TRANSFER PRICING CASE STUDIES WORKSHOP

MALAYSIA

2-6 December 2013

3. Chapters I-III of the Transfer Pricing Guidelines

OECD
BETTER POLICIES FOR BETTER LIVES

Comparability and Profit Methods

- **2010 Update to TPG. New guidance on:**
  - the selection of the “most appropriate transfer pricing method to the circumstances of the case”
  - comparability analysis
  - how to apply transactional profit methods (TNMM and profit split) in practice

Selection of the "Most Appropriate Method" to the Circumstances of the Case"

Which Method to Select?

- The "*most appropriate method to the circumstances of the case*"

- Selection criteria, in particular:
  - Respective strengths and weaknesses of each method;
  - Nature of the controlled transaction (determined in particular by functional analysis);
  - Availability and reliability of information (in particular on uncontrolled comparables);

- Preference for traditional methods if equally reliable

OECD Transfer Pricing Methods: Strengths and Weaknesses of Each Method

Comparable Uncontrolled Price Method (CUP)

Strengths	Weaknesses	Best applied
• Most direct and reliable way to apply the arm's length principle	• Very high degree of comparability required • In practice, often difficult to find uncontrolled transactions similar enough such that no differences have a material effect on the price	• Where the same product is bought/sold under comparable circumstances from/to the associated enterprise & independent enterprise(s) (*internal comparable)* • Where an independent enterprise buys/sells the same product as the associated enterprise in comparable circumstances (*external comparable*) • For some commodities and some financial transactions

Strengths and Weaknesses

Cost Plus Method

Strengths	Weaknesses	Best applied to
• Since there is a greater focus on functions performed, less product comparability required compared with CUP method, *i.e.* product differences are less likely to have material effect on cost plus margin than on price.	• Not always discernible link between costs incurred and arm's length prices / profit margins • In practice, often difficult to determine appropriate cost base (*i.e.* cost base must be comparable) • Accounting consistency important for comparability purposes	• Service Providers • Contract manufacturer, in particular of semi-finished goods • Contract R&D

Strengths and Weaknesses

Resale Price Method

Strengths	Weaknesses	Best applied to
• Since there is a greater focus on functions performed, less product comparability required compared with CUP method, *i.e.* product differences are somewhat less likely to have material effect on resale price margin than on price.	• Gross profit margins are affected by management efficiency, etc which may have an impact on profitability but not on the price of the goods or services. • Accounting consistency important for comparability purposes. • Resale price method difficult to use when the reseller adds substantial value, eg by further processing goods before resale or contributing to the creation or maintenance of intangibles associated with the product (*e.g.* trademarks, trade names).	• Marketing operations (not adding significant value)

Strengths and Weaknesses

TNMM

Strengths	Weaknesses	Best applied
• Net profit indicators (*e.g.* return on assets, operating profit to sales, etc.) are less affected by transactional differences than price. • Net profit indicators may be more tolerant to some functional differences than gross profit margins. • Net profit indicators avoid problem of lack of clarity in public data as regards the classification of expenses above or below the gross profit line.	• Net profit indicator can be influenced by factors that may not have a significant effect on price or gross margins, making accurate and reliable determinations of arm's length net profit indicators difficult. • Taxpayers may not have access to enough timely, specific information on the net profits attributable to comparable uncontrolled transactions.	**Cost Plus Analogue:** •(Contract) Manufacturer •Service Provider not adding significant unique intangibles **Resale Price Analogue:** •Distributor not adding significant value to the product **Asset Based TNMM:** •Manufacturer if reasonably reliable comparables for Cost Plus or cost based TNNM unavailable

Strengths and Weaknesses

Profit Split (1)

Strengths	Weaknesses	Best applied to
• Offers flexibility by taking into account specific, possibly unique, facts and circumstances of the associated enterprises that are not present in independent enterprises. • Tends to rely less on information about independent enterprises	• Often difficult to have access to information from foreign affiliates, especially where the foreign affiliate is the parent company or a sister company rather than a subsidiary of the taxpayer • Difficult to measure combined profits for all the associated enterprises participating in the controlled transactions, which would require stating books and records on a common basis and making adjustments in accounting practices and currencies.	•Transactions where both parties make unique and valuable contributions (*e.g.* intangibles) to the transaction

Strengths and Weaknesses

Profit Split (2)

Strengths	Weaknesses	Best applied to
• Less likely that either party to the controlled transaction is left with an extreme and improbable profit result, since both parties to the transaction are evaluated. • Two-sided approach may also be used to achieve a division of the profits from economies of scale or other joint efficiencies that satisfies both the taxpayer and tax administrations.	• When applied to operating profit, it may be difficult to identify the appropriate operating expenses associated with the transactions and to allocate costs between the transactions and the associated enterprises' other activities.	•Highly integrated transactions, *e.g.* global trading of financial instruments

Selection of the "Most Appropriate Method" to the Circumstances of the Case"

- Profit split for cases where both parties to the controlled transaction make significant, unique contributions (*e.g.* intangibles); highly integrated activities

- Difficulties in finding or adjusting comparables not sufficient to select the profit split method if this method is not appropriate given the functional analysis of the transaction

Transfer Pricing Methods

- Traditional transaction methods (CUP, Cost Plus, Resale Price)
  - Largely unchanged in 2010 update
- Transactional Profit Methods (TNMM and Profit Split):
  - Further guidance on practical application
  - TNMM: selection and determination of the net profit indicator
  - Berry ratios
  - Profit Split: determination of profit to be split and of splitting factors

New Guidance on the Use of Profit Split

- How to split the combined profits in a profit split method?
- How do (or how would) independent parties split profits?
- The allocation key must reflect the parties' contributions to the creation of value in the particular case
- No prescribed allocations keys that would not account for the facts and circumstances of the case
- Preference for "objective" allocation keys, e.g. based on costs, assets or other relevant contributions of the parties to the transaction

Comparability Analysis

- *Objective*: find the most reliable comparables
- No requirement for an exhaustive search of all possible sources of comparables
- Acknowledge limitations in availability of information and compliance costs
- "***Reasonably reliable comparables***": defined as the most reliable comparables in the circumstances of the case, keeping in mind the above limitations
- Typical 9-step process to perform a comparability analysis

Typical 9-step process

1. Determination of years to be covered

2. Broad-based analysis of the taxpayer's circumstances

3. Understanding the controlled transaction(s), based in particular on a functional analysis, in order to :

   – Choose the tested party (where needed),

   – Choose the most appropriate transfer pricing method to the circumstances of the case,

   – Choose the financial indicator that will be tested (in the case of a transactional profit method),

   – Identify the significant comparability factors that should be taken into account

4. Review of existing internal comparables, if any

5. Determination of available sources of information on external comparables where such external comparables are needed and the sources' reliability

Typical 9-step process

6. Selection of the most appropriate transfer pricing method and, depending on the method, determination of the relevant financial indicator

7. Identification of potential comparables: determining the key characteristics to be met by any uncontrolled transaction in order to be regarded as potentially comparable, based on the relevant factors identified in Step 3 and in accordance with the comparability factors

8. Determination of and making comparability adjustments where appropriate

9. Interpretation and use of data collected, determination of the arm's length remuneration

Note: The process may not be linear – you may have to go back and repeat earlier steps

Comparability Analysis

- Choice of the tested party
- Use of databases
- Internal/external comparables
- Secret comparables
- Foreign comparables
- Loss-making comparables
- Difficulties in finding comparables
- Comparability adjustments

Choice of the tested party

- The choice of the tested party should be consistent with the functional analysis of the transaction;

- The party to which a transfer pricing method can be applied in the most reliable manner and for which the most reliable comparables can be found,
  - Often the one that has the less complex functions

Use of databases

- **Comparability analysis should encourage quality over quantity (standard processes). In particular:**
  - The use of commercial databases may give rise to concerns about the reliability of the analysis compared to other sources of information, such as internal comparables
  - Use of commercial databases should not encourage quantity over quality.

Internal and external comparables

- Internal comparables can:
  - be easier to find and more reliable;
  - be more complete and less costly to document

- This is not always the case
  - there is **no hierarchy** between internal and external comparables

- But where internal comparables are reasonably reliable
  - no need to make a database search

Secret comparables

- Use of secret comparables discouraged
- Exception: in Mutual Agreement Procedures to eliminate double taxation

Foreign comparables

- Foreign comparables should not be automatically rejected

- Examine whether non-domestic comparables are reasonably reliable on a case-by-case basis:
  - Five comparability factors
  - Careful consideration of market differences and accounting standards, and of whether reasonably reliable comparability adjustments can be made where needed

Loss-making comparables

- Not systematically rejected; no systematic use of inter-quartile range in the OECD TP Guidelines
- But are they truly comparable to the tested party? (risk profile in particular)
- Independent enterprises would not continue loss-making activities unless they have a reasonable expectation of future profits
  - Where an associated enterprise is in losses over several years: is it providing a service to the group by maintaining a commercial presence?

Limitations in available comparables

- ❑ Assess the relative importance of missing information before rejecting a potential “comparable”
- ❑ A pragmatic solution may need to be found on a case-by-case basis

Lack of Comparables

- Lack of comparables does not necessarily mean that the taxpayer's controlled transaction is not arm's length

- Lacking evidence of what independent parties *have done* in comparable circumstances...

- ... need to determine whether the conditions of the taxpayer's controlled transaction are comparable to what independent parties *would have* agreed

Lack of Comparables

1. Due to uniqueness of the controlled transaction?
   - 1: If due to valuable, unique intangibles contributed by both parties, profit split may be appropriate
2. Due to lack of comparable independent enterprises (vertically integrated industry; small market)?
3. Due to limitation on publicly available information on potential comparables?
   - 2 and 3: Is the risk of error greater with a one-sided method applied with “imperfect comparables” or with a profit split applied with no comparables?

Questions and/or Comments?

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