BEPS TRANSFER PRICING WORKSHOP

TRANSFER PRICING DOCUMENTATION – RISK ASSESSMENT AND SAFE HARBOURS

JEJU ISLAND - KOREA

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2 & 3. Review of the Arm's Length Principle, Comparability and Transfer Pricing Methods

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ARM'S LENGTH PRINCIPLE

Arm's length principle

- Definition in para. **1.6 of the OECD TPG**
- Article 9(1) OECD Model Tax Convention:

  "(....) where conditions made or imposed between associated enterprises in their commercial or financial relations differ from those which would have been made between independent enterprises, then profits that, but for those conditions, would have accrued to one of the enterprises may be included in the profits of that enterprise and taxed".

Arm's length principle

- Treats associated enterprises as **separate entities** and not as simply parts of a unified whole
- Goal of the approach: associated and independent enterprises are treated the same
- Application on a **transaction-by-transaction** basis to achieve closest approximation to open market and economic reality
- Removes tax distortions and encourages international trade and investment.

COMPARABILITY

Comparability

- Comparability is the basis of the arm's length principle and cornerstone of TP analysis
- Search for "reasonably reliable comparables":
  - Compare conditions in controlled and uncontrolled transactions: see internal and external comparables
  - Ideally will be truly comparable or identical
  - More often there are differences
- If differences are material then not comparable, but small differences can be adjusted for to make comparable (on condition they can be expected to increase the reliability of the results)
- Case-by-case approach

Factors Determining Comparability

1. Characteristics of property or services
   - for instance trade marked product versus a non-trade marked product
2. Functional analysis
   - Functions performed, risks assumed, assets used
3. Contractual terms
   - How are risks, benefits and responsibilities divided?
   - Analyse terms whether written or oral, explicit or implied
   - When true terms differ from written terms then further investigation

Factors Determining Comparability

4. Economic circumstances
   – Geographic, size market, competition, substitutes
5. Business strategies
   – e.g. market penetration, innovation, diversification/ specialization

Functional Analysis

- Identify and compare the economically significant functions and who performs them
- Look at assets used and risks assumed
  - Risks are affected by the functions performed e.g. whether distributor acts on its own account or merely as agent
  - Check if assumption of risk accords with economic substance and ability to control & manage the risk in practice
- Value functions according to economic importance (taking into account assets used and risks assumed)
- Check assumption of risk accords with economic substance and ability to control and manage the risk in practice

Other Factors to Consider

- Recognition of actual transactions
- Losses
  - Do not necessarily indicate transfer pricing abuse
- Effect of government policies
  - How would independent companies deal with it
- Use of customs valuations
  - Use them with care

TRANSFER PRICING METHODS

Transfer Pricing Methods

- Traditional transaction methods:
  - Comparable Uncontrolled Price (CUP)
  - Cost plus method
  - Resale price method

Gross profit level indicator

- Transactional profit methods:
  - Transactional Net Margin Method (TNMM)
  - Profit Split method

Net profit level indicator

- The selected method should be the "most appropriate method to the circumstances of the case"

Transfer Pricing Methodology Matrix

TP Method	Main Focus	Benchmark
Comparable Uncontrolled Price (CUP)	Product	Price
Resale Price (RP)	Function	Gross Profit Margin
Cost Plus (C+)	Function	Gross Profit Mark-Up
Transactional Net Margin (TNMM)	Function	Net Profit Margin/Mark-UP
Profit Split (PS)	Function (Contribution)	Gross/Net Profit

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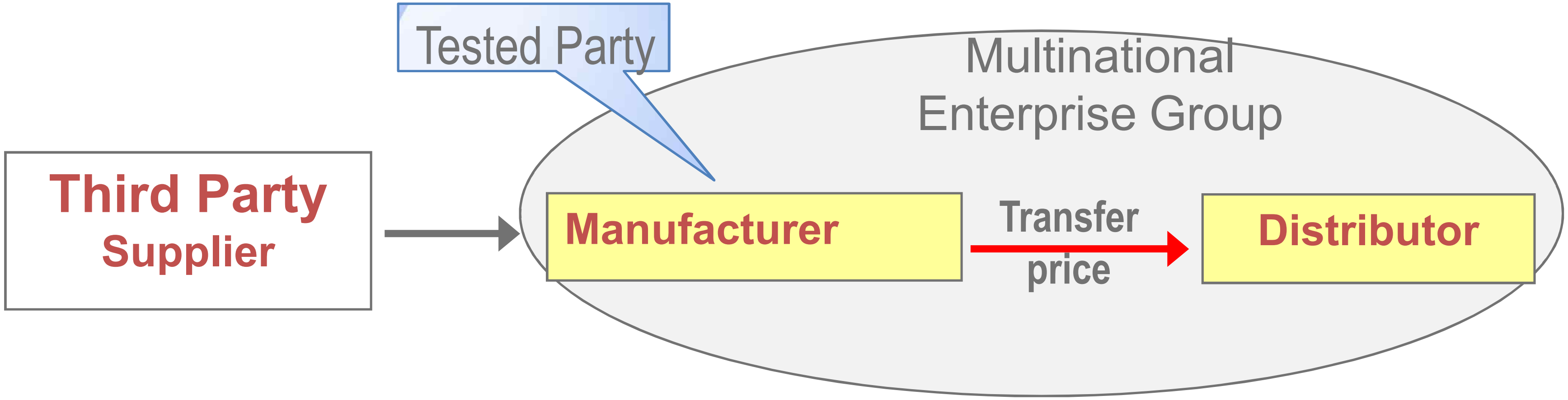
Cup Method

- The “most direct and reliable way to apply the arm’s length principle” (OECD TPG, para. 2.14)
- Preferred method if comparable uncontrolled prices can be found
- Focus on product (therefore requires strict comparability in products)
- Direct comparison with an uncontrolled transaction performed in comparable circumstances
- If no exact comparables → comparability adjustments for the differences

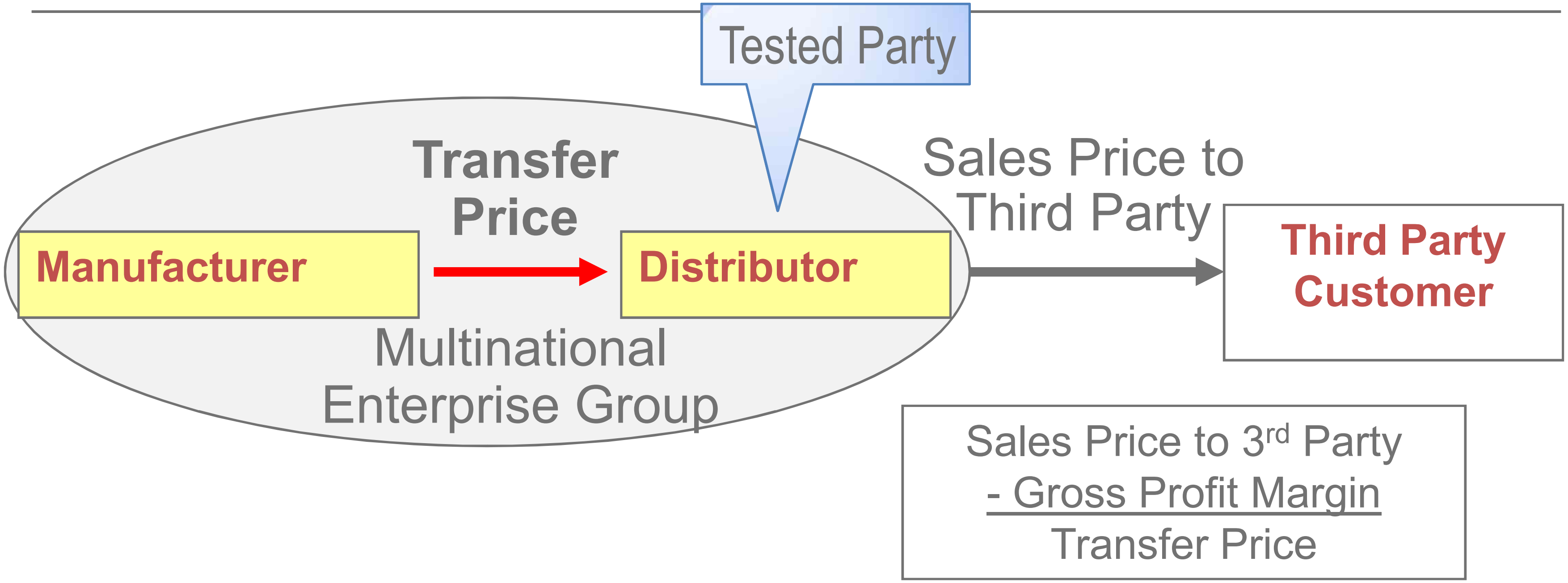
Cost Plus Method



Costs at arm's length + Gross profit mark-up = **Transfer Price**

- Looks at gross profit relative to costs of goods sold
- Calculate gross profit mark-up for manufacturer
- Easiest to apply for manufacturer of semi-finished goods and service providers.

Resale Price Method



- Looks at gross profit relative to sales
- Calculate gross margin for distributor/reseller
- Easiest to apply if reseller does not add substantially to value of product

TNMM Method

- Examines the **net profit margin** relative to an appropriate base that a taxpayer realizes from a controlled transaction, e.g.
  - Sales
  - Costs
  - Assets
  - Berry ratio (gross profit over operating expenses)
  - Other PLI (e.g. # of employees, time, floor area, …)
- Net margin computed **after all operating expenses** (except extraordinary items, interest and taxes)
- The TNMM must be applied in a manner consistent with resale price/cost plus method

Profit Split Method

- Two-sided approach
- When to apply?
  - ✓ The controlled transactions are **highly integrated**, i.e. they cannot be evaluated on a separate basis, and/or a one-sided method would not be appropriate
  - ✓ **Both parties** make **unique and valuable contributions** and
  - ✓ Reliable comparables for other methods unavailable
- 2 types of profit split method:
  - <u>Contribution analysis</u>: compute combined net profit + assign a profit split percentage
  - <u>Residual analysis</u>: compute combined net profit of associated enterprises + use other methods to assign basic return to each (routine) function of each company and divide residual profit according to a contribution analysis

Criteria to Select the Method

Most appropriate method determined in view of:

– Respective **strengths and weaknesses** of each transfer pricing method

– Nature and **functional analysis** of the controlled transaction

– Availability of reasonable reliable information

– Degree of comparability with uncontrolled transaction

Criteria to Select the Method

- Within OECD methods and if applicable in an equally reliable manner:
  - **CUP preferred over any other method**
  - traditional transaction methods are preferable over transactional profit methods.
- Non-OECD based methods can be used when OECD recognised methods are not appropriate to the facts and circumstances of the case.

OECD Transfer Pricing Methods: Strengths and Weaknesses of Each Method

Comparable Uncontrolled Price Method (CUP)

Strengths	Weaknesses	Best applied to
• Most direct and reliable way to apply the arm's length principle	• High degree of product comparability required • In practice, often difficult to find uncontrolled transactions similar enough that no differences have material effect on the price	• Transactions where the same product is sold to the associated enterprise and independent enterprise(s) (internal comparable) • Transactions where an independent enterprise sells the same product as the associated enterprises (external comparable) • In particular commodities and interest rates

OECD Transfer Pricing Methods:
Strengths and Weaknesses of Each Method

Cost Plus Method

Strengths	Weaknesses	Best applied to
• Product differences are less significant, *i.e.* are less likely to have material effect on profit margins than on price. • Less product comparability required compared with CUP method. • Fewer comparability adjustments needed compared to the CUP method to account for product differences, because focus is on functions performed.	• In practice, often difficult to determine appropriate cost basis • Costs incurred may not always be determinant of profit level • Not always discernible link between level of costs incurred and a market price • Accounting consistency important for comparability purposes	• (Contract) Manufacturer, in particular of semi-finished goods • (Contract) R&D • Service Provider

OECD Transfer Pricing Methods:
Strengths and Weaknesses of Each Method

Resale Price Method

Strengths	Weaknesses	Best applied to
• Product differences are less significant, *i.e.* are less likely to have material effect on profit margins than on price. • Fewer comparability adjustments needed compared to the CUP method to account for product differences, because focus is on functions performed.	• Gross profit margins may be 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 (i) goods are further processed before resale, or (ii) reseller contributes substantially to creation or maintenance of intangible associated with the product (*e.g.* trademarks, tradenames).	• Marketing operations (distributor not adding significant value to the product)

OECD Transfer Pricing Methods:
Strengths and Weaknesses of Each Method

TNMM

Strengths	Weaknesses	Best applied to
• Net profit indicators (*e.g.* return on assets, operating profit to sales, etc.) are less affected by transactional differences than price. • Net profit indicators are more tolerant to some functional differences between controlled and uncontrolled transactions. • In some countries net profit indicators avoid the problem of lack of clarity in public data as regards the classification of expenses in the gross or operating profits.	• Net profit indicator can be influenced by factors that would 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 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

OECD Transfer Pricing Methods:
Strengths and Weaknesses of Each Method

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 revenue and costs 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.	**Residual Profit Split (Residual Analysis):** •Highly integrated transactions, *e.g.* global trading of financial instruments •Transactions where both parties make unique and valuable contributions (*e.g.* intangibles) to the transaction

OECD Transfer Pricing Methods:
Strengths and Weaknesses of Each Method

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.	**Residual Profit Split (Residual Analysis):** •Highly integrated transactions, *e.g.* global trading of financial instruments •Transactions where both parties make unique and valuable contributions (*e.g.* intangibles) to the transaction

Selection of the most appropriate TP method to the circumstances of the case:		
If CUP and another method can be applied in an equally reliable manner	⇒CUP	
If not:		
Where one party to the transaction performs benchmarkable functions (e.g. manufacturing, distribution, services) with no valuable, unique intangible asset / risk	⇒One sided method ⇒Choice of the tested party (seller / purchaser)	
The tested party is the seller (e.g. contract manufacturing or provision of services)	⇒Cost plus ⇒Cost based TNMM ⇒Asset based TNMM	⇒ If Cost plus and TNMM can be applied in an equally reliable manner: Cost plus
The tested party is the buyer (e.g. marketing / distribution)	⇒Resale price ⇒Sales based TNMM	⇒ If Resale price and TNMM can be applied in an equally reliable manner: Resale price
Where each of the parties to the transaction contribute valuable unique intangibles / risks	⇒ Two-sided method ⇒Profit split	

PERFORMING 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) under examination, based in particular on a functional analysis, in order to choose the tested party (where needed), the most appropriate transfer pricing method to the circumstances of the case, the financial indicator that will be tested (in the case of a transactional profit method), and to identify the significant comparability factors that should be taken into account

Typical 9-step Process

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
6. Selection of the **most appropriate transfer pricing method** and, depending on the method, determination of the relevant financial indicator (e.g. determination of the relevant net profit indicator in case of a transactional net margin method)

Typical 9-step Process

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**

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Some Issues in Performing a Comparability Analysis

- Choice of the tested party
- Separate or combined transactions
- Internal <> external comparables
- Selecting potential comparables and sources of information
  - Non domestic comparables
  - Secret comparables
- Comparability adjustments
- Arm's length Range

Timing Issues in a Comparability Analysis

- Timing of origin and of collection
- Highly uncertain valuation at the outset and unpredictable events (Hindsight)
- Data from the years following the transaction
- Multiple year data

Q & A