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Transfer Pricing: Principles and Practice¹

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Overview

- This presentation provides an introduction to transfer principles and practice.
- Developing countries need to establish and enforce their transfer pricing rules to protect their tax base for cross-border controlled transactions.



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- The 2 main reasons for establishing and enforcing transfer pricing rules:
 - to prevent avoidance through profit-shifting, and
 - to ensure the correct allocation of revenue between the jurisdictions in which associated entities are based.
 - But transfer pricing is an art, not a science.




Definitions

- ‘Controlled transactions’ are transactions between associated entities.
 - Intra-group transactions (parent and subsidiary structure).
 - Intra-entity transactions (head office and branch structure).
- ‘Transfer pricing’ is the price at which intra-group transactions take place and is a normal business activity.



Reasons for shifting profits

- ‘Transfer pricing manipulation’ is the use of transfer pricing to shift profits between jurisdictions.
- The aim of transfer pricing manipulation is to reduce a group’s worldwide taxation by shifting profits to low tax countries.
- The aim is to maximise a group’s after-tax profits for distribution to shareholders.

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- A dividend imputation system may create an incentive for associated entities to pay more tax in developed countries.
 - In Australia shareholders receive tax credits for domestic company tax paid in Australia.
 - But tax credits are not provided for foreign taxes paid overseas.



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- Another reason for shifting profits to developed countries is to avoid the risk of transfer pricing adjustments, penalties and interest charges on the tax owing.
 - The risk of adjustment was highlighted by the 2006 GlaxoSmithKline (GSK) settlement with the US IRS in which GSK paid \$3.4 billion US and negotiated with the US IRS for over 14 years.



Transfer pricing measures

- The scope for transfer pricing manipulation is significant as 70% of world trade is estimated to be between associated entities.
- Measures to counter transfer pricing manipulation are usually in both domestic law and in tax treaties.



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- Transfer pricing rules are based on the arm's length principle.
 - Under the arm's length principle transfer prices should be comparable to prices for similar transactions between independent entities.



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- Article 9, the associated enterprises article, and Article 7, the business profits article, of the OECD *Model Convention on Income and Capital* are based on the arm's length principle.
 - For the purposes of Article 9 the OECD has issued the *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*.



Problems with the arm's length principle

- The arm's length principle is difficult to apply in practice and is usually impossible to find comparable transactions.
- The high levels of integration in multinational enterprises creates significant challenges in applying the arm's length principle.



- Transfer pricing is done on a case-by-case basis and can often be complex and costly for both the taxpayer and tax agency.
- The lack of comparables results in uncertainty.
- Intangible property creates further complexity and it is difficult in a company group to identify the economic owner of intangible property.



International transfer pricing practice

- Ernst & Young carries out transfer pricing surveys of (multinational enterprises) MNEs.
- The survey has revealed an increasing emphasis on transfer pricing enforcement to maintain tax revenue.



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- The findings of the 2005 survey were:
 - More than 80% of respondents intended to increase their efforts in managing their transfer pricing issues.
 - Around 60% of respondents allocate between 1-3 persons to manage their tax affairs.
 - Areas of concern were: managing head office expenses; information technology; and inter-group debt and guarantees.



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- The UK, US and Japan conduct the most transfer pricing audits.
 - The 2005 survey found that in 2006 the UK was expected to be the most active tax agency in the transfer pricing area.



Transfer pricing methods

- There are 5 transfer pricing methods.
- The traditional methods (transaction based) are:
 - comparable uncontrolled price method,
 - resale price method, and
 - cost plus method.
- The non-traditional methods (profit based) are:
 - the profit split method, and
 - the transactional net margin method.



Comparable uncontrolled price method

1. Comparable uncontrolled price method (CUP)
 - The CUP compares the price charged for property or services transferred in a controlled transaction.
 - If there is a difference between a CUP and the transfer prices between associated entities, the transfer prices may fail the arm's length test.



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- The CUP is the most direct and accurate method of checking transfer prices.
 - It is the preferred OECD method.
 - While the CUP is the most accurate it is often difficult to find a comparable transaction.



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- But material differences between a controlled and uncontrolled transactions may make the CUP unreliable.
 - It may not be possible to make adjustments to eliminate the effect of the material differences on prices.



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- There are internal CUPs and external CUPs.
 - An internal CUP is where an associated entity also enters into similar transactions with unrelated entities.
 - An external CUP is where two unrelated entities enter into similar transactions.



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- Every material difference must be corrected by adjustments.
 - The range of potential material differences are extensive and makes the CUP inapplicable even in the sale of primary products such as tea or minerals.



Resale price method

- The resale price method (RPM) begins with the price for which a product has been sold to an independent entity and works back to determine an appropriate transfer price.
- An appropriate transfer price is the resale price minus an appropriate profit margin.
- The RPM has advantages over the CUP in certain situations.



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- The resale price is reduced by the appropriate gross margin, to determine the appropriate resale price margin for the seller.
 - The gross profit margin is intended to cover the seller's operating expenses and provide a margin for the functions it performs.
 - A functional analysis is important for the RPM.



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- After subtracting the gross operating margin from the resale price, the resulting amount is the appropriate transfer price for the purchase of the goods by the reseller.
 - Other adjustments may be required to take account of customs duty.
 - This method is best when applied to distribution operations.



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- The resale price margin of the reseller in the controlled transaction may be determined by the resale price margin that the same reseller makes on similar uncontrolled transactions.
 - The resale price margin of independent sellers may be used to determine the appropriate margin.



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- As profit margins reflect gross compensation, product differences are less important.
 - For example, the profit margin on microwave ovens should be the same as the margin for other kitchen appliances.
 - But the products should be similar.



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- In applying the RPM attention should be given to the functions performed and economic functions.
 - If uncontrolled and controlled transactions are similar except that the products are different, the RPM will produce a more reliable result than the CUP.
 - In this situation the RPM will be better than the cost plus method.



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- The reliability of the RPM is affected by differences between the way associated entities and independent entities operate.
 - The differences could be:
 - costs,
 - management efficiency, and
 - inventory maintenance.



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- The RPM depends on the comparability of functions performed.
 - If there are material differences between the functions of associated and independent entities adjustments are required.
 - The requirement to make adjustments may decrease the reliability of the RPM.



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- The RPM works best if the reseller does not add substantially to the value of the goods.
 - If the reseller is only a distributor for goods the RPM may be used.
 - But the RPM does not work if the reseller substantially alters the goods.
 - If the reseller assembles and paints the products, the goods have been substantially altered.



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- The RPM works best if there is only a short period of time between the time of purchase and resale by the reseller.
 - The longer the reseller holds the goods the less reliable the RPM becomes.



Cost plus method

- The cost plus method (CPM) begins with the costs for a controlled transaction and allows for an appropriate mark-up to work up to an appropriate transfer price.
- The mark-up must reflect the functions performed by the taxpayer.
- A functional analysis is required for the CPM.



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- The CPM is best:
 - when semi-finished goods are sold between related parties,
 - where related parties have concluded joint facility agreements,
 - long term buy and sell arrangements, or
 - for the provision of services.



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- The cost plus mark-up of the supplier should be determined by reference to mark-up earned by the supplier in comparable uncontrolled transactions.
 - Alternatively, the mark-ups of independent entities in uncontrolled transactions may be used as a guide.



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- A problem with the CPM is to make sure that the cost bases being compared are the same.
 - Some differences between costs may emerge because some manufacturers operate from leased premises while other own their premises.
 - In this situation, the costs of manufacturers with leased premises will be higher.



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- Differences between controlled and uncontrolled transactions may have an effect on the mark-up which may be used.
 - Appropriate adjustments must be made to eliminate these differences.



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- It is important to consider the differences between costs.
 - The differences may be the result of including operating expenses and non-operating expenses including financing.
 - Consideration must be given to assets used and risks assumed.



Transactional profit methods

- The transactional profit methods considers the profits that are made from particular controlled transactions.
- The transactional profit methods may be used under the OECD Transfer Pricing Guidelines ‘in those exceptional circumstances in which the complexities of real life business put practical difficulties in the way of the application of the traditional transaction methods’.



Profit split method

- The profit split method (PSM) seeks to determine the profits that independent enterprises could have been expected to make from engaging in transactions.
- The PSM first identifies the profits that are to be split for associated entities from controlled transactions.
- The PSM then splits the profits between the associated enterprises on an economically valid basis that reflects profits that would have been made if the transactions were uncontrolled transactions.



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- The combined profits may be the total profits from the transactions.
 - The profit may also be residual profit arising from high value intangibles that cannot be attributed to a party.
 - For example, Ipods have a significant trademark and Ipods sell themselves. A considerable part of the profit from the sale of Ipods is attributable to its trademark.



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- The contribution of each party is determined by making a functional analysis of the functions performed.
 - Values are attributed to each function on the basis of reliable external market data.
 - External data may include profit-split percentages earned by independent entities performing similar functions.



Strengths of the PSM

- The strength of the PSM is that it does not rely on comparable transactions and provides flexibility.
- This allows it to be used when there are no comparable transactions that may be considered.
- External data is important for the purpose of valuing functions performed and contributions made by the associated entities.



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- As both associated entities are being examined, extreme results are unlikely to occur.
 - The PSM is likely to produce a result that is acceptable to the tax agencies involved as the profit allocation depends on the functions that each entity performed.



Weakness

- The PSM has several weaknesses.
- The external market data used for valuing contributions by each entity may result in distortions.
- The distortion arises from the fact that the external data is unreliable in valuing functions.



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- Another weakness is that an MNE may have difficulty in getting information from other MNE group members.
 - This is a problem that tax agencies share with some MNEs.



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- A problem with PSM is that independent entities do not use it unless they are involved in joint ventures.
 - The PSM requires a MNE group to prepare consolidated tax accounts for the profits to be split in accordance with a functional analysis.
 - This is a costly and complex process.
 - It may also be difficult to allocate operating costs under the PSM between the associated entities.



Guidance on the application of the PSM

- The aim of the PSM is to create the division of profits that independent entities operating at arm's length would have expected in a joint venture operation.
- But it is important for tax agencies to understand that the taxpayer did not know the profit results when the controlled transactions were created.



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- The PSM should not reward or penalise a taxpayer by focusing on information that the taxpayer could not have foreseen.
 - Independent entities in a joint venture only have profit projections to rely on when the joint venture is created.



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- There are 2 methods to be used under the PSM.
 - contribution analysis or
 - residual analysis.



Contribution analysis

- Under a contribution analysis, the combined profits from the controlled transaction are divided between the associated entities.
- The profit allocation depends on the relative value of the functions the associated entities carried out.



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- The profit to be divided is the operating profit. The profits and costs have to be allocated on a consistent basis.
 - But it is a difficult task to determine the relative contribution of each associated entity.



Residual analysis

- A residual analysis divides the profits from controlled transactions in 2 stages.
 1. The first stage is to provide each associated party with a basic return by reference to comparable transactions.
 2. The second stage is that any residual loss remaining after the first stage is allocated on the basis of facts and circumstances.



- Factors that could be used in allocating the residual profit are the party's contributions of intangible property and relative bargaining position of the parties.
- But is bargaining position a relevant fact in an MNC group with common control?



- This method provides a significant degree of flexibility in allocating residual profit, but it may lead to disagreements between tax agencies.
- The application of the residual analysis method depends on the circumstances of a particular case.
- The PSM should be applied with care.



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- One option is to apply the PSM on the basis of results from comparable transactions.
 - But it will generally be difficult to find comparable transactions and this is the reason why PSM would be applied in the first place.



Transactional net margin method

- The transactional net margin method (TNMM) examines the net profit margin in comparison to a particular base.
- This method is called the comparable profits method in the US.
- The bases could be assets, sales or costs.
- The TNMM operates in a manner similar to the RPM and CPM, but uses net rather than gross margins.



Strengths

- A strength of the TNMM is that net margins are not as sensitive to transactional differences as the CUP method.
- Another strength is that it only examines the functions performed by one associated entity rather than the functions of two associated entities.
- The accounts of the members in a MNE group do not have to be prepared on a common basis.



Weaknesses

- The TNMM may be influenced by factors that do not have a significant affect on profits.
- This makes it difficult to determine arm's length profit margins under the TNMM.
- Taxpayers may not have enough information on uncontrolled transactions in order to use this method.



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- Tax agencies have an advantage over taxpayers on this issue as they have information from a range of independent entities performing similar functions.
 - Another problem with the TNMM is that it does not consider the overall profitability of the MNE group.
 - A one-sided application may result in too little or too much profit in other associated entities.
 - It may be difficult to make appropriate adjustments to the TNMM.



Guidance for the application of the TNMM

1. The comparability standard to be applied to the TNMM:

- Operating profits are not highly affected by differences between products and functions performed.
- When the TNMM is applied, comparable transactions by independent entities are required, but factors other than products and functions can influence profits levels.



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- The TNMM introduces some volatility.
 - Net profit margins may be influenced by factors that do not have an affect on gross margins or prices because of the difference between operating expenses.
 - Net profit margins may be affected by factors such as competitive position, that can influence price and gross margins. These factors cannot be eliminated with adjustments.



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- Net margins may be influenced by:
 - the threat of new entrants,
 - competitive position,
 - management efficiency and
 - varying cost structures.



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- The range of adjustments required will affect the reliability of the TNMM.
 - The OECD claims that the TNMM provides a practical solution to otherwise insoluble transfer pricing problems.
 - The TNMM should only be used when the net margins of comparable uncontrolled transactions are available.
 - Are net profit margins available in your jurisdiction?



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- The TNMM should not be used on entity-wide basis if the company operates through a variety of controlled transactions that cannot be compared on an aggregate basis with uncontrolled transactions by an independent entity.
 - If comparable transactions do not exist for certain business lines, the TNMM should not be used for these business lines.



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- Multiple year data should be considered in the application of the TNMM.
 - This allows for consideration to be made about the affect of business cycles and product life cycles on profits.
 - Multiple year data allows a tax agency to determine if independent entities have had similar results.



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- It may be possible to apply the TNMM if there are no other functional differences between the controlled and uncontrolled transactions.
 - There is one proviso for the application of the TNMM; the net profits of an independent distributor relative to sales must be known.
 - It may be possible to apply the TNMM to the associated distributor by comparing the margin relative to the independent distributor's sales to net profits with the margin calculated on the same basis for the associated distributor.



Conclusion

- Developing countries need to develop and enforce transfer pricing rules to ensure their tax revenue from international transactions.
- The OECD has stated this year that transfer pricing is an area in which there are significant tax revenue opportunities.
- Transfer pricing is an art and not an exact science and this results in some uncertainty.



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- The OECD Transfer Pricing Guidelines provide internationally accepted transfer pricing rules.
 - In practice, the TNMM is the most commonly used method.