

# **Transfer Pricing**

## **TP METHODS**

# TP Methods

- **TRADITIONAL METHODS (Transaction-based):**
  - Comparable Uncontrolled Prices (**CUP**);
  - Resale Price Methods (**RPM**);
  - Cost Plus (**CPM**).
- **TRANSACTIONAL METHODS (Profit-based):**
  - Transactional Net Margin Method (**TNMM**);
  - Profit Split Method (**PSM**).

# Comparable uncontrolled price method (CUP)

- The **CUP** method **compares**:
  - *"the **price** charged for property or services transferred in a **controlled transaction**"; to*
  - *"the **price** charged for property or services transferred in a **comparable uncontrolled transaction** in comparable circumstances.[...]" (par. 2.13 TPG –emphasis added)*
- **Comparison** of **prices**:
  - **"Internal comparable"**: comparable transaction between **one party** to the controlled transaction and an **independent party**; or
  - **"External" comparable"**: comparable transactions between **two independent enterprises**, neither of which is a party to the controlled transaction.

# Comparable uncontrolled price method (CUP)

## Internal comparison



Prezzo:150

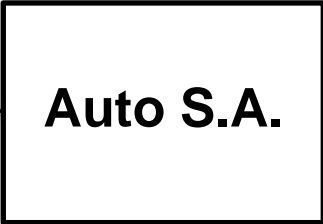
Third party



Intercompany

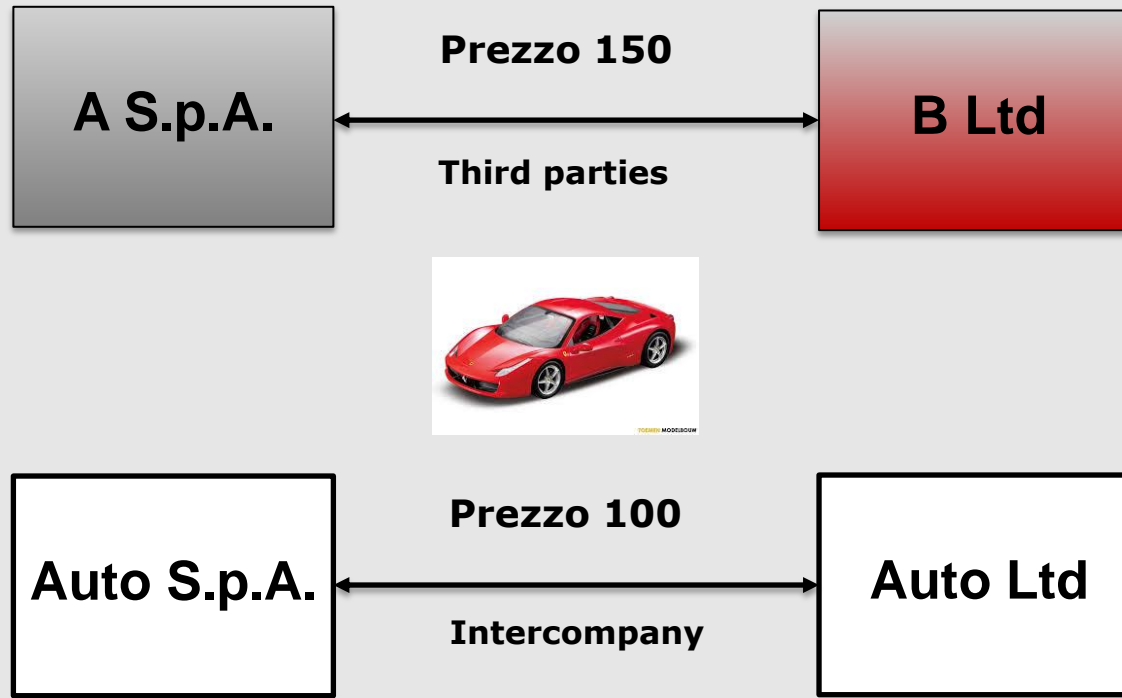


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# Comparable uncontrolled price method (CUP)

## External comparison



# Comparable uncontrolled price method (CUP)

- **Strengths:**

- CUP is a **direct method** as it directly identifies prices charged in comparable transactions (differently from the other traditional methods or from the profit methods where prices are indirectly determined through comparisons of margins);
- OECD **preferred method** when it can be applied in an **equally reliable manner**;
- CUP is a two-sided analysis, as market price is determined by market forces (demand and supply). Therefore it avoids to evaluate which of the two parties shall be subject to analysis.

- **Weaknesses:**

- In practice it is generally difficult to locate strict comparable transactions, especially in relation to product comparability (3rd comparability factor);
- Reliable information on external CUPS are generally rare to find in practice.

# Comparable uncontrolled price method (CUP)

- **Typical use of CUP:**
  - Availability of a comparable uncontrolled transaction of the controlled transaction (internal CUP), including situations where reliable adjustment can be applied in order to eliminate the effects of the differences between the transactions being compared;
  - When product differences do not materially affect the transactions being compared (e.g. commodities);
  - In case of interest bearing loans.

# Cost-plus method (CPM)

- **Main features:**

- The Cost plus method begins with the **costs incurred** by the **supplier** of a product or service provided to an **associated enterprise**;
- An **appropriate Mark-Up** is then **added** to those **costs** in order to arrive to an appropriate profit in light of the functions performed and the market conditions (in light of the comparability analysis);
- Financial Ratio used: **Gross Profit/Costs of Good Sold (COGS)**.



# Cost-plus method (CPM)

- **Comparison of the Gross Margin realized by the enterprise in its IC transactions with:**
  1. The **Gross Margin** realized in comparable **uncontrolled transactions** (internal comparable); or
  2. The **gross margin** earned by **independent enterprises** in comparable **uncontrolled transactions** (external comparable).
- **Comparison between **Gross Margins** not between Prices**

# Cost-plus method (CPM)

- **Strengths:**

- Cost-plus is a **traditional transactional method**, and then one of the preferred OECD methods, when transactional profit methods can be applied in an equally reliable manner.

- **Weaknesses:**

- Difficulties related to the determination of costs:
  - Reliable information on comparable gross margins earned by independent parties are not easy to find;
  - Accounting inconsistencies relevant to comparable transactions may affect the analysis;
  - It is a one-sided analysis, as opposed to the CUP method that takes into account both parties to the transaction;
  - No discernible link between the level of costs incurred and a market price (e.g. where a valuable discovery has been made and the owner has incurred only small research costs in making it).

# Cost-plus method (CPM)

- **Typical use of CPM:**
  - It is typically applied when the associated enterprise under analysis ("**tested party**") is a **manufacturing company** or a **service provider**;
  - Sales of products manufactured by one enterprise, performing **limited functions** assuming **limited** risks (e. g. *contract manufacturer, toll manufacturer or low risk assembler*).

# Resale Price Method (RPM)

- **Main features:**
  - **“Starting point” = Resale Price**
    - Price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise (Para. 2.21 of the TPG)
  - This price is **reduced** by an appropriate **Gross Margin** (the **“Resale Price Margin”**)
    - Amount out of which the reseller would seek to cover its selling and other operating expenses and, in the light of the functions performed (taking into account assets use and risks assumed), make an appropriate profit
  - The **Arm's Length Price** for the original transfer of property between the associated enterprises is then given by the **difference** between the **Resale Price** and the **Gross Margin**
  - **Financial Ratio = Gross Margin / Net Sales**

# Resale Price Method (RPM)

- **Comparison of the Resale Price Margin realized by the enterprise in its IC transaction with:**
  1. the **Resale Price Margin** realized in **comparable uncontrolled transactions** (internal comparable); or
  2. the **Resale Price Margin** realized by **independent enterprises** in **comparable uncontrolled transactions** (external comparable).
- **Comparison between **Gross Margins** not between Prices**

# Resale Price Method (RPM)

- **Strengths:**

- Resale Price is a **traditional** method, and then one of the preferred OECD methods, when transactional profit methods can be applied in an equally reliable manner;
- It is based on **market prices**, such as resale prices, determined by the demand.

- **Weaknesses:**

- **Accounting inconsistencies** relevant to comparable transactions may affect the analysis;
- It is a one-sided analysis, as opposed to the CUP method that takes into account both parties to the transaction.

# Resale Price Method (RPM)

- **Typical use of RPM:**
  - It is typically applied when the associated enterprise under analysis ("**tested party**") is a **distributor company**;
  - When applied to marketing operations, where the resellers does not add significant value to the products being transferred.

# Transactional Profit methods

- **General remarks:**
  - Examine the profits arising from particular controlled transactions;
  - Focus on functions rather than products;
  - Should be used if traditional methods may not apply in an equally reliable manner (e.g. insufficient or unreliable data on uncontrolled transactions).
- **Notes:**
  - They are more commonly used in practice than traditional transactional method;
  - It is easier to find comparables in practice than traditional transactional method since they are less affected by the differences of the products.



# Transactional Net Margin Method (TNMM)

- **Main features:**

- The TNMM examines the **Net Profit Margin** relative to appropriate bases for a particular transaction (i.e. **Profit Level Indicator** ("PLI") such as, profit to sales ratio, profit to costs ratio, profit to assets ratio);
- Depending on the profit level indicators used, a transactional net margin method operates in a manner similar to the cost plus and the resale price methods;
- TNMM compares the **Net Profit Margin** earned by an enterprise in a controlled transaction with the net profit margins realized by independent parties in comparable transactions;
- The TNMM is a more **indirect method** than Cost Plus or Resale Price that are based on gross margins and even more indirect than CUP that is based on comparison of prices.

# Transactional Net Margin Method (TNMM) - PLI

- **The selection of the PLI shall take into account:**
  - The respective strengths and weaknesses of the various possible indicators;
  - The appropriateness of the indicator considered in view of the nature of the controlled transaction, determined in particular through a functional analysis;
  - The availability of reliable information (in particular on uncontrolled comparables) needed to apply the transactional net margin method based on that indicator;
  - The degree of comparability between controlled and uncontrolled transactions, including the reliability of comparability adjustments that may be needed to eliminate differences between them, when applying the transactional net margin method based on that indicator;

# Transactional Net Margin Method (TNMM) - PLI

- **Return on sales (ROS) – EBIT/Sales**
  - Frequently used to determine the arm's length price of purchase from associated enterprise for resale to independent customers (i.e. for limited risk distributor);
  - It may be considered similar to the RPM method (**Net Margin vs Gross Margin**);
- **Full Cost Mark-Up (FCMU) – EBIT/Total Costs**
  - It should only be used in cases where costs are a relevant indicator of the value of the functions performed, asset used and risks assumed by the tested party;
  - It may be considered similar to the CPM method;
  - In most cases only those costs which are of an operating nature should be included in the denominator;
- **Return on Assets (ROA) – EBIT/Assets**
  - Appropriate when the assets (rather than costs and sales) are a better indicator of the value added by the tested party (i.e. in certain manufacturing or asset-intensive activities or capital-intensive activities);
  - Only operating assets should be considered.

# Transactional Net Margin Method (TNMM)

- **Gross Margin vs Net Margin**

	<b>Intercompany transaction</b>	<b>Uncontrolled transaction</b>
<b>Sales</b>	150	300
<b>COGS</b>	-141	-270
<b>Gross Profit</b>	9	30
<b>Gross Margin (%)</b>	6% (9/150)	10% (30/300)
<b>OPEX</b>	5	22
<b>Net profit</b>	4	8
<b>Net Margin (%) (4/150 and 8/300)</b>	<b>2,67%</b>	<b>2,67%</b>

# Transactional Net Margin Method (TNMM)

- **Strengths:**

- Net Margins are less affected by **product** differences than prices;
- Net Margins are less influenced by functional differences between the controlled and uncontrolled transactions than gross profit margins;
- Differences in the functions performed between enterprises are often reflected in variations in operating expenses (“Consequently, enterprises may have a wide range of gross profit margins but still earn broadly similar levels of net profits.”) (par. 2.62 TPG; see also Annex I to Chapter II);
- Net margins are less affected by accounting inconsistencies.

- **Weaknesses:**

- TNMM is a **one-sided** analysis (i.e it does not take into account the overall profitability of the MNE group from the controlled transactions);
- Net margins can be influenced by factors that do not have an effect, or have a less substantial or direct effect, on price or gross margins (e.g. differences in capacity utilization, because differences in the levels of absorption of indirect fixed costs (e.g. fixed manufacturing costs or fixed distribution costs) would affect the net profit but may not affect the gross margin or gross mark-up on costs if not reflected in price differences.

# Profit Split Methods (PSM)

- **Main features:**

- The transactional Profit Split Method seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transaction by determining the **division of profits** that **independent enterprises would have expected to realize** from engaging in the transaction or transactions;
- It addresses **transactions** which are so **interrelated** that they cannot be evaluated on separated basis or transaction in which **both of the parties use valuable intangibles**;
- **Two main approaches:**
  - **Contribution** analysis;
  - **Residual** analysis.

# Profit Split Methods (PSM)

## 1. Contribution analysis:

- Allocation of the profits of transactions between the contracting related parties on the basis of an Arm's Length economic agreement;

## 2. Residual analysis:

- a) Allocation of the ***routine profit*** to each contracting party performing *routine* activities;
- b) Allocation of the **residual profit** (or loss) between the related parties based on market parameters and depending on the facts and circumstances of the case.

# Profit Split Methods (PSM)

- **Strengths:**

- PSM does not generally rely on closely comparable transactions and, consequently, it can be used in cases when no such transactions between independent enterprises can be identified;
- PSM is a two sided-analysis with remote possibility that either party to the controlled transaction will be left with an extreme and improbable profit result;

- **Weaknesses:**

- Difficult to apply;
- External market data to evaluate the contribution of each associated enterprise less closely connected to the controlled transactions than is the case with the other available methods (subjectivity increased);
- Independent enterprises do not ordinarily use the profit split method to determine their transfer pricing (except j.v.) and, consequently, it may be required making adjustments in accounting practices and currencies;