,
Finland, Greece, Guernsey, Iceland, Indonesia, Ireland, Isle of Man, Italy, Jamaica, Latvia, Liechtenstein, Lithuania, Luxembourg, Malta, Mauritius, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Republic of Korea, Slovakia, Slovenia, South Africa, Spain, Sweden, and The United Kingdom. France, Germany, Hungary, India, and Israel are currently in negotiation with the U.S. albeit the U.S. has announced that for Germany and France it will implement CbCR via spontaneous exchange. (see Chapter 20).

New in-depth analysis is included for the ongoing litigation of Microsoft (see Chapter 21), Coca-Cola (Chapter 23), Facebook (Chapter 8 and Chapter 13), Altera (see Chapter 13), Amazon (see Chapter 9 and Chapter 13), Eaton (Chapter 19), and Medtronic (see Chapter 9). Analysis of this recent jurisprudence in the context of controversy management is discussed in Chapter 23.

On July 14, 2016 the Treasury issued final regulations clarifying that the IRS may contract with outside third party firms and provide the third parties with taxpayer’s confidential information in order to assist the IRS interview a summoned witness, but the IRS on March 28, 2018 proposed regulations that will exclude non-government attorneys from receiving summoned books, papers, records, or other data or from participating in the interview of a summoned witnesses. (see Chapter 21).

In the second half of 2015 LB&I unfolded a new organization and methodology, one based on risk management instead of the coordinated industry cases and continuous audit approach. The new IRS risk approach includes campaigns that focus on weighing the size of the compliance risk, how often the risk is occurring, where it is occurring, and if the risk is a result of a promoted scheme (see Chapters 1, 18, and 19). In January 2018 the Transfer Pricing Practice released five directives. The first, states that the “mandatory” transfer pricing information document request is no longer mandatory for all cases. The second requires approval of the Treaties and Transfer Pricing Operations (TTPO) Transfer Pricing Review Panel before changing a taxpayer’s chosen “best method” for transfer pricing. The third and fourth directives address cost sharing arrangements (CSAs). One instructs LB&I examiners to stop opening issues related to stock-based compensation included in CSAs until the Ninth Circuit issues a decision in Altera, which remains on appeal at the Ninth Circuit Court of Appeals. The other instructs examiners to stop developing adjustments to CSAs based on changing the taxpayer’s multiple reasonably anticipated benefits (RAB) shares until the IRS finalizes a Service-wide position. The final directive states that IRC § 6662(e) penalties should be applied if appropriate when a taxpayer fails to create or provide requested documentation. (see Chapter 21).

The IRS released its new Transfer Pricing Examination Process (TPEP), replacing the 2014 Roadmap, in order to line up transfer pricing exam work with the LB&I examination plan, which applies to non-transfer pricing examinations. The TPEP outlines how the IRS will approach transfer pricing audits. It emphasizes the importance of communication between the IRS and the taxpayer, as well as the importance of up-front planning and fact collection for building a successful case. (see Chapter 21).
As of 2017, the Director, Treaty and Transfer Pricing Operations Jennifer Best is responsible for 83 professionals, down from 92 last year and 99 the year before, among three groups: the Advance Pricing and Mutual Agreement group (APMA), the Transfer Pricing Practice, and the International Practice Networks (IPNs). In March 2018, Congress provided the IRS with a funding increase of $320 million over prior annual funding levels. The funding increase may assist APMA with its resource constraints and staffing shortages.

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In Memoriam

Robert T. Cole

The family of Robert T. Cole, who passed away in May 2013, wishes to provide this brief but loving tribute to Bob.

Professionally, Bob Cole was well known as a leading figure of international tax law. He was a lawyer who reached the pinnacle of his profession serving clients with difficult tax and business problems over his long career in private practice. He also served his country not only in the armed services, but also by providing his legal and tax expertise through prominent positions with the federal government at both the beginning and end of his career.

Bob combined service to his clients with service to the other tax professionals who were his colleagues. He was a prolific speaker and author on international tax issues, and a leader in tax and business professional associations. Bob was the editor and principal author of this, the leading book on transfer pricing, and his thoughts and works are embodied in many of the concepts and rules described in this book. He was also proud that he had assembled 22 lawyers, economists, and certified public accountants who worked with him on the book, who he called his “talented friends.” As his writings in this book reflect, he approached his legal work with fairness, intelligence, and common sense, as he did with everything in life. Over his long career, Bob earned the highest respect, admiration, and friendship of his colleagues.

But his many professional accomplishments reflect only one part of Bob Cole’s multifaceted and rich life. Teaming with his daughter Jamy, Bob ran multiple Little Gym operations in northern Virginia for nearly 20 years, because he loved the idea of childhood development and helping future generations. Indeed, so much about his life was focused on serving others and improving the world. For example, he also had a special interest in seeking solutions for the Middle East, and he sponsored seminars at Georgetown University on this topic. In his later years, he developed a passion for contributing to peacemaking through creating and leading organizations that bring different Middle Eastern factions together to address their common water resource needs.

Bob’s greatest passion, and pride, of course, was his family, including his wife Dr. C. Margaret Hall, three daughters, seven grandchildren, his sister, and all the rest of his family members. His devotion to his family and love for us all was absolute.

Dedicated to achievement, health (including his great passion for hiking and bringing others along on his journeys), and doing good on this planet, Bob Cole inspired people all over the world. He leaves an example of passion and dedication, words plus actions and deeds, caring and concern, followed through with commitment and energy, and above all, humanity and kindness.
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Dedication

To the IBFD and University of Amsterdam School of Law that 25 years ago introduced me to transfer pricing through a three-year fellowship study. To Texas A&M University School of Law that allows for this important transfer pricing research to continue. Finally, to Dr. Lorraine Eden of Texas A&M University Mays School of Business who allows me to participate in her transfer pricing course, teaching the next generation of Transfer Pricing Aggies and identifying research assistants.

William Byrnes
Acknowledgements

More than five years have passed since we were saddened by the passing of Bob Cole, who in his 81 years made such a tremendous impact in the field international taxation generally, and transfer pricing specifically. He stands as one of the American icons of international taxation, in the league of Stanley Surrey, Walter Diamond, and Marshall Langer.

I express my gratitude for my research assistant Whitney Pilch who joined KPMG’s international tax department in Los Angeles after studying transfer pricing under my tutelage for four years. Importantly, I recognize Texas A&M University School of Law for its collegial faculty and its former Dean, Dr. Andrew Morriss, who are supportive of international tax research and treatises of the law. Dean Morriss has been appointed the new Dean of the Texas A&M University School of Innovation. Texas A&M University School of Agriculture and Bush School of Government have provided me two economics graduate students, Nima Khodakarami and Carlos Navarro Perez respectively, to serve as my research assistants to pursue my project of comparing a supply chain, a value chain, and a transaction net margin method analysis of a hypothetical European coffee roaster operation of a U.S. group.

I am thankful for each of the chapter contributors. Each year I look forward to working with the co-authors and learning from our discussions. Last year I have included three new chapters that will benefit transfer pricing advisors. Chapter 30 by Knut Olsen, who served in the Norway revenue and as the transfer pricing counsel of a large European multinational group, presents the potential to mitigate transfer pricing audit risk through leveraging a group’s ISO 9001 certification, common among manufacturers. Chapter 31, developed by former corporate finance bankers Greg Johnson, Mark Nichols, and Robert Weiss, analyze the transfer pricing risks of intercompany debt. Finally, in response to subscriber feedback, I authored the new Chapter 32 to assist transfer pricing advisors understand an industry’s value chain analysis.

Last year I included four new chapters. Charles Lincoln, my alumnus, developed the concept for Chapter 2A that contrasts the diverging results of the outcome generated from risk allocation under the new 2017 Guidelines OECD and U.S. court decisions. Dr. Lorraine Eden of Texas A&M University Mays School of Business and renown transfer pricing scholar and Tetiana Zakrevska (Texas A&M University Bush School of Government alumnus) analyze the potential use of the Berry Ratio in Chapter 9A. Chapter 33 presents industry insider Susanna Hartanto’s Value chain analysis of the highly integrated tobacco industry. Finally, in Chapter 34 Dr. Mario Tenore of Maisto law firm (Italy) has analyzed the EU Commission’s approach to APAs in light of its campaign against State Aid, and the published decisions of Starbucks, FIAT, and Apple. This year I add five new chapters: Chapter 28A, “Business Restructuring And U.S. Tax And Transfer Pricing Rules,” by Carlos Gautrin; Chapter 35, “Applying the Arm’s Length Principle to Performance Guarantees,” by Dr. Vikram Chand and Adam Kosmala; Chapter 36, “Brazilian Transfer Pricing Rules,” by Felipe Casellato and Ralph Sticca; Chapter 37, “Porter Analysis: A Business Strategy Of Amazon.Com Through A Value Chain And Comparative Advantage Analysis Of Amazon’s Trademarks And Intangibles,” and Chapter 38, “M&A and Transfer Pricing,” by Jeff Kaufman and Guy Sanschagrin.

For the 2019 edition, I am planning to examine new issues, restructure the treatise into four parts to cope with the expansion of new chapters, and continue to develop new chapters. New chapter topics that subscribers have requested include permanent establishments, work force as an intangible, comparables case studies, foreign country coverage, and more industry case studies. Please contact me with further suggestions for this treatise to better add value for your research and practice.
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Preface

As updated, this treatise in 41 chapters describes and analyzes the United States rules and procedures governing transfer pricing as they existed at the end of August 31, 2018. Also, many chapters compare the Organisation for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations as they were revised in 2017, particularly Chapters 1, 2, 9, 10, 12, 14, 28 and 37, as well as contrast the 2017 UN Practical Manual. The most important development in transfer pricing since 2013 has been the momentum of the OECD’s Base Erosion and Profit Shifting (“BEPS”) initiatives, and their impact on the OECD Transfer Pricing Guidelines, the European Union, the United Nations, and the domestic transfer pricing policies of all countries (see Chapters 1, 2, 28, and 34). Of the many measures adopted by the OECD in 2015 that have been included within the revised Transfer Pricing Guidelines of 2017, the three most important that will impact all subscribers are (1) the country-by-country documentation and reporting (commonly referred by the acronym CbCR) requirements that over 80 countries have adopted and applying from January 1, 2016, (2) the evolved understanding of risks and the risks framework analysis for tangibles, services, capital, and intangibles, and (3) the value chain analysis, especially as it is applied to intangibles. New Chapter 37 examines a Porter value chain analysis as a case study of some of Amazon’s intangibles.

The new LB&I risk approach has been implemented in the form of “campaigns”, focusing on weighing the size of the compliance risk, how often the risk is occurring, where it is occurring and if the risk is a result of a promoted scheme. The 2016 Reorganization’s shift in strategy includes identifying issues that should be made part of issue focused campaigns that would be developed centrally. A campaign may consider other measures than labor intensive audits such as soft letters asking a taxpayer to consider its compliance in the reporting of certain transactions. Under the new campaign approach the newly renamed Treaty and Transfer Pricing Operations resources will focus on identifying and providing audit resources for particular transfer pricing issues that may have common elements among multiple taxpayers. The IRS has already announced a campaign in the transfer pricing area focused on in-bound distributors. In January 2018, LB&I issued five directives designed to provide guidance on transfer pricing issues to LB&I examiners and other field personnel.

LB&I continues its reorganization with a complete revamp of its 2010 structure. From 2010 until 2016, LB&I functions were split into international and domestic divisions. Under the new structure from 2016, the position of Deputy Commissioner (International) has been eliminated and its responsibilities transferred to a single Commissioner of LB&I. LB&I is now organized into ‘practice’ areas and ‘support’ elements. Each practice area is led by a Director. The practice areas that are to leverage knowledge-sharing capabilities with an international dimension include: A Director of Program and Business Solutions, an Assistant Deputy Commissioner of Compliance Integration, and the Assistant Deputy Commissioner International. The practice areas study compliance issues within their area of expertise and suggest campaigns to be included in the compliance plan. The support elements use data analysis and an integrated feedback loop to support LB&I’s new risk framework. In June 2018, the Service announced that APMA would undergo another organizational change in which there would be a contraction in the number of team leader groups and likely more team members per team.

For examination purposes, the IRS is divided into four operating ‘divisions’ of which the LB&I is the one with jurisdiction over virtually all transfer pricing audits. The renamed Treaty & Transfer Pricing Operations practice area is the compliance organization within LB&I responsible
for transfer pricing issues. It is led by the Director of Treaty & Transfer Pricing Operations, Jennifer Best, who is responsible for transfer pricing activity in the field and for allocating specialists and other resources to the most important transfer pricing cases. Under the Director of Treaty & Transfer Pricing Operations are a Director of Field Operations for the Transfer Pricing Practice (TPP), John Hinman, a Director of the Advance Pricing and Mutual Agreement Program (APMA), John Hughes, and a Director of Treaty Administration, Deborah Palacheck. Under this newest reorganization, LB&I’s TPP has retained autonomy and can be expected to garner more authority over audit issues that are identified for a campaign and perhaps more authority generally in the audit of transfer pricing.

As of August 2018 LB&I’s staffing has been reduced to below 5,500 from a high of 7,500 in 2010. Of the approximate 5,500 LB&I positions, between 500 and 600, it is reported, are international trained examiners in addition to 2,800 domestically trained. TPP includes 83 professionals, down from 92 last year and 99 the year before (see Chapter 1 and 21). Although the IRS reports that 80 percent of the issues, by revenue, are international in nature, only 20 percent of the resources are allocated to these issues. The new issue-based campaigns developed from a risk management perspective, with potential overlapping practice areas and support elements, will likely bring a spotlight onto international issues that may have previously lacked resources. The measurement of performance may shift from the number of case closures to number of case openings and time expended on each case. In March 2018, Congress provided the IRS with a funding increase of $320 million over prior annual funding levels. The funding increase may assist APMA with its resource constraints and staffing shortages. Although the acting director of transfer pricing within LB&I submitted a plan in 2015 to increase APMA staffing from 88 to 110 persons, APMA staffing levels remained basically unchanged from 2015 to 2016, and declined to 83 persons by the end of 2017.

LB&I has established International Practice Networks (IPNs) which are knowledge bases (intellectual nerve centers). The networks are staffed by up to a dozen professionals in the form of a steering committee of technical specialist staff, an international manager sponsor, LB&I, SB/SE and Associate Chief Counsel (International) attorneys, who maintain a database of relevant materials and operate a chatroom for IRS transfer pricing professionals to share information. The IPNs operate as a clearinghouse for issues and questions, both related to generic issues and to specific cases, connecting IRS people who were previously not connected. The IRS has released more than 150 International Practice Units, including more than 20 on transfer pricing issues.

On June 29, 2018, the IRS released the Transfer Pricing Examination Process (“TPEP”) guide to be used in transfer pricing examinations. The TPEP replaces the 2014 transfer pricing roadmap and provides Field personnel with a new framework to conduct transfer pricing examinations. It is intended to assist with planning, execution, and resolution of transfer pricing examinations consistent with the LB&I Examination Process.

On August 12, 2015 the IRS released two final revenue procedures: Procedures for Advance Pricing Agreements (Revenue Procedure 15-40) and Procedures for Requesting Competent Authority Assistance under Tax Treaties (Revenue Procedure 15-41). These two final revenue procedures contained 13 principal differences from the previous 2013 draft revenue procedures, analyzed in Chapter 1 and Chapter 19. User fees are increased for APA requests from $60,000 to $86,750 (for APAs filed between July 1, 2018 and December 31, 2018) and $113,500 (for APAs filed from January 1, 2019), and will continue to increase through 2020 to capture the IRS’ full cost of an APA, yet the total user fees may be reduced for multiple APA requests filed by the same controlled group within a 60-day period. Also, the user fee for requests for discretionary LOB relief was increased under the competent authority procedure to $32,500 and to $37,000 in 2016. Since the APA program’s inception in 1991, and through the end of 2015, over 1,500 APAs have been executed. Foreign multinationals have been the heaviest users of the procedure. On August 12, 2015 the IRS released the final revenue procedures: Procedures for Advance Pricing
Agreements (Revenue Procedure 15-40) and Procedures for Requesting Competent Authority Assistance under Tax Treaties (Revenue Procedure 15-41) discussed in Chapter 19. A notable milestone achieved by APMA in 2015 was the execution of the first bilateral APA between the United States and Italy and in 2016 a bilateral APA with India.

As discussed in Chapters 19 and 22, arbitration is effectively mandatory for the tax authorities and optional for the taxpayers and has become a reality with several cases having been decided by arbitration. It is available as a backstop to MAP under the income tax treaties with Belgium, Canada, France and Germany. Moreover, in the case of Belgium and Canada, if the MAP case is for an APA, the TPM of the prevailing party is to be used for the future APA years. Moreover, the OECD has initiated a MAP framework in 2016 that requires peer review to assess a country’s implementation. On February 17, 2016, the Treasury Department released a revised 2016 U.S. Model Income Tax Convention (the 2016 Model) including a mandatory and binding arbitration between competent authorities. The U.S. Model Income Tax Convention was last updated in 2006 (the 2006 Model). However, as of August 31, 2018, Treasury has not released an updated technical explanation.

Up from the 96 lodged in 2014 by India with $1.2 billion of adjustments and 56 in 2013 of $900 million of adjustment, by June of 2015 the IRS reported that the Revenue Authority of India lodged 61 new transfer pricing mutual agreement procedures with total proposed adjustments of $1.25 billion. Following the agreement between the U.S. and India on a framework to resolve the backlog of competent authority matters, the U.S. announced in February 2016 that it will begin accepting requests for bilateral APAs between the U.S. and India. In April 2016, the IRS director of the APMA reported that India had agreed to resolution of 93 of the cases pursuant to the framework agreement. APMA began accepting requests for pre-filing conferences ("PFCs") for bilateral APAs between the United States and India. In 2015, the MAP backlog has grown to 762 open cases with an average cycle time of 24 months, leading to an average per senior manager of 109 MAP cases and 13 MAP cases per team leader, in addition to the APA open cases mentioned above. However in late 2016, the U.S. and India resolved 66 MAP cases relating to transfer pricing issues and 42 MAP cases relating to treaty interpretation issues of one billion dollars for 1999–2000 to 2011–12. The resolved cases addressed royalties, management fees, cost contribution arrangements, engineering design services, contract R&D services, investment advisory services, marketing support services, software development services, IT enabled services (both BPO and KPO services) and treaty interpretative issues in the nature of presence of permanent establishment in India and profit attribution to such PEs, as well as categorization of royalty income versus business income. The competent authorities reached an agreement on the terms and conditions of the first bilateral APA involving India and USA. See Chapter 1 and Chapter 19.

In late 2011 the temporary cost sharing regulations were finalized and are discussed in Chapter 13, including the controversial Income Method and its discount rates; the requirement that the cost of stock-based compensation must be included in the cost pool to be shared; and the application of the cost sharing methods outside of cost sharing. On August 27, 2013, the IRS finalized a proposed cost sharing rule describing a new specified application of the income method for determining the arm’s length charge for platform contribution transactions, or buy-in-payments. But the Income Method and the stock-based cost requirements of the cost sharing regulations are contrary to the court decisions of Altera and Xilinx, albeit the taxable years involved in Xilinx were subject to regulations that did not have such provisions. On July 27, 2015, in a “reviewed opinion”, the U.S. Tax Court struck down in Altera the final cost sharing regulations which required participants in qualified cost-sharing arrangements to share stock-based compensation costs to achieve an arm’s length result. The court held that Regs. § 1.482-7(d)(2) violates the arm’s length standard because there is no evidence that unrelated parties ever share such costs. According to the ruling, the final 2003 regulations lack a “basis in fact”, are invalid as a matter of law and failed to satisfy the U.S. Supreme Court’s “reasoned decision
making” standard of the State Farm case. On July 24, 2018, the Ninth Circuit Court reversed en banc Tax Court decision and concluded that the IRS did not violate the Administrative Procedure Act. However, the decision was split 2-1, with Judge Kathleen M. O’Malley dissenting and concurring with the Tax Court. Yet, the death of Judge Reinhardt months before the final decision, one of the two judges siding with the IRS, led on August 7, 2018 the Ninth Circuit Court to withdraw its initial decision to allow time for a reconstituted panel to consider a decision.

The $2.2 billion Amazon case concluded December 23, 2014 and on March 23, 2017 the Tax Court published its decision in favor of Amazon. New in-depth analysis is included for the ongoing litigation of Microsoft (see Chapter 21), Coca-Cola (Chapter 23), and Facebook (Chapter 8 and Chapter 13), and for the decisions of Altera (see Chapter 13), Amazon (see Chapter 9 and Chapter 13), Eaton (Chapter 19), and Medtronic (August 16, 2017 the Eight Circuit Appeal vacated and remanded Medtronic back to the Tax Court, see Chapter 9). Analysis of this recent jurisprudence in the context of controversy management is discussed in Chapter 23.

Chapter 8 analyzes the Tax Cuts and Jobs Act’s expansion of the scope of intangible property for purposes of IRC Sections 367(d) and 482 to include “workforce in place, goodwill, and going concern value.” The TCJA codifies certain approaches to valuing intangible property that are consistent with the post-2009 cost sharing regulations, particularly permitting the IRS to value intangibles on an aggregate basis in cases where an aggregate valuation of multiple transferred intangibles “achieves a more reliable result,” and permitting the IRS to value intangibles based on the prices or profits that could have been realized if the taxpayer chose a “realistic alternative” to the related-party transfer of the intangibles.

Treasury published new Temporary Regulations Sections 1.721-1T through 7T addressing that an adjustment under IRC Section 482 does not prevent the application of the rules regarding certain transfers by U.S. persons to foreign-owned partnerships are analyzed in Chapter 24.

The 2016–17 EY survey found that MNEs are experiencing a substantial increase in transfer pricing controversy this year including 79 percent of transfer pricing examinations by the Indian Revenue examinations resulting in an adjustment. Tax risk management has increased as the top transfer pricing priority. With transfer pricing litigation becoming more frequent, Chapter 23 is even more important than in the past. Chapter 23 contains an analysis of the 2013 Wells Fargo decision which held that work product protection did apply to certain tax accrual workpaper as well as to tax accrual workpapers created by non-lawyers at Wells Fargo’s auditor. The chapter also discusses Supreme Court cases, including cases issued in 2011 and 2012, regarding the authority of the Treasury to issue regulations contrary to earlier court decisions. These decisions are particularly relevant to the Service’s efforts to impose tax on what it perceives is the value of U.S. intangibles that are migrated to low tax foreign countries, through cost sharing or otherwise.

On October 5, 2015 the OECD released its 2015 Final Report Country-by-Country Reporting Action 13. The CbCR Final Report comprised a three tier standardized approach, each tier designed to reveal distinct functions and risks of a group’s entities. The OECD Council amendments to Section V of its Transfer Pricing Guidelines include: A master file of the MNE’s transfer pricing documentation that provides tax administrations with high-level information regarding the MNE’s global business operations and transfer pricing policies, made available to all relevant tax administrations that have jurisdiction over a group member of an MNE. A local file that provides a granular transfer pricing analysis requiring that detailed transactional transfer pricing documentation specific to each country, identifying material related party transactions, the amounts involved in those transactions, and the company’s analysis of the transfer pricing determinations they have made with regard to those transactions. A Country-by-Country report (CbCR) containing revised standards for transfer pricing documentation and a template for country-by-country annual reporting of profit before income tax, income tax paid and accrued, and certain measures of economic activity. The CbCR, for this initial stage at least, applies only
to large MNEs. CbCR also requires MNEs to report their number of employees, stated capital, retained earnings and tangible assets in each tax jurisdiction. Finally, it requires MNEs to identify each entity within the group doing business in a particular tax jurisdiction and to provide an indication of the business activities each entity engages in.

The CbCR requirements are to be implemented for fiscal years beginning on or after January 1, 2016 and apply, subject to a 2020 review, to MNEs with annual consolidated group revenue equal to or exceeding EUR 750 million. On March 22, 2016 the OECD released its standardized electronic format for the exchange of Country-by-Country (CbC) Reports between jurisdictions (“CbC XML Schema”) and an accompanying CbC XML Schema User Guide (“CbC XML Guide”). The CbC XML Guide reiterates the information required to be included in each data element of the CbC Report, and guidance on how to make corrections of data. CbC Reports in the CbC XML Schema will be electronically transmitted between Competent Authorities. Thus, tax administrations will annually receive key information on the global allocation of income and taxes paid, together with other indicators of the location of economic activity within the MNE group. From a local file perspective, the key information will include which entities do business in the jurisdiction and the business activities each entity engages in.

On December 23, 2015 the U.S. Treasury issued proposed regulation REG-109822-15. On June 29, 2016, consistent with the proposed regulations and the OECD’s Action 13 Final Report, the Treasury released the final regulations requiring that annual country by country reporting by certain U.S. persons that are the ultimate parent entity of a multinational enterprise group. The final regulations (TD 9773) affect a U.S. person that is the ultimate parent entity of a multinational enterprise group with annual revenue for the preceding annual accounting period of at least $850 million. The regulations are effective from June 30, 2016 although the regulations allow a U.S. person to voluntary file a CbCR that includes the time period from January 1, 2016, in order to avoid a CbCR compliance reporting gap because of foreign tax administrations’ adoption of the OECD applicable date. The final regulations amend the proposed regulations to reflect the official number of the form, Form 8975, Country-by-Country Report, (Form 8975 or CbCR).

The 2017 OECD Transfer Pricing Guidelines consolidate the 2015 Final BEPS reports and later OECD developments through 2017. The Guidelines’ Chapters I, II, IV, V, VI, VII, VIII, and IX are extensively amended or replaced, and include the OECD Council revised recommendation for the determination of transfer pricing between associated enterprises. See Chapter 1 and 2. The 2017 International Fiscal Association (IFA) “The Future of Transfer Pricing” Cahiers included 43 national report submissions. 15 developed jurisdictions reported that the OECD guidelines are relevant for domestic transfer pricing. At least six countries reported that the 2017 OECD Guidelines are retrospectively applicable (‘dynamic approach’) while other countries are currently analyzing whether to apply dynamically or whether to apply statically only to transactions taking place after the implementation in July 2017. See Chapter 1.08.

OECD Working Party No. 6 continued its work on the 2017 Discussion Draft of the Attribution of Profits to Permanent Establishments in relation to BEPS Action 7 “Preventing the Artificial Avoidance of Permanent Establishment Status.” On March 22, 2018, the OECD released its 2018 Additional Guidance. See Chapter 2. The next supplement will contain a new chapter on PEs and attribution. Also, WP6 continues its work, in particular the transactional profit split method in the context of global value chains, on the 2017 Revised Guidance on Profit Splits that addresses its work in relation to BEPS Actions 8-10 (“Assure that transfer pricing outcomes are in line with value creation”). The 2017 Discussion Draft clarifies the application of the transactional profit split method by identifying indicators for its use as the most appropriate transfer pricing method and providing additional guidance on determining the profits to be split. On June 21, 2018, the OECD released the final guidance on the appropriate application of the Transactional Profit Split (“TPS”) Method and on Implementing the OECD’s guidance on Hard to Value Intangibles (“HTVI”). The final guidance on TPS makes only minor modifications to the

The 2017 United Nations Practical Manual on Transfer Pricing for Developing Countries revisions include a revised format and reorganization into four parts, as well as new chapters on intra-group services, cost contribution arrangements, and the treatment of intangibles. The four parts are
Part A transfer pricing in a global environment; Part B guidance on design principles and policy considerations; Part C addresses practical implementation of a transfer pricing regime in developing countries; and Part D contains country practices and statements.

The past two year’s updates contained seven new chapters. Chapter 30 presents the potential to mitigate transfer pricing audit risk through leveraging a group’s ISO 9001 certification, common among manufacturers. Chapter 31 analyzes the transfer pricing risks of intercompany debt. Chapter 32 undertakes a coffee industry value chain analysis as a case study. Chapter 2A contrasts the diverging results of the outcome generated from risk allocation under the new 2017 Guidelines OECD and U.S. court decisions. Chapter 9A analyzes the potential use of the Berry Ratio first presented in Du Pont (1979) as an ‘other’ comparable profits and transactional net margin method. The Berry ratio is oft referred to as the ratio of operating profits, rather than gross profits, to operating expenses. Chapter 33 presents a case study examining the aspects of transfer pricing in relation to the highly integrated and opaque tobacco industry. The chapter includes an identification of the supply chain of the tobacco industry, a value chain analysis, and the identification of transfer pricing indications. Chapter 34 analyzes the EU Commission’s approach to APAs in light of its campaign against State Aid, and the published decisions of Starbucks, FIAT, and Apple.

This 2018 supplement contains five new chapters.

- New Chapter 28A Business Restructuring And U.S. Tax And Transfer Pricing Rules that integrates the new provisions of the Tax Cuts and Jobs Act, such as GILTI, FDII, and BEAT, into the business structuring decision making process;

- New Chapter 35 Applying the Arm’s Length Principle to Performance Guarantees in light of the OECD’s ongoing revisions of determining the arm’s length price for the intra group provision of financial services and of intragroup debt;

- New Chapter 36 Brazilian Transfer Pricing Rules examines the unique approach applied by Brazil that is often discussed as an alternative for developing countries seeking to cope with application of the arm’s length standard but that do not want to move out of the main stream to a formulary apportionment regime;

- New Chapter 37 Porter Analysis: A Business Strategy Of Amazon.Com Through A Value Chain And Comparative Advantage Analysis Of Amazon’s Trademarks And Intangibles attempts to apply the OECD’s suggested Porter’s analysis as part of the continuing series of applied data search examples; and

- New Chapter 38 M&A and Transfer Pricing that highlights a diligence checklist of factors to be considered in an M&A transaction wherein parties will become related as a result.

The EU continues to define the transfer pricing audit landscape for its members. The EU JTPF published “The Study on the Application of Economic Valuation Techniques for Determining Transfer Prices of Cross Border Transactions between Members of Multinational Enterprise Groups in the EU” in September 2016. This 2016 Report investigates the differences between valuations for transfer pricing purposes and valuations for other purposes, such as financial and accounting. This was conducted through four aspects: 1) a SWOT analysis of
economic valuation techniques applied in the context of transfer pricing, 2) the practical application of these techniques in the EU Member States and trade partners, 3) the identification of potential legislative measures, and 4) capacity building approaches for tax administrations. See Chapter 1.08.

Since June 2013, the EU Commission has been investigating the tax ruling practices of Member States. It extended its investigation of tax ruling practices to all Member States in December 2014. Besides its 2015 decision in the Starbucks and Fiat cases, and its 2016 $14 billion tax assessment against Apple, the EU Commission also has many ongoing in-depth investigations where it raised concerns that tax rulings may give rise to state aid issues, such as Amazon in Luxembourg. On August 24, 2016 U.S. Treasury issued a White Paper formally criticizing the EU Commission’s approach as new and departing from prior EU case law and commission decisions. The U.S. Treasury stated that the EU Commission has advanced several previously unarticulated theories as to why its Member States’ generally available tax rulings may constitute impermissible State aid in particular cases. Such a change in course, which has required the Commission to second-guess Member State income tax determinations, was an unforeseeable departure from the status quo. U.S. Treasury has stated that it will explore retaliatory options if the State Aid penalties are applied retroactively to U.S. MNEs. See Chapter 34.

Fiscal State aid rules are not the only EU tax regulations having a direct impact upon multinational companies in Europe. Although EU and OECD tax policy are often aligned to a large degree, many EU tax experts observe that EU regulations often are more complex, rigorous, and expand well-beyond the requirements established by the OECD’s Model Tax Convention (MTC). In several key areas of corporate related taxation and tax practice, such as the tax avoidance rules, the EU has surpassed the OECD’s rules for addressing tax avoidance by multinational companies doing business within the EU’s internal market. For example, in January 2016 the European Commission released its version of the Anti-Tax Avoidance Package, commonly referred to as the “EU BEPS Plan.” One of the central items of this Anti-Tax Avoidance Package is the newly proposed EU Directive recommended by the European Commission that imposes enactment of domestic regulations against tax avoidance practices by MNEs that would directly affect the functioning of the internal market under EU law. The Council adopted the anti tax avoidance directive on July 12, 2016. It further adopted its amendment introducing rules to tackle hybrid mismatches with the tax systems of countries outside the EU on May 29, 2017.

The EU’s Anti-Avoidance Package comprises four main documents: an Anti-Tax Avoidance Directive (ATA Directive); a Recommendation on Tax Treaties; a Revised Administrative Cooperation Directive; and a Communication on External Strategy on Effective Taxation. This package collectively addresses seven critical areas of European corporate taxation including the deductibility of interest between related companies and the mandatory automatic exchange of information regarding CbCR, among others. The package’s new rules are more comprehensive in application than the OECD’s MTC and far more complex. The ATAD also ensures that the OECD anti-BEPS measures are transposed in a coordinated manner, including by seven EU member states that are not members of the OECD. The member states will have until December 31, 2018 to transpose it into their national laws and regulations, except for the exit taxation rules, for which they will have until December 31, 2019. The amended ATAD which introduces the rules neutralizing hybrid mismatches with third countries has to be implemented by January 1, 2020. Member states which have targeted rules that are equally effective to the interest limitation rules of the ATAD may apply them until the OECD reaches agreement on a minimum standard, or until January 1, 2024 at the latest. The EU proposal for a Common Consolidated Corporate Tax Base (CCCTB) has yet to be implemented. However, the European Parliament’s ECON Committee announced in March 2018 that a substantially stricter version is planned to be implemented by the end of 2020.
CHAPTER 33: The Value Chain: A Study of the Tobacco Industry

SUSANNA HARTANTO*

SYNOPSIS

§ 33.01 Introduction

This chapter presents a case study examining the aspects of transfer pricing in relation to the tobacco industry in Indonesia. The certain aspects include an identification of the supply chain of the tobacco industry, a value chain analysis of the industry, and the identification of transfer pricing indication.

§ 33.02 Tobacco Supply Chain

Supply chain is the set of activities required to transform a raw product into finished goods sold to consumers. There are six stages in tobacco global supply chain, including three distinct post-harvest for tobacco, which often occur in different locations and under different institutional arrangements are:

1. Curing, which is almost done on-farm and involves drying green tobacco leaf, followed by two processing functions.

2. Stemming, stripping and blending tobacco.

3. Transforming raw tobacco into a finished product, such as cigarettes.

A brief summary of the stages of production for tobacco below describes the activities involved, input-output structure, and lead actor for each stage of the chain (see Figure 1):

Stage 1: Input—land, labor, and physical requirements for competitive production.

Stage 2: Cultivation

Stage 3: Curing

Stage 4: Primary processing and trading—stemming and stripping of tobacco

Stage 5: Secondary processing—manufacturing

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Stage 6: Marketing and distribution—final product to consumers

Over time, the tobacco industry has grown extremely concentrated. A small number of tobacco companies and leaf buyers have a high degree of market power over the supply chain (see Figure 2), while small farmers generally have very little bargaining power. Although tobacco is still produced in a variety of different arrangements, to ensure supply, “outgrower” or contract based production models have become the dominant way for leaf buyers to set up inter-firm relations. Under these models, the buyer may provide inputs and credit to the producer, either individually or through collective groups of 10 to 30 farmers, known as “tobacco clubs.” In return, the tobacco producers agree to supply the specified amount of raw tobacco once it is cultivated and assume the risks incurred in cultivation.

Figure 1. Tobacco Global Supply Chain

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Figure 2. Tobacco Domestic Supply Chain


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Stage 1: Input—Land, labor, and physical requirements for competitive production.
Tobacco is a highly labor-intensive agricultural commodity compared to other crops because tobacco is technically challenging to mechanize. This makes tobacco farming an important source of employment. Activities associated with input are:

a. Seed provision: Ensuring farmers have an adequate supply of seeds (tobacco companies, leaf merchants, large producers).

b. Agrochemical production and blending: Supply of fertilizers, herbicides, and pesticides for use with tobacco crops (agrochemical supply companies).

c. Banking and finance capital: Capital for tobacco producers to acquire seeds, agrochemicals, and other inputs (tobacco companies, leaf merchants, banks, and governments).

d. Research and development: Develop new seed varieties (e.g., drought resistant, pest resistant), machinery and production processes (tobacco companies, public research organizations, and biotechnology firms).

Stage 2: Cultivation. The cultivation process requires specific biophysical conditions, and the soil quality, climate, and access to irrigation systems affect both the yield and quality. Activities associated with cultivation are:

a. Agricultural extension: Weekly, biweekly, or monthly visits from agronomists to producers focused on education and training in the production of tobacco (tobacco companies, leaf merchants, industry associations, producer collectives, and governments).

b. Spraying: Spraying of agrochemicals on tobacco crops during cultivation (producers, third-party firms for smallholder production).

c. Hail insurance: Protects growers from unexpected events, such as hail and wind (insurance companies, tobacco companies, and leaf merchants).

d. Farm equipment and infrastructure maintenance: Maintaining irrigation systems and other farm equipment used in the cultivation and reaping of tobacco (local technicians, mechanics, and producers).

e. Market information provision: Provide infrastructure and venues for farmers to exchange and obtain market information (mobile telecommunication providers, traders, governments, industry associations, and producer collectives).

Although maintenance and harvesting of the tobacco plants requires a very high investment of labor hours, producers tend to command a low share of the total value of the final
product.

Stage 3: Curing. After harvest, leaves are dried (cured) to stabilize, graded into homogenous lots and then aged or fermented. The curing process varies from flue cured and fire cured tobacco, which requires an energy source for heat (usually heat or coal), while air cured and sun cured varieties do not require an energy source for heat. Activities associated with curing are:

a. Transportation: Transport from fields to curing locations and warehouses (producers, affiliates of MNCs, and leaf merchants).

b. Firewood or coal provision: Harvesting, mining, processing, and distribution of fuel for curing purposes (producers—firewood, or third-party suppliers).

c. Equipment and infrastructure maintenance: Maintaining equipment and infrastructure used in the curing of tobacco such as flues, boilers, and sheds (construction firms, producers, or mechanics).

d. Warehousing: Storage for cured, unprocessed tobacco (leaf merchants, producers, or agents).

After curing, the tobacco is prepared into strips (for some varieties), sorted, and packaged into homogeneous bales for export and delivery to the manufacturers that transform them into cigarettes, cigars, etc. Some of the tobacco refuse (the by-product from the stemming, curing, and stripping process) is also exported.

Stage 4: Primary processing and trading—Stemming and stripping of tobacco (Primary Processing). Stemming and stripping of tobacco leaves ensures that moisture content is controlled to prevent deterioration in storage. Unprocessed (but cured) tobacco is a semi-perishable commodity, thus primary processing must take place relatively quickly. Processing facilities are generally located in producing countries and carried out by leaf merchants and audited by buyers. In this stage, tobacco is reclassified according to grade and blended to meet client quality specifications. Then, tobacco is threshed to remove the stem from the lamina and sieved to remove waste. Then tobacco is re-dried to extend the storage shelf life, although almost tobacco is typically used within two or three years. Stored tobacco is packaged in bales, cases, and cartons for shipment. The leaf merchants typically hold the inventory until the buyers (tobacco MNCs) specify shipping dates. Then tobacco is shipped to the manufacturing destination, where the final tobacco products are made.

Primary processing stage is highly consolidated with two global leaf merchant companies, Alliance One International and Universal Corporation, for large market share. Activities associated with primary processing are:

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a. Auction: Services for linking farmers with leaf merchants and tobacco companies that are not using a direct, contract-based procurement system (parastatal institutions or private auction firms).

b. Transportation: Transport to and from stemming and stripping locations, and warehouses to export destinations (leaf merchants, producers, agents, tobacco MNCs, and transportation firms).

c. Warehousing: Storage for primary processed tobacco (leaf merchants, agents, producers, and tobacco MNCs).

d. Import/export: Processing customs, duties, taxes, etc. (governments or private contractors).

Stage 5: Secondary processing—Manufacturing. Secondary processing involves transforming raw tobacco into cigarettes, cigars, cigarillos, and other final tobacco products. Tobacco companies tend to manufacture internally. In contrast to the production stage of the value chain, cigarettes manufacturing is highly automated, involving the rolling and cutting of rods into individual cigarettes, the insertion of filters, packaging into individual packs of 0–20 cigarettes, and into cartons of 10 packs each. The largest firm in secondary processing are:

- Phillip Morris International (PMI) has 26.2 percent of market share with 48 plants in 32 countries.
- British American Tobacco (BAT) has 19.1 percent of market share with 44 plants in 42 countries.
- Japan Tobacco International (JTI) has 15.8 percent of market share with 25 plants worldwide.
- Imperial Tobacco has 8.9 percent of market share with 51 plants worldwide.

Activities associated with secondary processing are:

a. Transportation: Transport from import locations to manufacturing facilities, and from manufacturing facilities to export destinations or retail outlets (logistics companies, tobacco MNCs, leaf merchants, and agents).

b. Warehousing: Storage for finished tobacco products (tobacco MNCs).

c. Paper provision: Rolling paper for cigarette manufacturing (tobacco MNCs and paper suppliers).

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d. Manufacturing equipment provision: Supply equipment for manufacturing of cigarettes and other tobacco products (equipment suppliers).

e. Manufacturing equipment maintenance: Maintain cigarette manufacturing equipment and production lines (tobacco MNCs and mechanics).

f. Financial consulting (for leaf merchants and global buyers): Strategic advice for maintaining and increasing shareholder value (management consulting firms and tobacco MNCs).

g. Financial and banking (for leaf merchants and global buyers): Asset management, investment, and accounting for global tobacco companies and leaf merchants (hedge funds, investment banks, or tobacco MNCs).

h. Legal: Legal advice pertaining to tobacco production and research and development (law firms and tobacco MNCs).

Stage 6: Marketing and distribution—Final product to consumers. The large transnational tobacco companies also coordinate the branding and marketing of final products. Activities associated with marketing and distribution stage are:

a. Transportation: Transport to distribution warehouses and retail outlets (logistics firms and tobacco MNCs).

b. Advertising: Marketing and product promotion within the constraints of domestic tobacco marketing restrictions in particular countries (advertising agencies and tobacco MNCs).

c. Logistics: Logistical management of product warehousing and distribution to retail outlets (logistics firms and tobacco MNCs).

Cigarette segment is divided into premium, economy and low-value brands, which offer different price-points based on consumer willingness to pay. Leading international brands and companies are shown in below Table 1.6

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Table 1
Leading International Cigarettes Brands and Companies

<table>
<thead>
<tr>
<th>Top brands</th>
<th>Company</th>
</tr>
</thead>
<tbody>
<tr>
<td>Marlboro</td>
<td>• Philip Morris International Inc. • Altria Group Inc.</td>
</tr>
<tr>
<td>Winston</td>
<td>• Japan Tobacco Inc. • Reynolds American Inc.</td>
</tr>
<tr>
<td>Pall Mall</td>
<td>• British American Tobacco Plc. • Reynolds American Inc.</td>
</tr>
<tr>
<td>L&amp;M</td>
<td>• Philip Morris International Inc. • Altria Group Inc.</td>
</tr>
<tr>
<td>Mevius</td>
<td>• Japan Tobacco Inc.</td>
</tr>
<tr>
<td>Camel</td>
<td>• Japan Tobacco Inc. • Reynolds American Inc.</td>
</tr>
<tr>
<td>Gudang Garam</td>
<td>• Gudang Garam Tbk PT.</td>
</tr>
<tr>
<td>Kent</td>
<td>• British American Tobacco Plc.</td>
</tr>
<tr>
<td>Dunhill</td>
<td>• British American Tobacco Plc.</td>
</tr>
<tr>
<td>Gold Flake</td>
<td>• ITC Ltd. • British American Tobacco Plc.</td>
</tr>
</tbody>
</table>

Overall, input-output structure of tobacco has multiple stages of production and processing, which typically occur in locations that are geographically dispersed. The reason for geographic separation of stages is variation in the production requirements of each stage: some involve highly labor- and land-intensive (cultivation), while others are capital-intensive, quality-sensitive, and mechanized (cigarette manufacturing). Within this structure, small producers are situated in a low-value segment of the tobacco global value chain that is highly competitive, while MNCs typically operate in the highest value segments of chain (marketing and distribution). This structure also brings out transfer pricing issue among division or companies across countries (MNCs) in tobacco industry.

§ 33.03 Transfer Pricing

Transfer pricing is the pricing of intercompany transactions that take place between affiliated businesses, for example, trade between a parent company and its foreign subsidiary or between two foreign affiliates. Alternatively, transfer pricing is also the pricing of cross border intrafirm transaction between related parties. Transfer pricing has become increasingly high and accelerating rapidly worldwide for multinational corporations in the past decade.

The transfer pricing process determines the amount of income that each party earns from that transaction. There are both internal and external motivation for MNCs to establish transfer prices for intrafirm trade. Many foreign affiliates are run as profit centers. As a result, the rewards of the top management team in these affiliates depend on their affiliate’s profits. The setting of transfer pricing can be internally driven as a way to both motivate managers and monitor subsidiary performance. Externally, MNCs have to pay corporate income taxes on their domestic and foreign source income, necessitating that they set transfer prices for cross border trade flows. Customs authorities also require transfer prices for intrafirm imports of parts, components, and
finished goods, either for custom duties or rules of origin purposes.

Taxpayers and the taxing authorities focus exclusively on related-party transactions, or controlled transactions, and have no direct impact on independent-party transactions, or uncontrolled transactions. In this context, transactions are determined broadly and include sales, licensing, leasing, services, interest, etc. Transfer pricing manipulation, as distinct from transfer pricing, is the over or under-invoicing of related party transactions in order to avoid government regulations (e.g: under-invoicing to avoid paying ad valorem tariff) or to exploit cross border differences in tax rates (e.g: shifting deductible expenses to the high tax location and revenues to the low tax location in order to reduce overall corporate tax payments). It is not transfer pricing that is the problem. The potential for transfer pricing manipulation is what governments fear and want to prevent through regulation. Transfer pricing risk for government that might be difficult to detect and understand the whole range and possible consequences is Base Erosion and Profit Shifting (BEPS).

§ 33.04 Identifying Transfer Pricing Indication in Tobacco Industry

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 transfer pricing 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.

What a multinational group considers legitimate forms of price setting may sceptically be viewed by a revenue authority as illegitimate profit manipulation. A transfer of profit may be inferred where, for example, transactions occur at prices higher or lower than prevailing market. Mechanisms to reduce taxes through transfer pricing include:

1. Setting the selling price lower, usually employed when affiliated companies are buyers located in a higher tax rate country than the seller’s (e.g. Indonesia) tax rate. By example, Company X in Indonesia intended to make sale price lower when selling to B Pte Ltd in a foreign country (e.g. Singapore. Tax rate in Indonesia is 25 percent and in Singapore 17 percent. Indonesia will realize less revenues and Singapore more. Thus, there will be profit shifting from Indonesia to Singapore.

2. Making buying price higher, usually employed when affiliated companies as sellers are located in lower tax rate than Indonesia’s tax rate. E.g. Company X in Indonesia buys from Y Ltd in Hong Kong. The tax rate in Indonesia is 25 percent and in Hong Kong is 17 percent. Therefore, a higher cost is borne by the Indonesia buyer, and higher revenues shifted to Hong Kong.

A transfer pricing advisor will be able to find the worldwide finished cigarettes market prices for comparability. But there is not such comparability data for the worldwide tobacco-before secondary processing-market prices. Tobacco before secondary processing means tobacco after primary processing and before processing into finished goods-cigarettes. This function area of the supply chain has unique characteristics because tobacco before secondary processing is very specific and depends on the type and source countries or origin of the tobaccos. Therefore,
prices will vary from one type to another and from one country to another. Indonesian tobaccos are different from other countries tobaccos in qualities, appearances, and tastes. It is not accurate to discern a comparable arm’s length price for an Indonesian tobacco product from the products of other countries. The best comparability derives from the same origin country and type of tobaccos.

In tobacco export-import, tobaccos are classified according to a Harmonized System Code. The Harmonized System (HS) or Harmonized Commodity Description and Coding System is a multipurpose international product nomenclature or an internationally standardized system of names and numbers to classify traded products developed by the World Customs Organization (WCO). Indonesian tobaccos before secondary processing are exported to various countries like Singapore, United States, and European Countries classified according to an HS Code.

Indication of transfer pricing usage to reduce taxes in the Indonesian tobacco industry can be seen from the selling price that is used in export. In Table 2, the average selling price for Indonesian Flue Cured Virginia Tobacco-not stemmed or stripped is $4.8 per kg. The selling price of export to a destination such as Singapore or Germany, where the tax rate in those destinations is lower than the tax rate in Indonesia, is lower than $4.8. This may indicate transfer pricing usage to reduce tax and profit shifting from Indonesia to Singapore and Germany. Another export destination is Sri Lanka, as shown in Table 2, wherein the tax rate is 28 percent and the selling price is $19 per kg, higher than the tax rate and the $4.8 per kg price in Indonesia. This higher price creates profit shifting from Sri Lanka to Indonesia. The overall tax for an MNC may potentially be lower with such a transfer price setting.

Table 2
Export Volume and Value of Tobacco (HS: 2401101000) From Indonesia to Destination Country For 2015

<table>
<thead>
<tr>
<th>No</th>
<th>HS Code</th>
<th>Destination</th>
<th>Volume (Kgs)</th>
<th>Value ($US)</th>
<th>Price/Kg</th>
<th>Tax Rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>HS: 2401101000</td>
<td>Singapore</td>
<td>150,480</td>
<td>711,770</td>
<td>4.73</td>
<td>17</td>
</tr>
<tr>
<td></td>
<td>Virginia Tobacco</td>
<td>Malaysia</td>
<td>40,000</td>
<td>158,620</td>
<td>3.97</td>
<td>25</td>
</tr>
<tr>
<td></td>
<td>Not stemmed/stripped</td>
<td>Sri Lanka</td>
<td>9,895</td>
<td>188,036</td>
<td>19.00</td>
<td>28</td>
</tr>
<tr>
<td></td>
<td>Flue-cured</td>
<td>Germany</td>
<td>18,000</td>
<td>26,280</td>
<td>1.46</td>
<td>15</td>
</tr>
<tr>
<td></td>
<td>Indonesia's Tax Rate 25%</td>
<td>Belgium</td>
<td>56,430</td>
<td>234,185</td>
<td>4.15</td>
<td>33</td>
</tr>
<tr>
<td></td>
<td><strong>Total</strong></td>
<td></td>
<td>274,805</td>
<td>1,318,891</td>
<td>4.80</td>
<td></td>
</tr>
</tbody>
</table>

---

Table 3 for Indonesian Non Flue Cured Virginia Tobacco-not stemmed or stripped shows no export transaction for this type of tobacco during 2015, while in Table 4, Burley tobacco is only exported to Belgium. No comparable data to identify transfer pricing usage to reduce taxes for both type of tobaccos. Table 3 and Table 4 are reproduced below, noting that Table 3 is empty of any (comparable) data because of the lack of transactions.

**Table 3**

Export Volume and Value of Tobacco (HS: 2401101000) From Indonesia to Destination Country For 2015

<table>
<thead>
<tr>
<th>No</th>
<th>HS Code</th>
<th>Destination</th>
<th>Volume (Kgs)</th>
<th>Value ($ US)</th>
<th>Price/Kg</th>
<th>Tax Rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>HS: 2401101000</td>
<td>Virginia Tobacco</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Not stemmed/stripped</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Not Flue-cured</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td><strong>Total</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Table 4**

Export Volume and Value of Tobacco HS: (2401104000) From Indonesia to Destination Country For 2015

<table>
<thead>
<tr>
<th>No</th>
<th>HS Code</th>
<th>Destination</th>
<th>Volume (Kgs)</th>
<th>Value ($ US)</th>
<th>Price/Kg</th>
<th>Tax Rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>3</td>
<td>HS: 2401104000</td>
<td>Belgium</td>
<td>17,820</td>
<td>65,934</td>
<td>3.70</td>
<td>33</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Burley Tobacco</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Not stemmed/stripped</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td><strong>Total</strong></td>
<td>17,820</td>
<td>65,934</td>
<td>3.70</td>
<td></td>
</tr>
</tbody>
</table>
In Table 5, Flue cured Oth tobacco, not stemmed or stripped, averages a selling price of $3.85 per kg for this type of tobacco. Some destinations with export selling prices lower than $3.85 have a lower tax rate than in Indonesia, such as Singapore, United States, and Russia. This indicates transfer pricing usage to reduce tax and profit shifting from Indonesia to those countries. Another export destination like Sri Lanka and Belgium, as in Table 5, the tax rate in Sri Lanka is 28 percent and Belgium is 33 percent, while the selling price is $19.75 per kg to Sri Lanka and $4.37 to Belgium, which is much higher than $3.85. This higher price setting will make profit shifting from Sri Lanka and Belgium to Indonesia. Again, overall taxes for MNCs will be much lower with the transfer price setting by shifting profit from higher tax rates countries to lower tax rates countries. Transfer pricing usage for tax reduction may be indicated for other types of Indonesian tobaccos (see the appendix to this chapter).

Table 5
Export Volume and Value of Tobacco (HS: 2401105000) From Indonesia to Destination Country For 2015

<table>
<thead>
<tr>
<th>No</th>
<th>HS Code</th>
<th>Destination</th>
<th>Volume (Kgs)</th>
<th>Value ($ US)</th>
<th>Price/Kg</th>
<th>Tax Rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>4</td>
<td>HS: 2401105000</td>
<td>Singapore</td>
<td>52,530</td>
<td>83,549</td>
<td>1.59</td>
<td>17</td>
</tr>
<tr>
<td></td>
<td>Oth Tobacco</td>
<td>Philippines</td>
<td>8,800</td>
<td>22,000</td>
<td>2.50</td>
<td>30</td>
</tr>
<tr>
<td></td>
<td>Not stemmed/stripped</td>
<td>Sri Lanka</td>
<td>129,064</td>
<td>2,549,242</td>
<td>19.75</td>
<td>28</td>
</tr>
<tr>
<td></td>
<td>Flue-cured</td>
<td>Egypt</td>
<td>691,078</td>
<td>1,125,260</td>
<td>1.63</td>
<td>25</td>
</tr>
<tr>
<td></td>
<td></td>
<td>United States</td>
<td>298,612</td>
<td>826,784</td>
<td>2.77</td>
<td>15 to 39</td>
</tr>
<tr>
<td></td>
<td>Indonesia's Tax Rate</td>
<td>Germany</td>
<td>19,200</td>
<td>74,880</td>
<td>3.90</td>
<td>15</td>
</tr>
<tr>
<td></td>
<td>25%</td>
<td>Belgium</td>
<td>288,170</td>
<td>1,259,694</td>
<td>4.37</td>
<td>33</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Slovakia</td>
<td>5,400</td>
<td>70,011</td>
<td>12.97</td>
<td>22</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Russia</td>
<td>100,000</td>
<td>115,000</td>
<td>1.15</td>
<td>20</td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td></td>
<td>1,592,854</td>
<td>6,126,420</td>
<td>3.85</td>
<td></td>
</tr>
</tbody>
</table>
### APPENDIX

**Table 6**

Export Volume and Value of Tobacco (HS: 2401109000) From Indonesia to Destination Country For 2015

<table>
<thead>
<tr>
<th>No</th>
<th>HS Code</th>
<th>Destination</th>
<th>Volume (Kgs)</th>
<th>Value ($ US)</th>
<th>Price/Kg</th>
<th>Tax Rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>5</td>
<td>HS: 2401109000</td>
<td>Japan</td>
<td>408</td>
<td>8,127</td>
<td>19.92</td>
<td>25.5*</td>
</tr>
<tr>
<td></td>
<td>Oth Tobacco</td>
<td>China</td>
<td>57,119</td>
<td>850,294</td>
<td>14.89</td>
<td>25</td>
</tr>
<tr>
<td></td>
<td>Not stemmed/stripped</td>
<td>Philippines</td>
<td>5,900</td>
<td>81,150</td>
<td>13.75</td>
<td>30*</td>
</tr>
<tr>
<td></td>
<td>Not Flue-cured</td>
<td>Malaysia</td>
<td>318,780</td>
<td>2,029,757</td>
<td>6.37</td>
<td>25</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Bangladesh</td>
<td>36,000</td>
<td>126,000</td>
<td>3.50</td>
<td>25</td>
</tr>
<tr>
<td></td>
<td>Indonesia's Tax Rate = 25%</td>
<td>Sri Lanka</td>
<td>911,036</td>
<td>21,641,230</td>
<td>23.75</td>
<td>28*</td>
</tr>
<tr>
<td></td>
<td>Egypt</td>
<td></td>
<td>46,000</td>
<td>97,520</td>
<td>2.12</td>
<td>25</td>
</tr>
<tr>
<td></td>
<td>Tunisia</td>
<td></td>
<td>78,400</td>
<td>99,816</td>
<td>1.27</td>
<td>25</td>
</tr>
<tr>
<td></td>
<td>South Africa</td>
<td></td>
<td>44,000</td>
<td>46,200</td>
<td>1.05</td>
<td>28</td>
</tr>
<tr>
<td></td>
<td>Australia</td>
<td></td>
<td>48,000</td>
<td>5,600</td>
<td>0.95</td>
<td>30</td>
</tr>
<tr>
<td></td>
<td>United States</td>
<td></td>
<td>2,318,941</td>
<td>4,107,270</td>
<td>1.77</td>
<td>15 to 39*</td>
</tr>
<tr>
<td></td>
<td>Honduras</td>
<td></td>
<td>56,182</td>
<td>1,432,474</td>
<td>25.50</td>
<td>25</td>
</tr>
<tr>
<td></td>
<td>Nicaragua</td>
<td></td>
<td>118,502</td>
<td>1,278,853</td>
<td>10.79</td>
<td>30*</td>
</tr>
<tr>
<td></td>
<td>Puerto Rico</td>
<td></td>
<td>330,291</td>
<td>1,215,017</td>
<td>3.68</td>
<td>39</td>
</tr>
<tr>
<td></td>
<td>Dominican Republic</td>
<td></td>
<td>671,310</td>
<td>7,277,266</td>
<td>10.84</td>
<td>27*</td>
</tr>
<tr>
<td></td>
<td>United Kingdom</td>
<td></td>
<td>39,600</td>
<td>166,320</td>
<td>4.20</td>
<td>21*</td>
</tr>
<tr>
<td></td>
<td>Netherlands</td>
<td></td>
<td>748,791</td>
<td>5,116,297</td>
<td>6.83</td>
<td>25</td>
</tr>
<tr>
<td></td>
<td>France</td>
<td></td>
<td>18,000</td>
<td>53,100</td>
<td>2.95</td>
<td>33.33</td>
</tr>
<tr>
<td></td>
<td>Germany</td>
<td></td>
<td>224,310</td>
<td>1,808,345</td>
<td>8.06</td>
<td>15</td>
</tr>
<tr>
<td></td>
<td>Belgium</td>
<td></td>
<td>304,022</td>
<td>1,303,210</td>
<td>4.29</td>
<td>33</td>
</tr>
<tr>
<td></td>
<td>Sweden</td>
<td></td>
<td>29,400</td>
<td>67,620</td>
<td>2.30</td>
<td>22*</td>
</tr>
<tr>
<td></td>
<td>Italy</td>
<td></td>
<td>23,400</td>
<td>25,446</td>
<td>1.09</td>
<td>27.5</td>
</tr>
<tr>
<td></td>
<td>Spain</td>
<td></td>
<td>24,606</td>
<td>158,500</td>
<td>6.44</td>
<td>28</td>
</tr>
<tr>
<td></td>
<td>Bulgaria</td>
<td></td>
<td>45,600</td>
<td>75,304</td>
<td>1.65</td>
<td>10*</td>
</tr>
<tr>
<td></td>
<td>Malta</td>
<td></td>
<td>6,000</td>
<td>10,800</td>
<td>1.80</td>
<td>35</td>
</tr>
</tbody>
</table>
### Table 7
Export Volume and Value of Tobacco (HS: 2401201000) From Indonesia to Destination Country For 2015

<table>
<thead>
<tr>
<th>No</th>
<th>HS Code</th>
<th>Destination</th>
<th>Volume (Kgs)</th>
<th>Value ($ US)</th>
<th>Price/Kg</th>
<th>Tax Rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>6</td>
<td>HS: 2401201000</td>
<td>Singapore</td>
<td>571,560</td>
<td>2,093,319</td>
<td>3.66</td>
<td>17*</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Philippines</td>
<td>105,435</td>
<td>254,687</td>
<td>2.42</td>
<td>30</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Malaysia</td>
<td>4,144,932</td>
<td>28,302,627</td>
<td>6.83</td>
<td>25</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Vietnam</td>
<td>4,622</td>
<td>20,797</td>
<td>4.50</td>
<td>22*</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Sri Lanka</td>
<td>4,500</td>
<td>73,040</td>
<td>16.23</td>
<td>28*</td>
</tr>
<tr>
<td></td>
<td>Indonesia's Tax Rate 25%</td>
<td>Jordan</td>
<td>178,200</td>
<td>623,700</td>
<td>3.50</td>
<td>30</td>
</tr>
<tr>
<td></td>
<td></td>
<td>South Africa</td>
<td>19,800</td>
<td>91,080</td>
<td>4.60</td>
<td>28</td>
</tr>
<tr>
<td></td>
<td></td>
<td>United States</td>
<td>140,300</td>
<td>687,525</td>
<td>4.90</td>
<td>15 to 39</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Brazil</td>
<td>224,145</td>
<td>1,175,980</td>
<td>5.25</td>
<td>15*</td>
</tr>
<tr>
<td></td>
<td></td>
<td>United Kingdom</td>
<td>166,320</td>
<td>638,550</td>
<td>3.84</td>
<td>21*</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Germany</td>
<td>28,560</td>
<td>79,858</td>
<td>2.80</td>
<td>15*</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Belgium</td>
<td>329,670</td>
<td>909,008</td>
<td>2.76</td>
<td>33</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Switzerland</td>
<td>79,200</td>
<td>455,400</td>
<td>5.75</td>
<td>12 to 24*</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Lithuania</td>
<td>176,964</td>
<td>356,898</td>
<td>2.02</td>
<td>15*</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Czech Republic</td>
<td>4,320</td>
<td>40,608</td>
<td>9.40</td>
<td>19</td>
</tr>
<tr>
<td></td>
<td><strong>Total</strong></td>
<td></td>
<td><strong>6,178,528</strong></td>
<td><strong>35,803,077</strong></td>
<td><strong>5.79</strong></td>
<td></td>
</tr>
</tbody>
</table>

* Indicates potential transfer pricing usage for tax reduction.
Table 8
Export Volume and Value of Tobacco (HS: 2401202000) From Indonesia to Destination Country For 2015

<table>
<thead>
<tr>
<th>No</th>
<th>HS Code</th>
<th>Destination</th>
<th>Volume (Kgs)</th>
<th>Value ($ US)</th>
<th>Price/Kg</th>
<th>Tax Rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>7</td>
<td>HS: 2401202000</td>
<td>Philippines</td>
<td>19,800</td>
<td>41,580</td>
<td>2.10</td>
<td>30</td>
</tr>
<tr>
<td></td>
<td>Virginia Tobacco</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Partly or wholly stemmed/stripped</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Not Flue-cured</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Indonesia's Tax Rate 25%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>Total</strong></td>
<td></td>
<td>19,800</td>
<td>41,580</td>
<td>2.10</td>
<td></td>
</tr>
</tbody>
</table>

Table 9
Export Volume and Value of Tobacco (HS: 2401203000) From Indonesia to Destination Country For 2015

<table>
<thead>
<tr>
<th>No</th>
<th>HS Code</th>
<th>Destination</th>
<th>Volume (Kgs)</th>
<th>Value ($ US)</th>
<th>Price/Kg</th>
<th>Tax Rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>8</td>
<td>HS: 2401203000</td>
<td>Pakistan</td>
<td>560</td>
<td>9,038</td>
<td>16.14</td>
<td>33</td>
</tr>
<tr>
<td></td>
<td>Oriental Tobacco</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Partly or wholly stemmed/stripped</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Indonesia's Tax Rate 25%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>Total</strong></td>
<td></td>
<td>560</td>
<td>9,038</td>
<td>16.14</td>
<td></td>
</tr>
</tbody>
</table>
### Table 10
Export Volume and Value of Tobacco (HS: 2401204000) From Indonesia to Destination Country For 2015

<table>
<thead>
<tr>
<th>No</th>
<th>HS Code</th>
<th>Destination</th>
<th>Volume (Kgs)</th>
<th>Value ($ US)</th>
<th>Price/Kg</th>
<th>Tax Rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>9</td>
<td>HS: 2401204000</td>
<td>Taiwan</td>
<td>200</td>
<td>100</td>
<td>0.50</td>
<td>17*</td>
</tr>
<tr>
<td></td>
<td>Burley Tobacco</td>
<td>Philippines</td>
<td>59,400</td>
<td>294,030</td>
<td>4.95</td>
<td>30</td>
</tr>
<tr>
<td></td>
<td>Partly or wholly stemmed/stripped</td>
<td>Malaysia</td>
<td>245,618</td>
<td>2,058,277</td>
<td>8.38</td>
<td>25</td>
</tr>
<tr>
<td></td>
<td></td>
<td>United States</td>
<td>178,200</td>
<td>873,180</td>
<td>4.90</td>
<td>15 to 39*</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Belgium</td>
<td>111,910</td>
<td>590,748</td>
<td>5.28</td>
<td>33</td>
</tr>
<tr>
<td></td>
<td>Indonesia's Tax Rate 25%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>Total</strong></td>
<td></td>
<td><strong>595,328</strong></td>
<td><strong>3,816,335</strong></td>
<td><strong>6.41</strong></td>
<td></td>
</tr>
</tbody>
</table>

* Indicates potential transfer pricing usage for tax reduction.

### Table 11
Export Volume and Value of Tobacco (HS: 2401205000) From Indonesia to Destination Country For 2015

<table>
<thead>
<tr>
<th>No</th>
<th>HS Code</th>
<th>Destination</th>
<th>Volume (Kgs)</th>
<th>Value ($ US)</th>
<th>Price/Kg</th>
<th>Tax Rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>10</td>
<td>HS: 2401205000</td>
<td>Taiwan</td>
<td>150</td>
<td>75</td>
<td>0.50</td>
<td>17*</td>
</tr>
<tr>
<td></td>
<td>Oth Tobacco</td>
<td>China</td>
<td>5,580</td>
<td>101,966</td>
<td>18.27</td>
<td>25</td>
</tr>
<tr>
<td></td>
<td>Partly or wholly stemmed/stripped</td>
<td>Singapore</td>
<td>108,600</td>
<td>478,350</td>
<td>4.40</td>
<td>17</td>
</tr>
<tr>
<td></td>
<td>Flue-cured</td>
<td>Sri Lanka</td>
<td>520,890</td>
<td>6,443,032</td>
<td>12.37</td>
<td>28*</td>
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<tr>
<td></td>
<td></td>
<td>Egypt</td>
<td>469,923</td>
<td>787,198</td>
<td>1.68</td>
<td>25</td>
</tr>
<tr>
<td></td>
<td>Indonesia's Tax Rate 25%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>Total</strong></td>
<td></td>
<td><strong>1,783,316</strong></td>
<td><strong>17,988,546</strong></td>
<td><strong>10.43</strong></td>
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</tr>
<tr>
<td>Country</td>
<td>Export Volume (Kgs)</td>
<td>Export Value ($US)</td>
<td>Price/Kg</td>
<td>Tax Rate (%)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>------------------------------</td>
<td>---------------------</td>
<td>--------------------</td>
<td>----------</td>
<td>--------------</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>United States</strong></td>
<td>1,587,500</td>
<td>3,258,852</td>
<td>2.05</td>
<td>15 to 39*</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Nicaragua</td>
<td>8,734</td>
<td>214,016</td>
<td>24.50</td>
<td>30*</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Puerto Rico</td>
<td>180,000</td>
<td>935,708</td>
<td>5.20</td>
<td>39*</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dominican Republic</td>
<td>63,593</td>
<td>122,380</td>
<td>1.92</td>
<td>27</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Netherlands</td>
<td>543,318</td>
<td>2,645,046</td>
<td>4.87</td>
<td>25</td>
<td></td>
<td></td>
</tr>
<tr>
<td>France</td>
<td>72,000</td>
<td>720,000</td>
<td>10.00</td>
<td>33.33*</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Germany</td>
<td>54,772</td>
<td>411,367</td>
<td>7.51</td>
<td>15</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Belgium</td>
<td>1,169,322</td>
<td>3,811,684</td>
<td>3.26</td>
<td>33</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Denmark</td>
<td>59,400</td>
<td>261,360</td>
<td>4.40</td>
<td>23.5</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sweden</td>
<td>19,800</td>
<td>62,370</td>
<td>3.15</td>
<td>22*</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Italy</td>
<td>227,400</td>
<td>827,146</td>
<td>3.64</td>
<td>27.5</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Portugal</td>
<td>1,029</td>
<td>24,427</td>
<td>23.74</td>
<td>21</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Poland</td>
<td>18,000</td>
<td>25,478</td>
<td>1.42</td>
<td>19*</td>
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<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>5,229,211</td>
<td>21,683,345</td>
<td>4.15</td>
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<td></td>
</tr>
</tbody>
</table>

* Indicates potential transfer pricing usage for tax reduction.

**Table 12**
Export Volume and Value of Tobacco (HS: 2401209000) From Indonesia to Destination Country For 2015
<table>
<thead>
<tr>
<th>No</th>
<th>HS Code</th>
<th>Destination</th>
<th>Volume (Kgs)</th>
<th>Value ($ US)</th>
<th>Price/Kg</th>
<th>Tax Rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>12</td>
<td>HS: 2401301000</td>
<td>Korea</td>
<td>20,160</td>
<td>6,917</td>
<td>0.34</td>
<td>22*</td>
</tr>
<tr>
<td></td>
<td>Tobacco Stems</td>
<td>China</td>
<td>90,000</td>
<td>36,500</td>
<td>0.41</td>
<td>25</td>
</tr>
<tr>
<td></td>
<td>Philippines</td>
<td>12,870</td>
<td>17,503</td>
<td>1.36</td>
<td></td>
<td>30*</td>
</tr>
<tr>
<td></td>
<td>Malaysia</td>
<td>784,750</td>
<td>290,184</td>
<td>0.37</td>
<td></td>
<td>25</td>
</tr>
<tr>
<td></td>
<td>Cambodia</td>
<td>Indonesia's Tax Rate 25%</td>
<td>Sri Lanka</td>
<td>Turkey</td>
<td>Egypt</td>
<td>United States</td>
</tr>
<tr>
<td>----------------</td>
<td>----------</td>
<td>--------------------------</td>
<td>-----------</td>
<td>--------</td>
<td>-------</td>
<td>--------------</td>
</tr>
<tr>
<td></td>
<td>60,095</td>
<td>36,000</td>
<td>21,600</td>
<td>20,160</td>
<td>21,756</td>
<td>148,046</td>
</tr>
<tr>
<td></td>
<td>100,028</td>
<td>21,600</td>
<td>8,267</td>
<td>7,661</td>
<td>8,267</td>
<td>84,823</td>
</tr>
<tr>
<td></td>
<td>1.66</td>
<td>0.60</td>
<td>0.38</td>
<td>0.38</td>
<td>0.38</td>
<td>0.57</td>
</tr>
<tr>
<td></td>
<td>20</td>
<td>28*</td>
<td>28*</td>
<td>20*</td>
<td>25</td>
<td>15 to 39</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>* Indicates potential transfer pricing usage for tax reduction.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Table 14**

Export Volume and Value of Tobacco (HS: 2401309000) From Indonesia to Destination Country For 2015

<table>
<thead>
<tr>
<th>No</th>
<th>HS Code</th>
<th>Destination</th>
<th>Volume (Kgs)</th>
<th>Value ($ US)</th>
<th>Price/Kg</th>
<th>Tax Rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>13</td>
<td>HS: 2401309000</td>
<td>Taiwan</td>
<td>495,640</td>
<td>15,282</td>
<td>0.03</td>
<td>17*</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Other Tobacco</td>
<td>39,616</td>
<td>69,318</td>
<td>1.75</td>
<td>25</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Refuse</td>
<td>2</td>
<td>1</td>
<td>0.50</td>
<td>17*</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Singapore</td>
<td>6,300</td>
<td>15,120</td>
<td>2.40</td>
<td>30*</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Philippines</td>
<td>29,304</td>
<td>90,344</td>
<td>3.08</td>
<td>25</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Indonesia's Tax Rate 25%</td>
<td>Vietnam</td>
<td>120,792</td>
<td>289,903</td>
<td>2.40</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Egypt</td>
<td>58,550</td>
<td>63,540</td>
<td>1.09</td>
<td>25</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Botswana</td>
<td>44,000</td>
<td>40,150</td>
<td>0.91</td>
<td>22*</td>
</tr>
<tr>
<td></td>
<td></td>
<td>South Africa</td>
<td>22,000</td>
<td>23,100</td>
<td>1.05</td>
<td>28</td>
</tr>
<tr>
<td></td>
<td></td>
<td>United States</td>
<td>61,735</td>
<td>32,212</td>
<td>0.52</td>
<td>15 to 39*</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Dominican Republic</td>
<td>82,000</td>
<td>32,800</td>
<td>0.40</td>
<td>27</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Netherlands</td>
<td>19,800</td>
<td>82,080</td>
<td>4.15</td>
<td>25</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>-------</td>
<td>--------</td>
<td>--------</td>
<td>-------</td>
<td>-------</td>
<td></td>
<td></td>
</tr>
<tr>
<td>France</td>
<td>28,710</td>
<td>9,474</td>
<td>0.33</td>
<td>33.33</td>
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<td></td>
</tr>
<tr>
<td>Germany</td>
<td>23,330</td>
<td>50,825</td>
<td>2.18</td>
<td>15</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Belgium</td>
<td>288,076</td>
<td>775,638</td>
<td>2.69</td>
<td>33*</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Russia</td>
<td>17,820</td>
<td>49,361</td>
<td>2.77</td>
<td>20</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>1,337,675</strong></td>
<td><strong>1,639,148</strong></td>
<td><strong>1.23</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* Indicates transfer pricing usage for tax reduction.
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CHAPTER 33 The Value Chain: A Study of the Tobacco Industry

SUSANNA HARTANTO*

SYNOPSIS

33.01 Introduction § 33.02 Tobacco Supply Chain § 33.03 Transfer Pricing § 33.04 Identifying Transfer Pricing Indication in Tobacco Industry § 33.01 Introduction

This chapter presents a case study examining the aspects of transfer pricing in relation to the tobacco industry in Indonesia. The certain aspects include an identification of the supply chain of the tobacco industry, a value chain analysis of the industry, and the identification of transfer pricing indication. § 33.02 Tobacco Supply Chain

Supply chain is the set of activities required to transform a raw product into finished goods sold to consumers. There are six stages in tobacco global supply chain, including three distinct post-harvest for tobacco,

which often occur in different locations and under different institutional arrangements are: 1. Curing, which is almost done on-farm and involves drying green tobacco leaf, followed by two processing functions. 2. Stemming, stripping and blending tobacco. 3. Transforming raw tobacco into a finished product, such as cigarettes. A brief summary of the stages of production for tobacco below describes the activities involved, input-output structure, and lead actor for each stage of the chain (see Figure 1): Stage 1: Input—land, labor, and physical requirements for competitive production. Stage 2: Cultivation Stage 3: Curing Stage 4: Primary processing and trading—stemming and stripping of tobacco Stage 5: Secondary processing—manufacturing * Susanna Hartanto is a tobacco practitioner and lecturer at Widya Mandala Catholic University, Indonesia (email:susanahartanto@ukwms.ac.id or cvtasusan@yahoo.com). Stage 6: Marketing and distribution—final product to consumers Over time, the tobacco industry has grown extremely concentrated.

A small number of tobacco companies and leaf buyers have a high degree of market power over the supply chain (see Figure 2), while small farmers generally have very little bargaining power. Although tobacco is still produced in a variety of different arrangements, to ensure supply, "outgrower" or contract based production models have become the dominant way for leaf buyers to set up inter-firm relations. Under these models, the buyer may provide inputs and credit to the producer, either individually or through collective groups of 10 to 30 farmers, known as "tobacco clubs." In return, the tobacco producers agree to supply the specified amount of raw tobacco once it is cultivated and assume the risks incurred in cultivation.

"tobacco clubs." In return, the tobacco producers agree to supply the specified amount of raw tobacco once it is cultivated and assume the risks incurred in cultivation.

Tobacco is a highly labor-intensive agricultural commodity
compared to other crops because tobacco is technically challenging to mechanize. This makes tobacco farming an important source of employment. Activities associated with input are: a. Seed provision: Ensuring farmers have an adequate supply of seeds (tobacco companies, leaf merchants, large producers). b. Agrochemical production and blending: Supply of fertilizers, herbicides, and pesticides for use with tobacco crops (agrochemical supply companies). 1 Annelies, G., Penny, B., & Gary, G. The Tobacco Global Value Chain in Low-Income Countries. Duke University Center on Globalization, Governance and Competitiveness. Durham, NC. (2014). 2

Indonesia: Child Tobacco Workers Suffer as Firms Profit. (May 27, 2016).
Available at http://thefifthcolumnnews.com

1/2016/05/indonesia-child-tobacco-workers-suffer-as-firms-profit/ (accessed Aug 1, 2017). c. Banking and finance capital: Capital for tobacco producers to acquire seeds, agrochemicals, and other inputs (tobacco companies, leaf merchants, banks, and governments). d. Research and development: Develop new seed varieties (e.g., drought resistant, pest resistant), machinery and production processes (tobacco companies, public research organizations, and biotechnology firms).

Stage 2: Cultivation.

The cultivation process requires specific biophysical conditions, and the soil quality, climate, and access to irrigation systems affect both the yield and quality.

Activities associated with cultivation are: a. Agricultural extension: Weekly, biweekly, or monthly visits from agronomists to producers focused on education and training in the production of tobacco (tobacco companies, leaf merchants, industry associations, producer collectives, and governments). b. Spraying: Spraying of agrochemicals on tobacco crops during cultivation (producers, third-party firms for smallholder production). c. Hail insurance: Protects growers from unexpected events, such as hail and wind (insurance companies, tobacco companies, and leaf merchants). d. Farm equipment and infrastructure maintenance: Maintaining irrigation systems and other farm equipment used in the cultivation and reaping of tobacco (local technicians, mechanics, and producers). e. Market information provision: Provide infrastructure and venues for farmers to exchange and obtain market information (mobile telecommunication providers, traders, governments, industry associations, and producer collectives). Although maintenance and harvesting of the tobacco plants requires a very high investment of labor hours, producers tend to command a low share of the total value of the final product. Stage 3: Curing. After harvest, leaves are dried (cured) to stabilize, graded into homogenous lots and then aged or fermented. The curing process varies from flue cured and fire cured tobacco, which requires an energy source for heat (usually heat or coal), while air cured and sun cured varieties do not
require an energy source for heat. Activities associated with curing are: a. Transportation: Transport from fields to curing locations and warehouses (producers, affiliates of MNCs, and leaf merchants). b. Firewood or coal provision: Harvesting, mining, processing, and distribution of fuel for curing purposes (producers—firewood, or third-party suppliers). c. Equipment and infrastructure maintenance: Maintaining equipment and infrastructure used in the curing of tobacco such as flues, boilers, and sheds (construction firms, producers, or mechanics). d. Warehousing: Storage for cured, unprocessed tobacco (leaf merchants, producers, or agents). After curing, the tobacco

1is prepared into strips (for some varieties), sorted, and packaged into homogeneous bales for export and delivery to the manufacturers that transform them into cigarettes, cigars, etc. 3 Some of the tobacco refuse (the by-product from the stemming, curing, and stripping process) is also exported. Stage 4: Primary processing and trading —Stemming and stripping

of tobacco (Primary Processing). Stemming and stripping of tobacco leaves

1ensures that moisture content is controlled to prevent deterioration in storage. Unprocessed (but cured) tobacco is a semi-perishable commodity, thus primary processing must take place relatively quickly. Processing facilities are generally located in producing countries and carried out by leaf merchants and audited by buyers. In this stage, tobacco is reclassified according to grade and blended to meet client quality specifications. Then, tobacco is threshed to remove the stem from the lamina and sieved to remove waste. Then tobacco is re-dried to extend the storage shelf life, although almost tobacco is typically used within two or three years. Stored tobacco is packaged in bales, cases, and cartons for shipment. The leaf merchants typically hold the inventory until the buyers (tobacco MNCs) specify shipping dates.

Then tobacco is

1shipped to the manufacturing destination, where the final tobacco products are made. Primary processing stage is

highly consolidated with two global leaf merchant companies, Alliance One International and Universal Corporation, for large market share. 4 Activities associated with primary processing are: a. Auction: Services for linking farmers with leaf merchants and tobacco companies that are not using a direct, contract-based procurement system (parastatal institutions or private auction firms). b. Transportation: Transport to and from stemming and stripping locations, and warehouses to export destinations (leaf merchants, producers, agents, tobacco MNCs, and transportation firms). c. Warehousing: Storage for primary processed tobacco (leaf merchants, agents, producers, and tobacco MNCs). d. Import/export: Processing customs, duties,

Tobacco companies tend to manufacture internally.

In contrast to the production stage of the value chain, cigarettes manufacturing is highly automated, involving the rolling and cutting of rods into individual cigarettes, the insertion of filters, packaging into individual packs of 0–20 cigarettes, and into cartons of 10 packs each.

The largest firm in secondary processing are: a. Phillip Morris International (PMI) has 26.2 percent of market share with 48 plants in 32 countries. b. British American Tobacco (BAT) has 19.1 percent of market share with 44 plants in 42 countries. c. Japan Tobacco International (JTI) has 15.8 percent of market share with 25 plants worldwide. d. Imperial Tobacco has 8.9 percent of market share with 51 plants worldwide.

Activities associated with secondary processing are: a. Transportation: Transport from import locations to manufacturing facilities, and from manufacturing facilities to export destinations or retail outlets (logistics companies, tobacco MNCs, leaf merchants, and agents). b. Warehousing: Storage for finished tobacco products (tobacco MNCs). c. Paper provision: Rolling paper for cigarette manufacturing (tobacco MNCs and paper suppliers). d. Manufacturing equipment provision: Supply equipment for manufacturing of cigarettes and other tobacco products (equipment suppliers). e. Manufacturing equipment maintenance: Maintain cigarette manufacturing equipment and production lines (tobacco MNCs and mechanics). f. Financial consulting (for leaf merchants and global buyers): Strategic advice for maintaining and increasing shareholder value (management consulting firms and tobacco MNCs). g. Financial and banking (for leaf merchants and global buyers): Asset management, investment, and accounting for global tobacco companies and leaf merchants (hedge funds, investment banks, or tobacco MNCs). h. Legal: Legal advice pertaining to tobacco production and research and development (law firms and tobacco MNCs).

Stage 6: Marketing and distribution—Final product to consumers. The large transnational tobacco companies also coordinate the branding and marketing of final products.

Activities associated with marketing and distribution stage are: a. Transportation: Transport to distribution warehouses and retail outlets (logistics firms and tobacco MNCs). b. Advertising: Marketing and product promotion within the constraints of domestic tobacco marketing restrictions in particular countries (advertising agencies and tobacco MNCs). c. Logistics: Logistical management of product warehousing and distribution to retail outlets (logistics firms and tobacco MNCs).
Cigarette segment is divided into premium, economy and low-value brands, which offer different price-points based on consumer willingness to pay.

Leading international brands

and companies are shown in below Table 1:

<table>
<thead>
<tr>
<th>Top brands</th>
<th>Brand Company</th>
</tr>
</thead>
<tbody>
<tr>
<td>Marlboro</td>
<td>Philip Morris International Inc.</td>
</tr>
<tr>
<td>Winston</td>
<td>Japan Tobacco Inc.</td>
</tr>
<tr>
<td>Winston</td>
<td>Reynolds American Inc.</td>
</tr>
<tr>
<td>Japan Tobacco Inc.</td>
<td>Pall Mall</td>
</tr>
<tr>
<td>L&amp;M</td>
<td>Philip Morris International Inc.</td>
</tr>
<tr>
<td>Altria Group Inc.</td>
<td>Mevius</td>
</tr>
<tr>
<td>Japan Tobacco Inc.</td>
<td>Altria Group Inc.</td>
</tr>
</tbody>
</table>

Altria Group Inc. • Japan Tobacco Inc. • Reynolds American Inc. • Pall Mall • British American Tobacco Plc. • Reynolds American Inc. L&M • Philip Morris International Inc. • Altria Group Inc. • Mevius • Japan Tobacco Inc.

Camel • Japan Tobacco Inc. • Reynolds American Inc. Gudang Garam • Gudang Garam Tbk. PT. Kent • British American Tobacco Plc. Dunhill • British American Tobacco Plc. 6 Japan Tobacco, Inc. Annual Report. Tokyo, Japan (2016). Gold Flake • ITC Ltd. • British American Tobacco Plc. Overall,

Input-output structure of tobacco has multiple stages of production and processing, which typically occur in locations that are geographically dispersed. The reason for geographic separation of stages is variation in the production requirements of each stage: some involve highly labor- and land-intensive (cultivation), while others are capital-intensive, quality-sensitive, and mechanized (cigarette manufacturing).

Within this structure, small producers are situated in a low-value segment of the tobacco global value chain that is highly competitive, while MNCs typically operate in the highest value segments of chain (marketing and distribution). This structure also brings out transfer pricing issue among division or companies across countries (MNCs) in tobacco industry. § 33.03 Transfer Pricing Transfer pricing is the pricing of intercompany transactions that take place between affiliated businesses,

For example, trade between a parent company and its foreign subsidiary or between two foreign affiliates. Alternatively, transfer pricing is also the pricing of cross border intrafirm transaction between related parties. Transfer pricing has become increasingly high and accelerating rapidly worldwide for multinational corporations in the past decade. The transfer pricing process determines the amount of income that each party earns from that transaction. There are

8both internal and external motivation for MNCs to establish transfer prices for intrafirm trade.
Many foreign affiliates are run as profit centers. As a result, the rewards of the top management team in these affiliates depend on their affiliate’s profits. The setting of transfer pricing can be internally driven as a way to both motivate managers and monitor subsidiary performance. Externally, MNCs have to pay corporate income taxes on their domestic and foreign source income, necessitating that they set transfer prices for cross border trade flows. Customs authorities also require transfer prices for intrafirm imports of parts, components, and finished goods, either for custom duties or rules of origin purposes.

Taxpayers and the taxing authorities focus exclusively on related-party transactions, or controlled transactions, and have no direct impact on independent-party transactions, or uncontrolled transactions. In this context, transactions are determined broadly and include sales, licensing, leasing, services, interest, etc. Transfer pricing manipulation, as distinct from transfer pricing, is the over or under-invoicing of related party transactions in order to avoid government regulations (e.g: under-invoicing to avoid paying ad valorem tariff) or to exploit cross border differences in tax rates (e.g: shifting deductible expenses to the high tax location and revenues to the low tax location in order to reduce overall corporate tax payments). It is not transfer pricing that is the problem. The potential for transfer pricing manipulation is what governments fear and want to prevent through regulation.

Transfer pricing risk for government that might be difficult to detect and understand the whole range and possible consequences is Base Erosion and Profit Shifting (BEPS). § 33.04 Identifying Transfer Pricing Indication in Tobacco Industry

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 transfer pricing 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.

What a multinational group considers

**2 legitimate forms of price setting may** sceptically be viewed by a revenue authority as **illegitimate profit manipulation.**

A transfer of profit may be inferred where, for example, transactions occur at prices higher or lower than prevailing market. Mechanisms to reduce taxes through transfer pricing include: 1. Setting the selling price lower, usually employed when affiliated companies are buyers located in a higher tax rate country than the seller’s (e.g. Indonesia) tax rate. By example, Company X in Indonesia intended to make sale price lower when selling to B Pte Ltd in a foreign country (e.g. Singapore. Tax rate in Indonesia is 25 percent and in Singapore 17 percent. Indonesia will realize less revenues and Singapore more. Thus, there will be profit shifting from Indonesia to Singapore. 2. Making buying price higher, usually employed when affiliated companies as sellers are located in lower tax rate than Indonesia’s tax rate. E.g. Company X in Indonesia buys from Y Ltd in Hong Kong. The tax rate in Indonesia is 25 percent and in Hong Kong is 17 percent. Therefore, a higher cost is borne by the Indonesia buyer, and higher revenues shifted to Hong Kong. A transfer pricing advisor will be able to find the worldwide finished cigarettes market prices for comparability. But there is not such comparability data for the worldwide tobacco- before secondary processing-market prices. Tobacco before secondary processing means tobacco after primary processing and before processing into finished goods-cigarettes. This function area of the supply chain has unique characteristics because tobacco before secondary processing is very specific and depends on the type and source countries or origin of the tobaccos. Therefore, prices will vary from one type to another and from one country to another. Indonesian tobaccos are different from other countries tobaccos in qualities, appearances, and tastes. It is not accurate to discern a comparable arm’s length price for an Indonesian tobacco product from the products of other countries. The best comparability derives from the same origin country and type of tobaccos. In tobacco export-import, tobaccos are classified according to a Harmonized System Code. The Harmonized System

9(HS) or Harmonized Commodity Description and Coding System is

a multipurpose international product nomenclature or

9 an internationally standardized system of names and numbers to classify traded products developed by the World Customs Organization (WCO). Indonesian tobaccos before secondary processing are exported to various countries like Singapore, United States, and European Countries classified according to an HS Code. Indication of transfer pricing usage to reduce taxes in the Indonesian tobacco industry can be seen from the selling price that is used in export. In Table 2,7 the average selling price for 7 Indonesian Directorate General of Estate Crops, Ministry of Agriculture. Tree Crop Estate Statistics of Indonesia. Jakarta, Indonesia (with column modification) (2016). Indonesian Flue Cured Virginia Tobacco-not stemmed or stripped is $4.8 per kg. The selling price of export to a destination such as Singapore or Germany, where the tax rate in those destinations is lower than the tax
rate in Indonesia, is lower than $4.8. This may indicate transfer pricing usage to reduce tax and profit shifting from Indonesia to Singapore and Germany. Another export destination is Sri Lanka, as shown in Table 2, wherein the tax rate is 28 percent and the selling price is $19 per kg, higher than the tax rate and the $4.8 per kg price in Indonesia. This higher price creates profit shifting from Sri Lanka to Indonesia. The overall tax for an MNC may potentially be lower with such a transfer price setting. Table 2 Export Volume and Value of Tobacco (HS: 2401101000) From Indonesia to Destination Country For 2015 Export No HS Code Destination Volume (Kgs) Value ($ US) Price/Kg Tax Rate (%) 1 HS: 2401101000 Singapore 150,480 711,770 4.73 17 Virginia Tobacco Malaysia 40,000 158,620 3.97 25 Not stemmed/stripped Sri Lanka 9,895 188,036 19.00 28 Flue-cured Indonesia's Tax Rate 25% Germany Belgium 18,000 56,430 26,280 234,185 1.46 4.15 15 33 Total 274,805 1,318,891 4.80 Table 3 for Indonesian Non Flue Cured Virginia Tobacco-not stemmed or stripped shows no export transaction for this type of tobacco during 2015, while in Table 4, Burley tobacco is only exported to Belgium. No comparable data to identify transfer pricing usage to reduce taxes for both type of tobaccos. Table 3 and Table 4 are reproduced below, noting that Table 3 is empty of any (comparable) data because of the lack of transactions. Table 3 Export Volume and Value of Tobacco (HS: 2401101000) From Indonesia to Destination Country For 2015 Export No HS Code Value ($ US) Price/Kg Tax Rate (%) 2 HS: 2401101000 - - - - Vietnam Tobacco Not stemmed/stripped Not Flue-cured Total - - - - Table 4 Export Volume and Value of Tobacco HS: (2401104000) From Indonesia to Destination Country For 2015 Export No HS Code Value ($ US) Price/Kg Tax Rate (%) 3 HS: 2401104000 Singapore 65,934 3.70 33 Burley Tobacco Not stemmed/stripped Total 17,820 65,934 3.70 In Table 5, Flue cured Oth tobacco, not stemmed or stripped, averages a selling price of $3.85 per kg for this type of tobacco. Some destinations with export selling prices lower than $3.85 have a lower tax rate than in Indonesia, such as Singapore, United States, and Russia. This indicates transfer pricing usage to reduce tax and profit shifting from Indonesia to those countries. Another export destination like Sri Lanka and Belgium, as in Table 5, the tax rate in Sri Lanka is 28 percent and Belgium is 33 percent, while the selling price is $19.75 per kg to Sri Lanka and $4.37 to Belgium, which is much higher than $3.85. This higher price setting will make profit shifting from Sri Lanka and Belgium to Indonesia. Again, overall taxes for MNCs will be much lower with the transfer price setting by shifting profit from higher tax rates countries to lower tax rates countries. Transfer pricing usage for tax reduction may be indicated for other types of Indonesian tobaccos (see the appendix to this chapter). Table 5 Export Volume and Value of Tobacco (HS: 2401105000) From Indonesia to Destination Country For 2015 Export No HS Code Value ($ US) Price/Kg Tax Rate (%) 4 HS: 2401105000 Singapore 80,800 22,000 2.50 30 Not stemmed/stripped Sri Lanka 129,064 2,549,242 19.75 25 Flue-cured Egypt United States 691,078 298,612 1,125,260 826,784 1.63 2.77 25 15 39 Indonesia's Tax Rate 25% Germany Belgium 19,200 288,170 74,880 1,259,694 3.90 4.37 15 33 Slovakia 5,400 70,001 12.97 22 Russia 100,000 115,000 1.15 20 Total 1,592,854 6,126,420 3.85 APPENDIX Table 6 Export Volume and Value of Tobacco (HS: 2401109000) From Indonesia to Destination Country For 2015 Export No HS Code Destination Volume (Kgs) Value ($ US) Price/Kg Tax Rate (%) 5 HS: 2401109000 Japan 408 8,127 19.92 25.5* Oth Tobacco China 57,119 850,294 14.89 25 Not stemmed/stripped Philippines 5,900 81,150 13.75 30* Not Flue-cured Malaysia 318,780 2,029,757 6.37 25 Indonesia's Tax Rate = 25% Bangladesh Sri Lanka 36,000 911,036 126,000 21,641,230 3.50 23.75 25 28* Egypt 46,000 97,520 2.12 25 Tunisia 78,400 99,816 1.27 25 South Africa 44,000 46,200 1.05 28 Australia 48,000 5,600 0.95 30 United States 2,318,941 4,107,270 1.77 15 to 39* Honduras 56,182 1,432,474 25.50 25 Nicaragua 118,502 1,278,853 10.79 30* Puerto Rico 330,291 1,215,017 3.68 39 25 28* Dominican Republic 671,310 7,277,266 10.84 27* United Kingdom 39,600 166,320 4.20 21* Netherlands 748,791 5,116,297 6.83 25 France 18,000 53,100 2.95 33.33 Germany 224,310 1,808,345 8.06 15 Belgium 304,022 1,303,210 4.29 33 Sweden 29,400 67,620 2.30 22* Italy 23,400 25,446 1.09 27.5 Spain 24,606 158,500 6.44 28 Bulgaria 45,600 75,304 1.65 10* Malta 6,000 10,800 1.80 35 Czech Republic 500 4,000 8.00 19 Total 6,505,098 49,125,516 7.55 * Indicates potential transfer pricing usage for tax reduction. Table 7 Export Volume and Value of Tobacco (HS: 2401201000) From Indonesia to Destination Country For 2015 Export Tax No HS
<table>
<thead>
<tr>
<th>Code</th>
<th>Destination</th>
<th>Volume Value</th>
<th>Price/Kg Rate</th>
<th>Tax Rate</th>
</tr>
</thead>
</table>

### Table 8 Export Volume and Value of Tobacco (HS: 2401202000) From Indonesia to Destination Country For 2015 No HS Code Destination Volume Value Price/Kg Rate (%) 6 HS: 2401200000 Pakistan 560 9,038 16.14 33 Oriental Tobacco Partly or wholly stemmed/stripped Not Flue-cured Indonesia's Tax Rate 25% Total 560 9,038 16.14 Table 10 Export Volume and Value of Tobacco (HS: 2401204000) From Indonesia to Destination Country For 2015 No HS Code Destination Volume Value Price/Kg Rate (%) 6 HS: 2401200000 Pakistan 560 9,038 16.14 33 Oriental Tobacco Partly or wholly stemmed/stripped Not Flue-cured Indonesia's Tax Rate 25% Total 560 9,038 16.14 Table 12 Export Volume and Value of Tobacco (HS: 2401209000) From Indonesia to Destination Country For 2015 No HS Code Destination Volume Value Price/Kg Rate (%) 6 HS: 2401200000 Pakistan 560 9,038 16.14 33 Oriental Tobacco Partly or wholly stemmed/stripped Not Flue-cured Indonesia's Tax Rate 25% Total 560 9,038 16.14 Table 13 Export Volume and Value of Tobacco (HS: 2401301000) From Indonesia to Destination Country For 2015 No HS Code Destination Volume Value Price/Kg Rate (%) 6 HS: 2401300000 Korea 20,160 6,917 0.34 22% Tobacco Stems China Philippines 90,000 12,870 36,500 17,503 0.41 1.36 25 30% Malaysia 784,750 290,184 0.37 25 Cambodia 60,095 100,028 1.66 20 Indonesia's Tax Rate 25% Sri Lanka 36,000 21,600 0.60 28% Turkey 20,160 7,661 0.38 20% Egypt 21,756 8,267 0.38 25 United States Puerto Rico 148,046

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338,511 84,823 142,484 0.57 0.42 15 to 39 39 Netherlands 103,200 36,732 0.36 25 France 141,120 33.33
Belgium 38,160 14,954 0.39 33 Romania 31,080 11,347 0.37 16* Total 1,845,908 830,206 0.45 * Indicates
potential transfer pricing usage for tax reduction.

Table 14 Export Volume and Value of Tobacco (HS:
2401309000) From Indonesia to Destination Country
For 2015 Export No HS Code Destination Volume
Value ($ Tax Rate (Kgs) US) Price/Kg (%) 13 HS:
2401309000 Taiwan 495,640 15,282 Other Tobacco
Refuse China 39,616 69,318 0.03 17* 1.75 25 Singapore 2 1 0.50 17* Philippines 6,300 15,120 2.40 30*
Malaysia 29,304 90,344 3.08 25 Indonesia's Tax Rate 25% Vietnam 120,792 289,903 2.40 22 Egypt 58,550
63,540 1.09 25 Botswana 44,000 40,150 0.91 22* South Africa 22,000 23,100 1.05 28 United States 61,735
32,212 0.52 15 to 39* Dominican Republic Netherlands 82,000 19,800 32,800 82.080 0.40 4.15 27 25
France 28,710 9,474 0.33 33.33 Germany 23,330 50,825 2.18 15 Belgium 288,076 775,638 2.69 33* Russia
17,820 49,361 2.77 20 Total 1,337,675 1,639,148 1.23 * Indicates transfer pricing usage for tax reduction.
19,800 41,580 2.10 18,000 25,478 1.42 152,393 1,045,293 6.86 51,206 0.36