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Transfer Pricing and Attribution of Profits to Permanent Establishment

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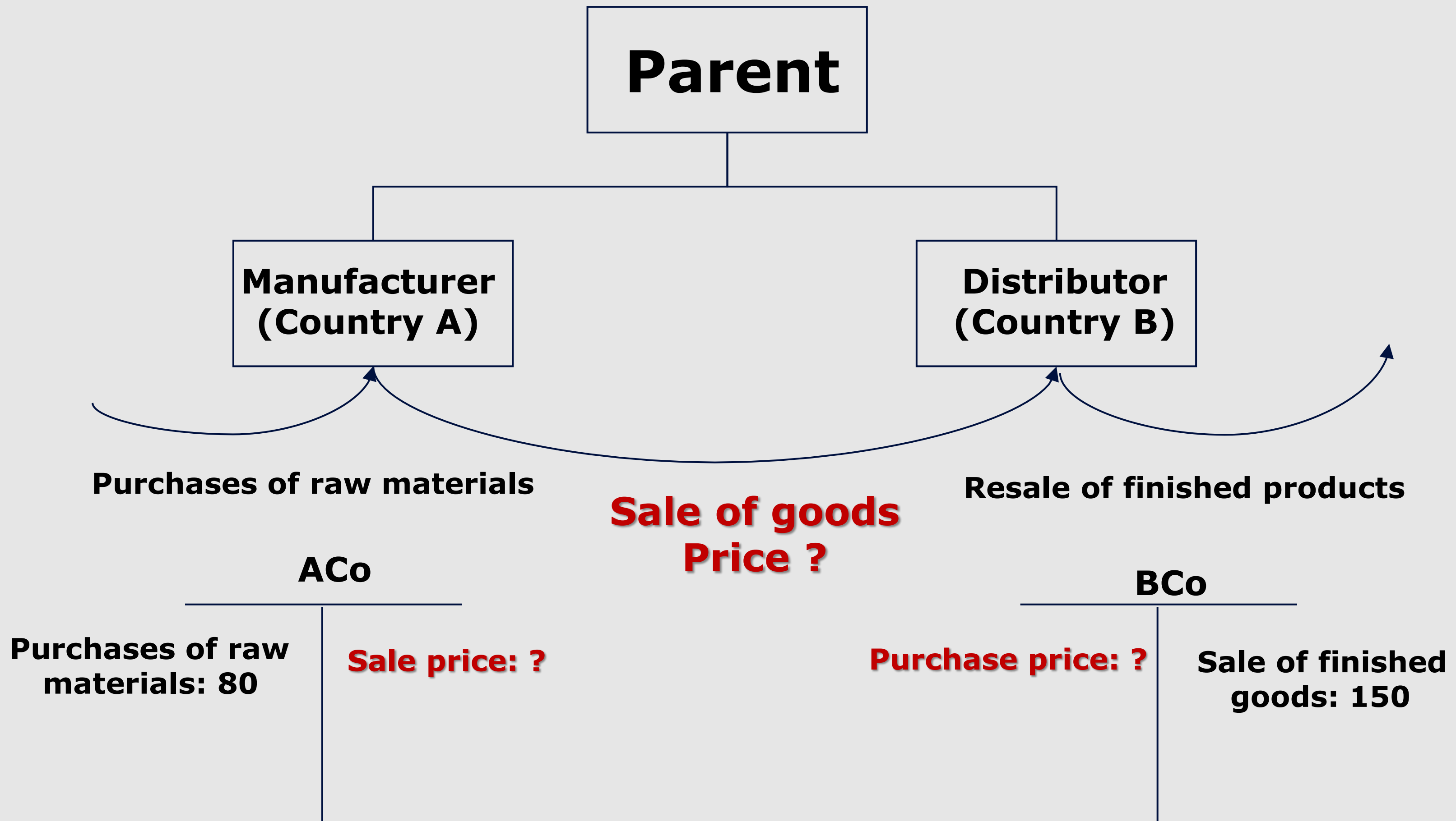
Transfer Pricing

THE ISSUE

Transfer Pricing



Transfer Pricing

THE ARM’S LENGTH PRINCIPLE (ALP)

International legal framework

- **International Legal framework**:
  - Article 9(1) and (2) of the OECD Model Convention (OECD MC);
  - Article 9 (1) and (2) of the OECD MC;
  - 2017 OECD Transfer Pricing Guidelines for Multinational Enterprises and tax Administrations (TPG);
    - 1979: “Transfer Pricing for Multinational Enterprises”;
    - 1984: “Transfer Pricing and Multinational Enterprises: Three Taxation Issues”;
    - 1995: “Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations”;
    - 2010: Update of the 1995 “Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations”
    - 2015: Release of the BEPS Report on Actions 8-10 and 13 (endorsed in the 2017 TPG)

Art. 9(1) OECD MC

- The authoritative statement of the arm's length principle can be found at art. 9(1) of the OECD MC:

  [Where] *conditions are made or imposed between the two* [associated] *enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.*

- The arm's length principle follows the approach of treating the members of an MNE group as operating as separate entities rather than as inseparable parts of a single unified business (TPG Para. 1.6)

- The analysis of the controlled and uncontrolled transactions, which is referred to as a "comparability analysis", is at the heart of the application of the arm's length principle

Transfer Pricing

APPLICATION OF THE ALP: COMPARABILITY ANALYSIS

Comparability Analysis

1. **Understanding the economically significant characteristics of the controlled transaction**:

    - **Contractual terms** of the transaction;
    - **Functions** performed by each of the parties to the transaction (taking into account **assets used** and **risks assumed**, including how those functions relate to the wider generation of value by the MNE group to which the parties belong, the circumstances surrounding the transaction, and industry practices);
    - **Characteristics of property** transferred or **services** provided;
    - **Economic circumstances** of the **parties** and of the **market** in which the parties operate;
    - **Business strategies** pursued by the parties.

2. **Identifying potentially comparable transactions**

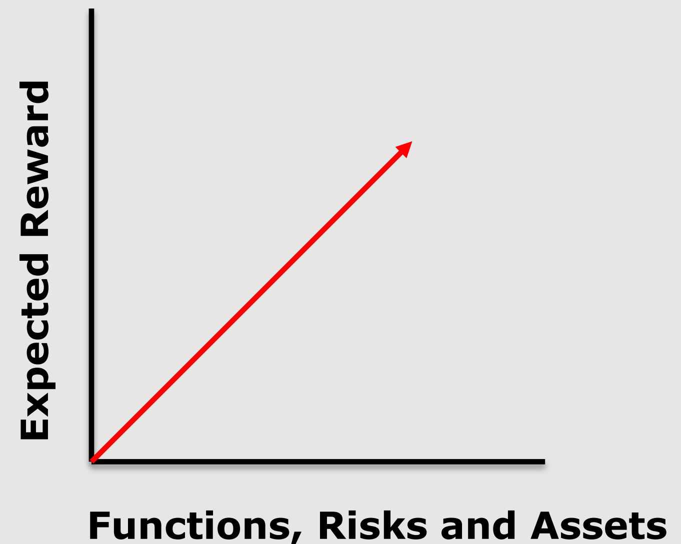
3. **Selection of the most appropriate transfer pricing method** (determination of an(a range of) arm’s length price(s) or profit(s))

Contractual Terms

- **What** is important?
  - Quality and quantity;
  - Responsibilities and obligations;
  - Risks;
  - Price and other commercials (e.g., delivery terms);
  - Penalties;
  - Payment terms and conditions.
- **Why** is it important?
  - Contractual terms of a transaction define how the responsibilities, risks and benefits are to be divided between the parties;
  - Helps to determine factors which could have influenced the price and calculate necessary adjustments;
  - **BEPS**: the actual conduct of the party shall adhere to the contractual terms

Functional Analysis

- **Scope**
  - The functional analysis seeks to identify the economically significant activities and responsibilities undertaken, assets used or contributed, and risks assumed by the parties to the transactions
- **Assumption**
  - In transactions between two independent enterprises, compensation usually reflects the functions that each enterprise performs (taking into account assets used and risks assumed)



Characteristic of Property or Services

- **What** is important?
  - Characteristics of **property**:
    - Physical features;
    - Quality and reliability;
    - Availability and volume supply;
  - Characteristics of **services**:
    - Nature of services;
    - Scope of services;

- **Why** is it important?
  - Differences in the specific characteristics of the property or services often account, at least in part, for their price differences in the open market;

Economic Circumstances

- **What** is important?
  - Market comparability includes:
    - Geographic location;
    - The size of the markets;
    - The extent of competition;
    - Availability of substitute goods and services;
    - Levels of supply and demand;
    - Consumer purchasing power.
- **Why** is it important?
  - Arm’s Length prices vary across markets;
  - Comparability requires that the markets in which the independent and related companies operate do not have differences that have a material effect on price.

Business Strategies

- **What** is important?
  - Possible businesses may include among the others:
    - Innovation and new product development;
    - Degree of diversification;
    - Risk aversion;
    - Assessment of political changes;
    - Market penetration strategies.
- **Why** is it important?
  - Business strategies might have an impact on prices and comparability

Identifying potentially comparable transactions

- **Internal comparables**:
  - Transactions carried out by the associated enterprise with third parties
  - Have a more direct and closer relationship to the transaction under review;
  - Financial analysis may be easier (more data available);
- **External comparables:**
  - Transactions occurred among third parties
  - Financial data sourced from commercial databases (e.g., Aida, Orbis, etc..);
  - Use of commercial database should not encourage quantity over quality – research need to be properly refined;
  - Proprietary database developed and maintained by advisory firms – in this case Tax Authorities may ask to have access to the same database for transparency reasons.

Selection of the most appropriate TP Methods

- The OECD has developed different transfer pricing methods aimed at determining an(a range of) arm's length price(s) or profit(s)
- The **selection of a transfer pricing method** depends on the peculiarities of each transaction under review;
- The **selection process** should take account of:

1. Respective **strengths** and **weaknesses** of each method;
2. **Appropriateness** of the method in view of the **nature** of the **controlled transaction**, determined in particular through a functional analysis;
3. **Availability** of reasonably reliable **information** (in particular on uncontrolled comparables) to apply the selected method or other methods;
4. Degree of **comparability**, including reliability of any comparability adjustments needed.

Transfer Pricing

TRANSFER PRICING METHODS

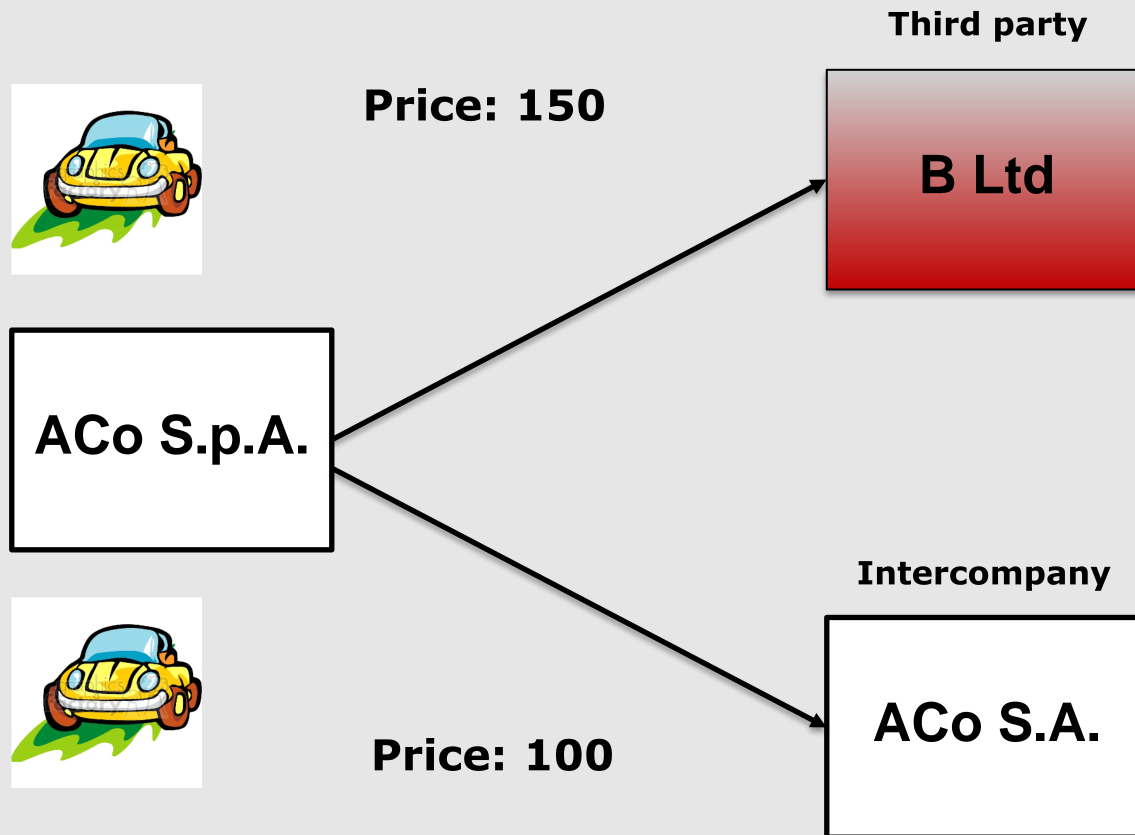
TP Methods

- **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)

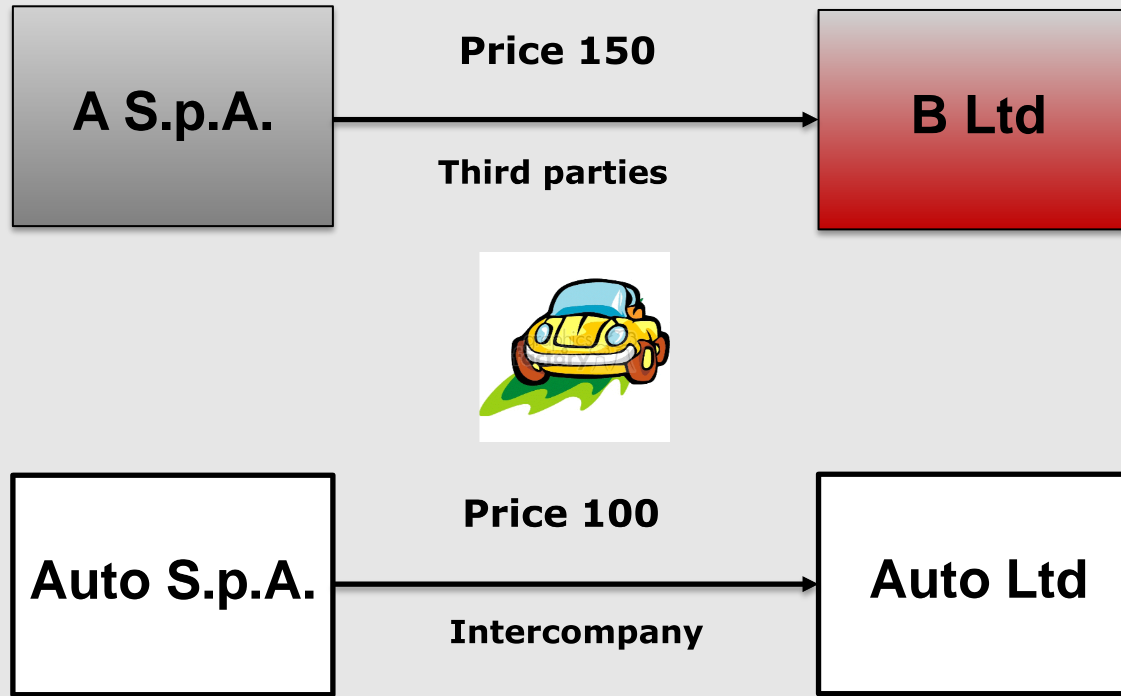
- The **CUP** method compares:
  - *"the **price** charged for property or services transferred in a **controlled transaction**"; to*
  - *"the **price** charged for property or services transferred in a **comparable uncontrolled transaction** in comparable circumstances.[…]"* (par. 2.14 TPG–emphasis 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)



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)**
- **Comparison of the Gross Margin realized by the enterprise in its IC transactions with:**
  1. The Gross Margin relized in comparable uncontrolled transactions (internal comparable); or
  2. The gross margin earned by independent enterprises in comparable uncontrolled transactions (external comparable).

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** and 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)

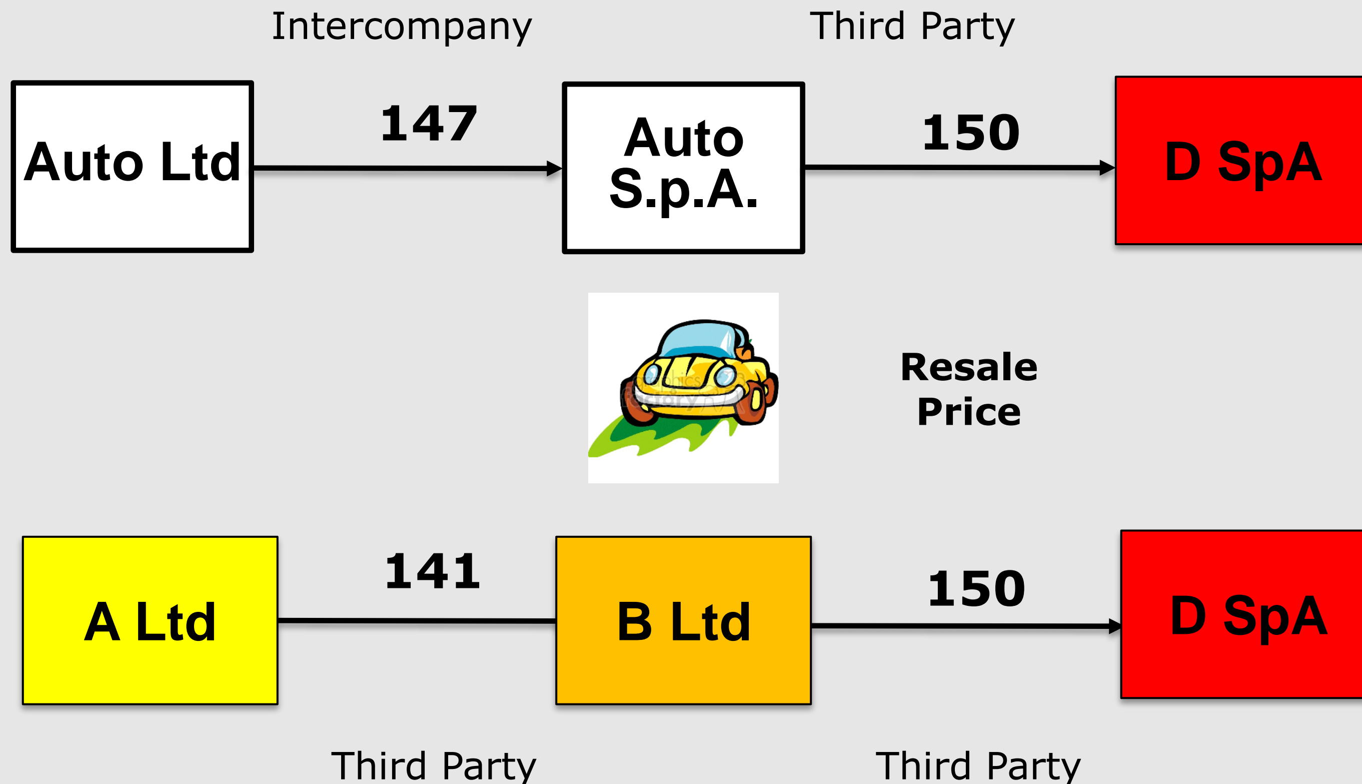
- **Comparison of the Resale Price Margin realized by the enterprise in its IC transaction with**:

  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 <u>not between Prices</u>**

Resale Price Method (RPM)



Gross margin Auto S.p.A.: 3

Gross margin Car S.p.A.: 9

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)

Net Margin vs Gross Margin

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

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;
- **Common PLIs:**
  - Return on sales (**ROS**) - EBIT/Sales;
  - Full Cost Mark-Up (**FCMU**) – EBIT/Total Costs;
  - Return on Assets (**ROA**) – EBIT/Assets.

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. 2.68 TPG);
  - 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 i**ndependent 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 **approches**:
    - **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;

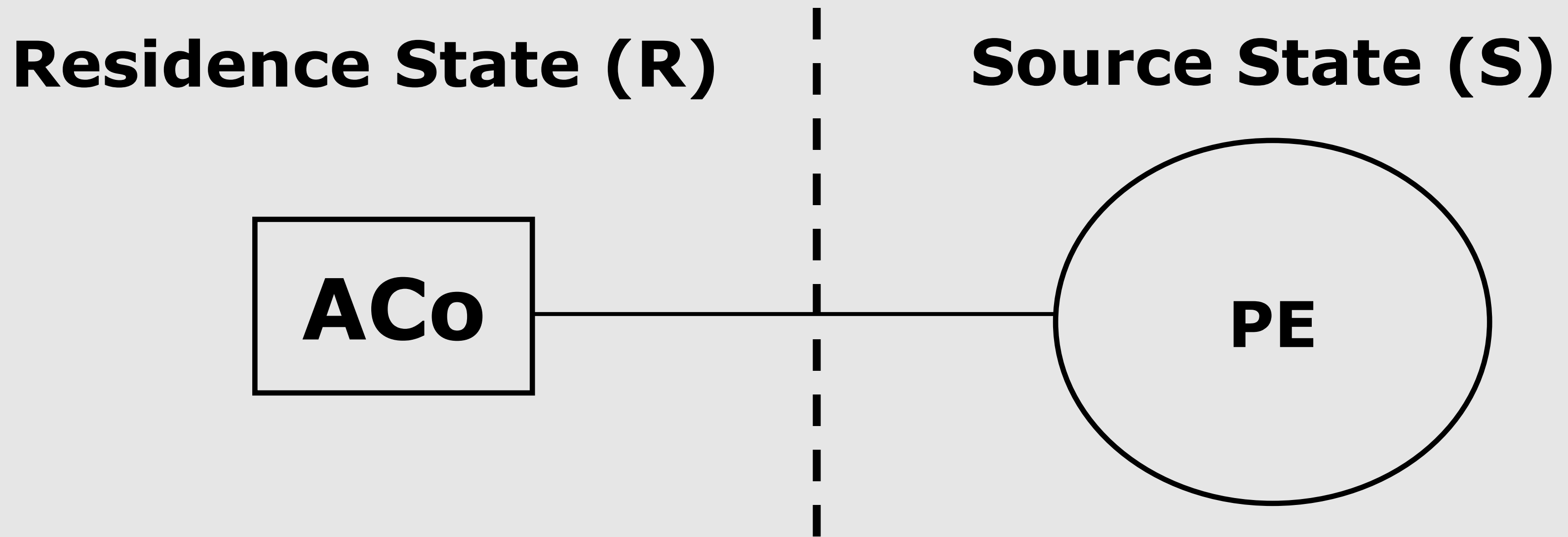
    b) Allocation of the **residual profit** (or loss) between the related parties based on market parameters and depending on the facts and circumstances of the case.

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;

ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENT (PE)

The Issue



- ACo performs business activities in state R and in state S through its PE
- Which share of the overall profits recorded by ACo should be attributed to the PE?

International legal framework

- **International Legal framework**:
  - Article 7 of the OECD MC;
  - Article 7 of the OECD MC Commentary;
  - OECD, *Report on the Attribution of Profits to Permanent Establishments* (2010)

Art. 7 OECD MC

Article 7

Business Profits

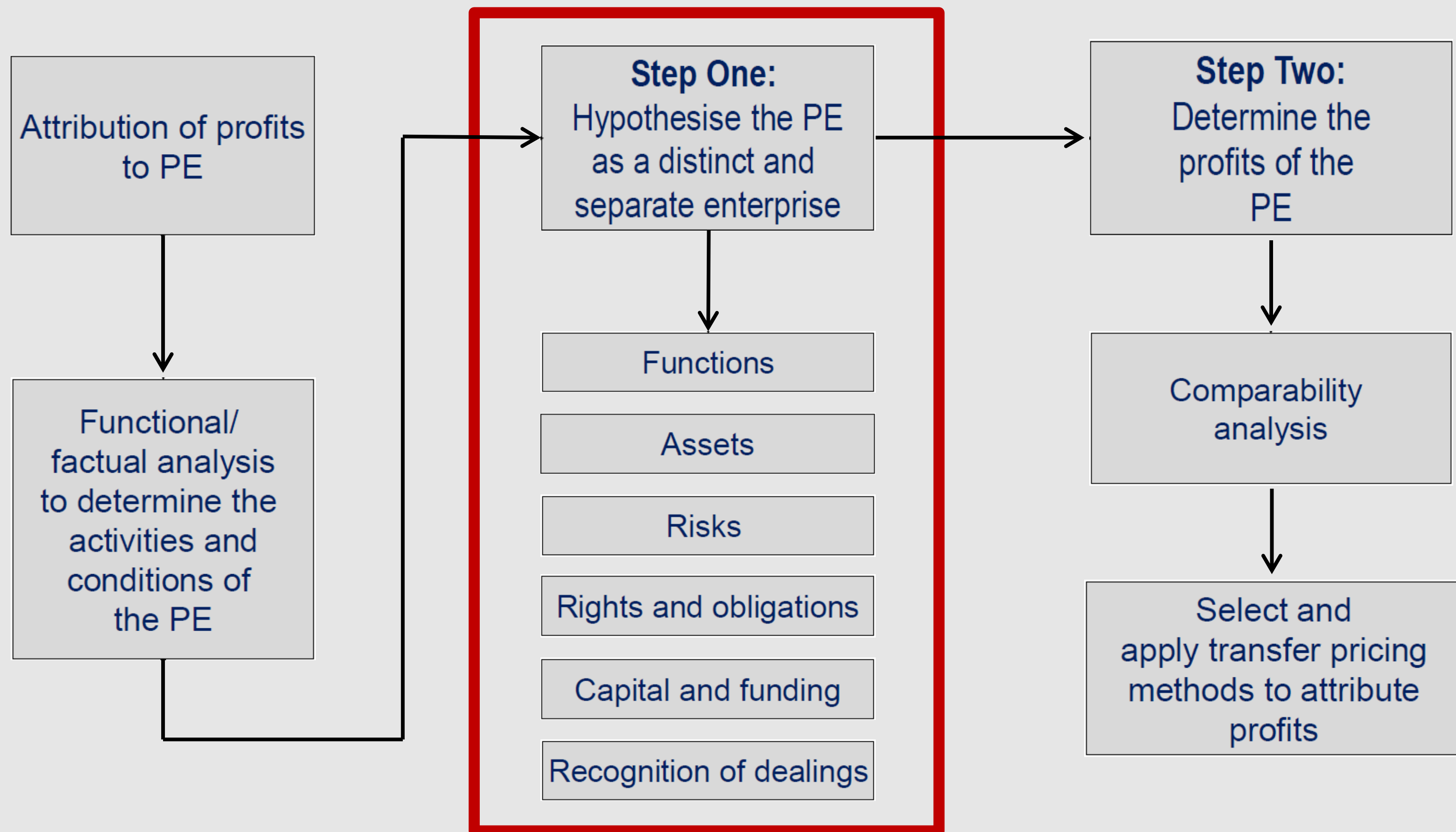
(1). Profits of an enterprise of a Contracting State shall be taxable only in that State unless ***the enterprise carries on business*** *in the other Contracting State* ***through a permanent establishment*** *situated therein. If the enterprise carries on business as aforesaid, the* ***profits that are attributable to the permanent establishment*** *in accordance with the provisions of paragraph 2* ***may be taxed in that other State***

(2) […] the ***profits that are attributable*** *in each Contracting State to the permanent establishment referred to in paragraph 1 are the profits it might be expected to make, in particular in its* ***dealings with other parts of the enterprise****, if it were a separate and* ***independent enterprise*** *engaged in the* ***same or similar activities*** *under the same or similar conditions, taking into account the* ***functions performed****,* ***assets used*** *and* ***risks assumed*** *by the enterprise through the permanent establishment and through the other parts of the enterprise.*

Authorized OECD Approach

- Article 7 currently reflects the Authorised OECD Approach (AOA) developed in the OECD Report on the Attribution of Profits to Permanent Establishments (2010)
- Under the AOA profits to be attributed to a PE are those that the PE might be expected to make if it were
  - A separate and independent enterprise
  - Engaged in the same or similar activities under the same or similar conditions
  - Taking into account the functions performed, the assets used, and the risks assumed through the PE and through other parts of the enterprise
- The AOA requires a **two-step analysis**
  1. Performance of a functional and factual analysis in order to hypothesise the PE as separate and independent entity
  2. Remuneration of the internal dealings with the rest of the enterprise of which the PE is a part at arm's length, by applying by analogy the transfer pricing tools enshrined in Article 9 of the OECD Model

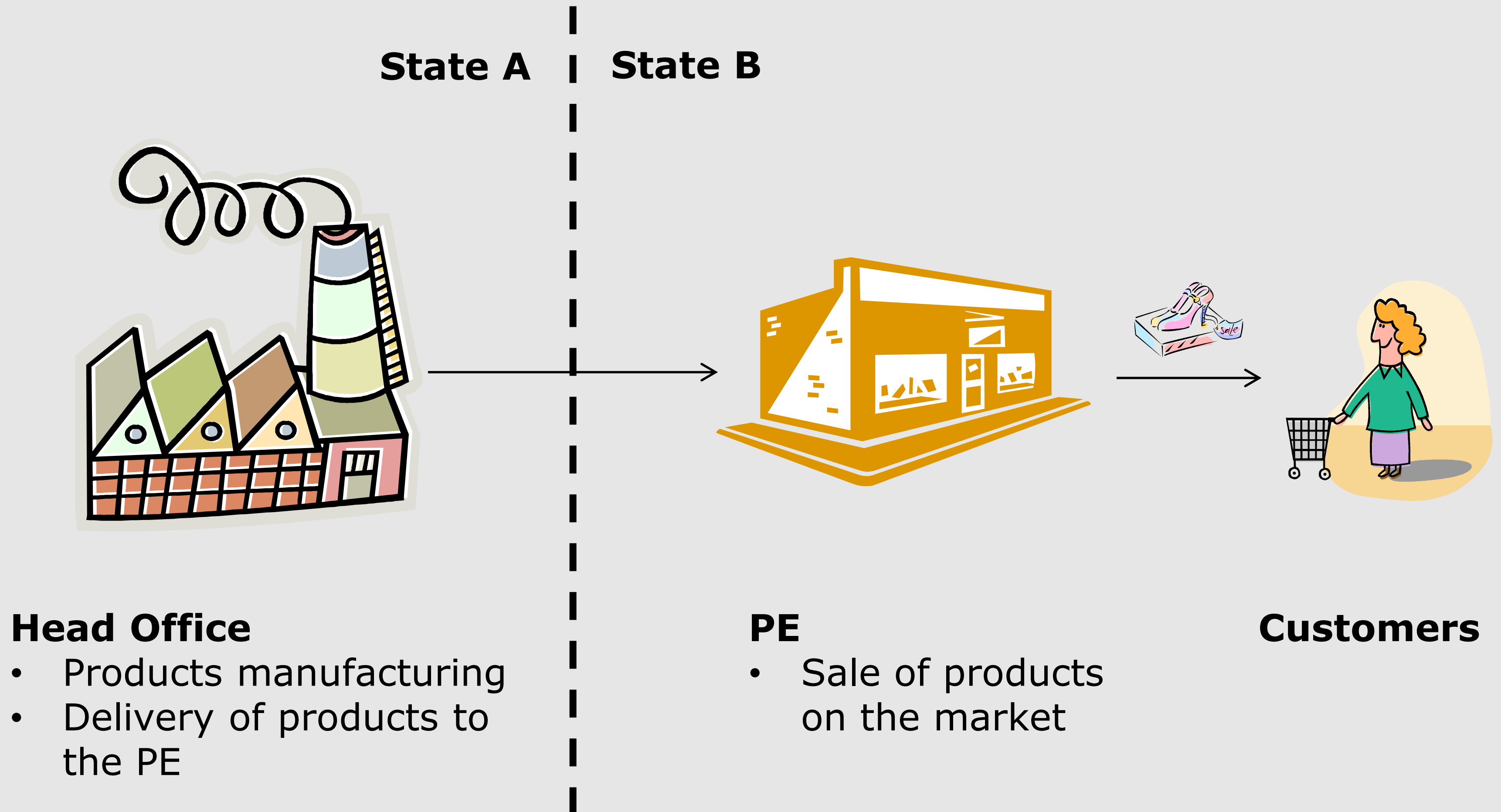
Authorized OECD Approach



Authorized OECD Approach Step One - Functions

- The analysis seeks to identify and compare the economically significant activities and responsibilities undertaken by the enterprise as a whole and by the enterprise through the PE for the purpose of hypothesizing the PE as a separate and independent enterprise
    - Which functions are performed by the personnel ("people functions") of the enterprise as a whole?
    - Which people functions are performed in the PE's premises?
    - What significance do these functions have in generating the profits of the business?
- *"People functions"* can range from support or ancillary functions to significant functions relevant to the attribution of economic ownership of assets and/or the assumption of risks

Authorized OECD Approach
Step One – PE acting as distributor



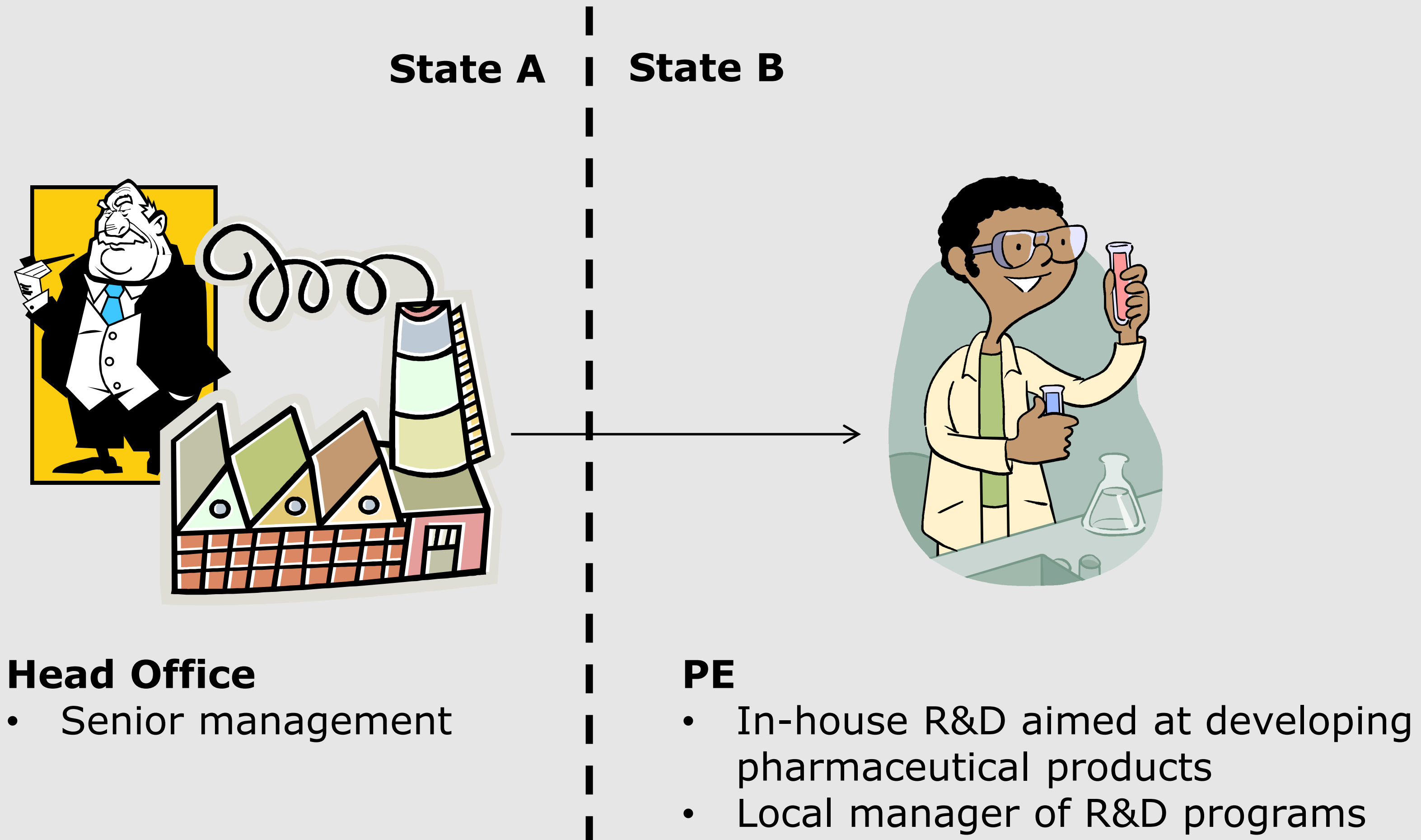
Authorized OECD Approach Step One – Functions

- What are the economically relevant characteristics of the production/distribution functions (e.g. business strategy, decisions regarding product to be manufactured, inventory management, etc.)?
- Where are the significant people functions performed (i.e., Head Office and/or PE?
- What activities do other parts of the enterprise perform on behalf of the PE?
- What activities does the PE perform on behalf of other parts of the enterprise?

Authorized OECD Approach Step One – Assets

- The functional analysis has to determine:
  - The extent to which assets of the enterprise are economically owned by and/or used by the PE
  - The conditions under which those assets are used by the PE (e.g. as joint or sole owner, licensee, member of a cost contribution agreement)
- Economic ownership lies upon the performance of significant people functions relevant to the assumption of risks
- Tangible assets:
  - Broad consensus to generally take into account the "use" as a basis for attributing economic ownership (pragmatic solution)
- Intangible assets:
  - Key issues which require an in-depth case-by-case analysis:
    - Which part(s) of the enterprise is(are) the economic owner of intangible property?
    - What is the impact of intangible property on profits generated by the enterprise as a whole and by the PE?

Authorized OECD Approach
Step One – R&D Example



Authorized OECD Approach Step One – Attribution of Assets

- Should the PE be deemed the economic owner of the IP developed?
  - Where does the active decision-making with respect to the R&D programs occur?
  - What is the role of senior management with respect to the R&D programs?
  - Does senior management simply say yes or no to the proposals of the programs' local manager?
  - Who designs the testing specifications and processes within which the R&D is conducted?
  - Who reviews and evaluates the data produced by these tests?
  - Who sets the program milestones at which key decisions are taken?
  - Who takes the decisions at these milestones on whether to commit further resources to (or to abandon) the R&D project?

Authorized OECD Approach Step One – Risks

- Risks cannot be attributed to the PE on basis of contractual arrangements because it is the enterprise as a whole that legally bears all the risks

- Under the AOA, risks are attributable to the PE to the extent that the significant people functions relevant to the assumption those risks are performed by its personnel at its premises

  - The Significant people functions are those involved in the active decision making with regard to the assumption of the risks

  - To the extent that risks are assumed by the enterprise as a result of significant people functions performed by the PE, the assumption of those risks should be taken into account when attributing profit to the PE (i.e. attribution of extra-profits or losses)

Authorized OECD Approach Step One –Rights and Obligations

- Identification of the transactions performed by the enterprise with separate entities which should be hypothesized as being entered into by the PE according to the functions performed, the assets used and the risks assumed

- The PE’s profits (or losses) related to those transactions can be computed
  - Directly (in the case of transactions with unrelated enterprises); or
  - Through the application of the TPG by analogy (in the case of transactions with related enterprises)

Authorized OECD Approach Step One – Capital

- "**Free" capital:** *an investment which does not give rise to an investment return in the nature of interest that is deductible for tax purposes under the rules of the host country of the PE*

- The AOA requires that, **for tax purposes only**, an appropriate portion of the enterprise's "free" capital be "fictitiously" attributed to its PE according to the functions perfomed, the risks assumed and the asset used by the PE

- Different approaches to determine the "free" capital:
  - **Capital allocation** (allocation based on proportion of assets and risks attributed to the PE)
  - **Thin capitalization** (PE attributed same amount of "free" capital as independent enterprise performing same or similar activities under same or similar conditions)
  - **Other methods** (insurance sector)

Authorized OECD Approach Step One – Recognition of dealings

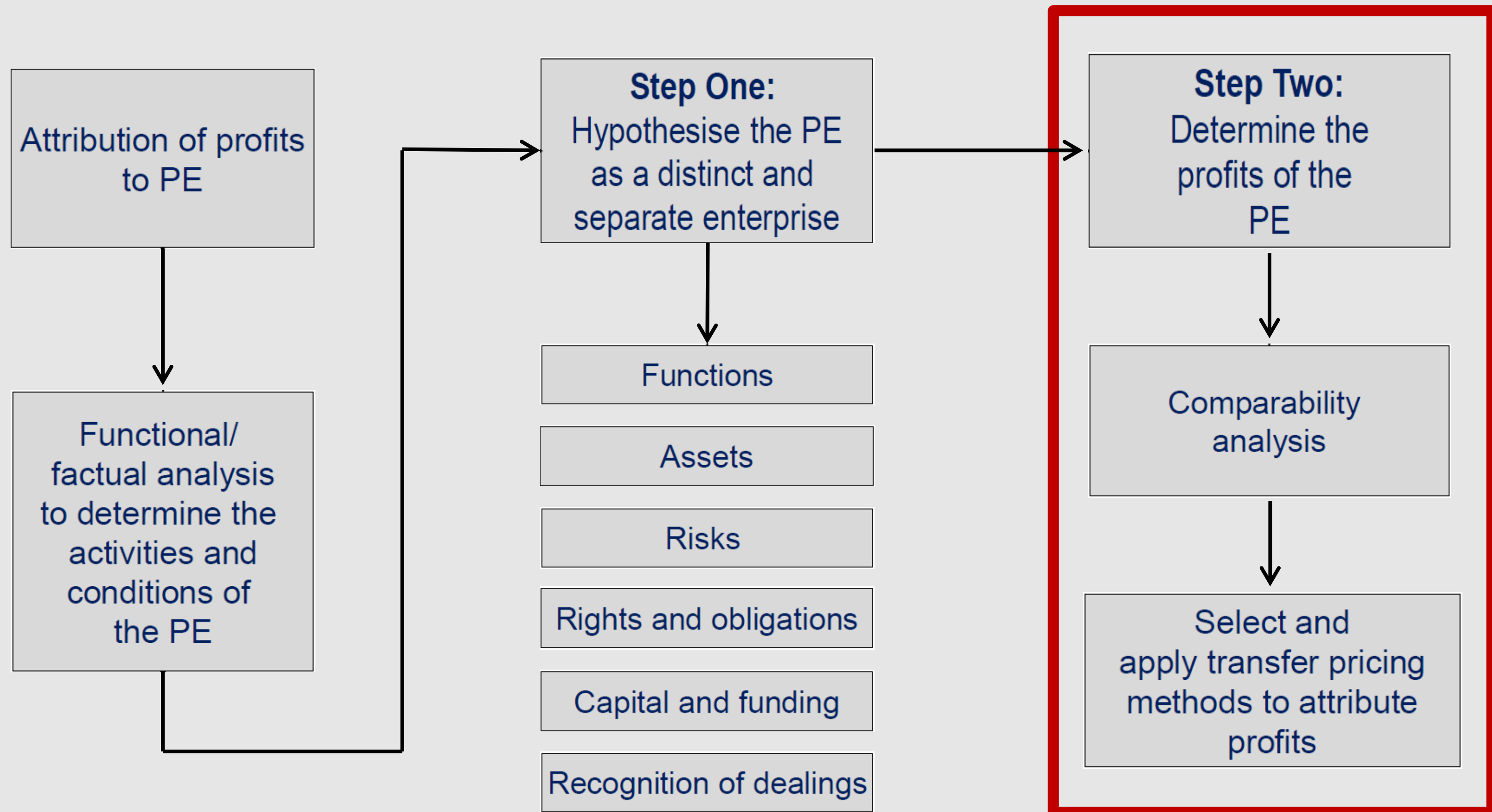
- Hypothesizing the PE as a separate entity requires identifying and determining the nature of the PE's dealings with the rest of the enterprise of which it is a part

- A dealing will be recognised if it concerns with a real and identifiable event, *i.e.* an economically significant transfer of risks, responsibilities and benefits
  - Functional and factual analysis
  - Application by analogy the guidance in Chapter 1 of the TPG on contractual terms

- Starting point: accounting records and internal documentation – analogous to contractual terms of transactions

- Taxpayers are encouraged to document their dealings

Authorized OECD Approach



Authorized OECD Approach Step Two

- Compare dealings between the PE and the enterprise of which it is a part with uncontrolled transactions
  - Application of the comparability analysis enshrined in the TPG by analogy
  - Comparability: none of the differences (if any) between the dealing and the transaction materially should affect the measure used to attribute profits to the PE, or reasonably accurate adjustments can be made to eliminate the material effects of those differences

Authorized OECD Approach Step Two

- Determination of the arm's length remuneration of the Internal Dealings by selecting the most appropriate method to the circumstances of the case applying by analogy the TPG

- No double-counting: to the extent that another part of the enterprise has incurred costs related to a dealing with the PE and those costs have been reflected in the arm's length price for that dealing, these costs should not be allocated to the PE

- It may be necessary to take into account expenses incurred by the enterprise for the purposes of the PE, where such expenses represent functions (performed by other parts of the enterprise) for which compensation would be charged at arm's length