LIUC – Università Carlo Cattaneo

International Tax Law
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Transfer pricing

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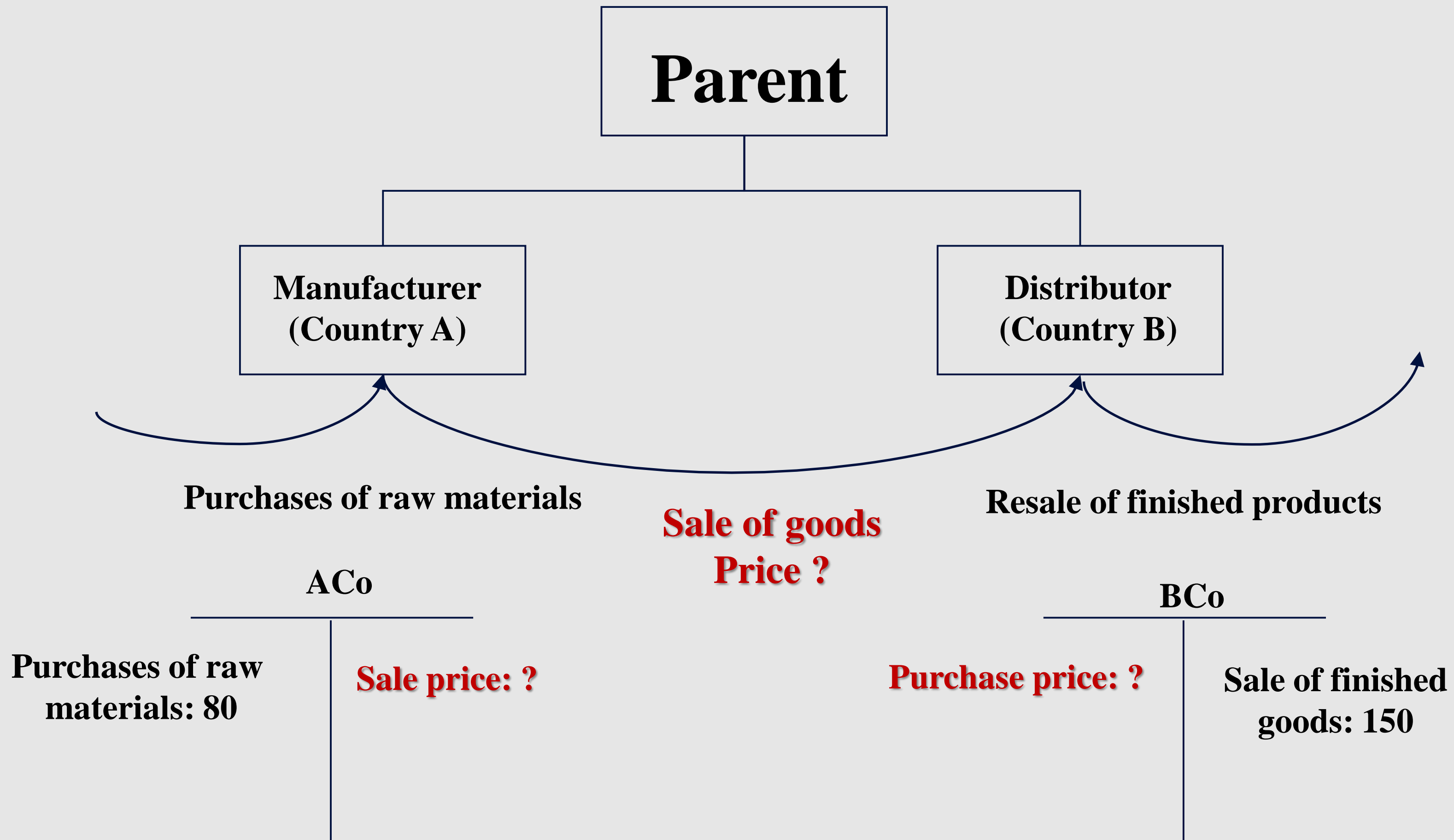
THE ISSUE

Transfer Pricing



International legal framework

- **International Legal framework**:
  - Article 9(1) and (2) of the OECD Model Convention (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)

International legal framework

- OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (luglio 2017): specific reference in the OECD MC
- Art. 9 (1) OECD Commentary (par. 1): "*Its conclusions are set out in the report entitled Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, which is periodically updated to reflect the progress of the work of the Committee in this area. That report represents internationally agreed principles and provides guidelines for the application of the arm's length principle of which the Article is the authoritative statement*".

Associated enterprise

- The concept of associated enterprise in Art. 9(1):

(1). Where:

a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or

b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

and in either case ***conditions are made or imposed*** *between the two 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****.*

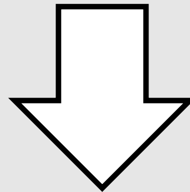
Associated enterprise

- The concept of associated enterprise in Art. 9(2):

(2). Where a Contracting State includes in the profits of an enterprise of that State — and taxes accordingly — profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State ***if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits****. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other.*

Associated enterprise

Chapter I of the TPG: by seeking to adjust profits by reference to the conditions which would have obtained between independent enterprises in comparable transactions and comparable circumstances, **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.



The "**comparability analysis**" (i.e., the analysis of the controlled and uncontrolled transactions) is at the heart of the application of the ALP

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**

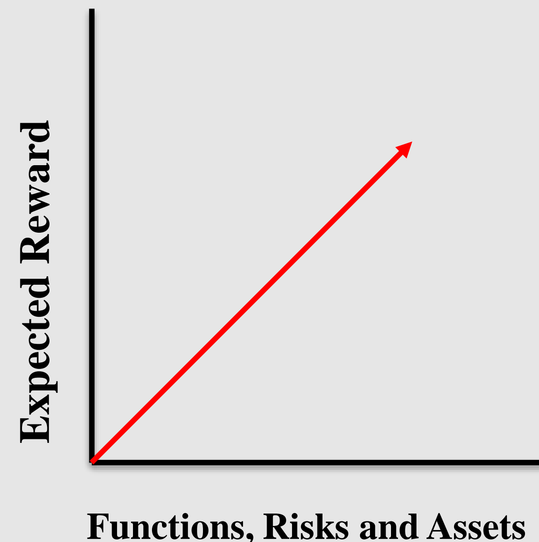
3. **Selection of the most appropriate transfer pricing method** (determination of an(a range of) arm's length price(s) or profit(s))

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** are they 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:
    - o Innovation and new product development;
    - o Degree of diversification;
    - o Risk aversion;
    - o Assessment of political changes;
    - o Market penetration strategies.
- **Why** are they 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 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**).

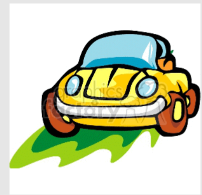
Comparable uncontrolled price method (CUP)

- 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.

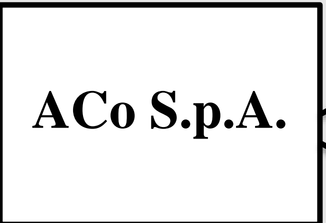
Comparable uncontrolled price method (CUP)

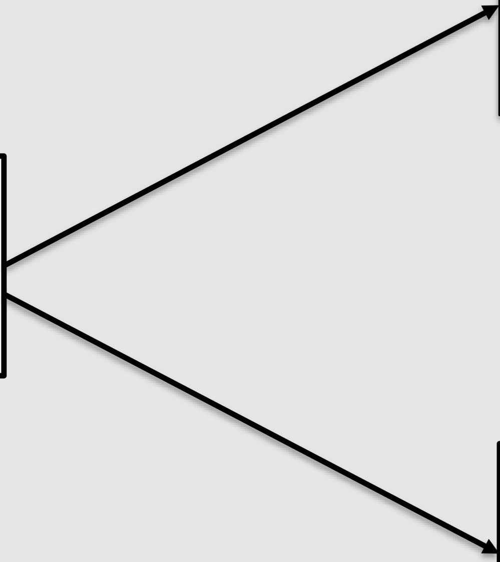
Internal comparison

Third party

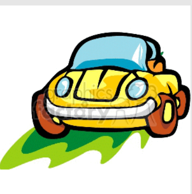


Price: 150





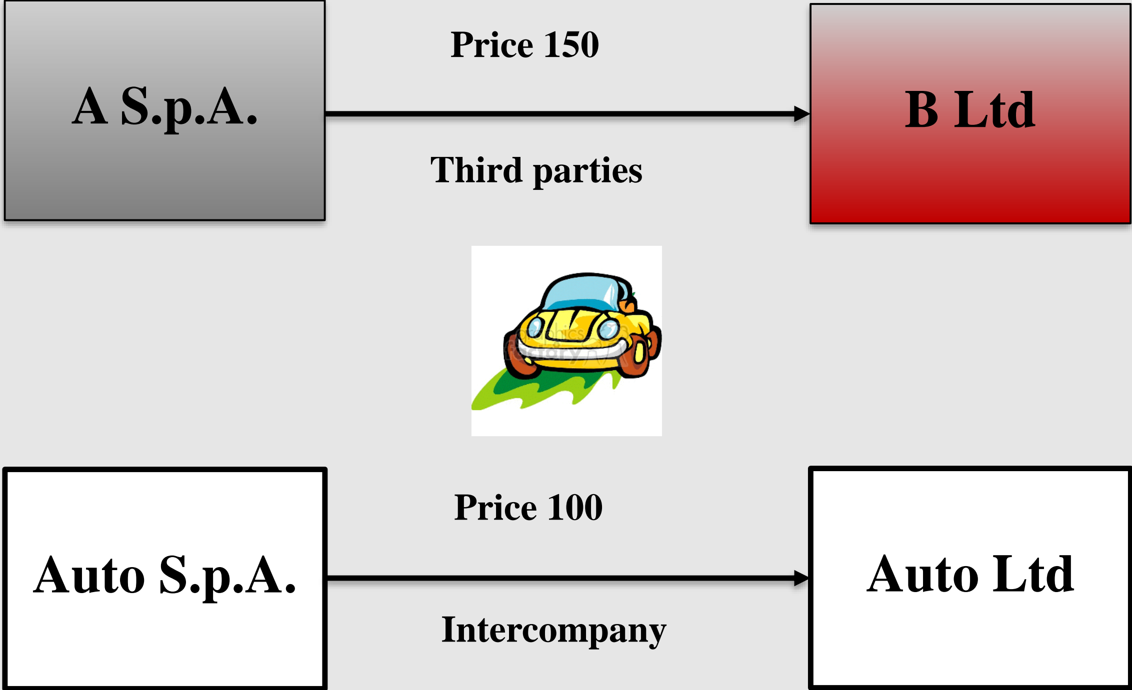
Intercompany



Price: 100

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)

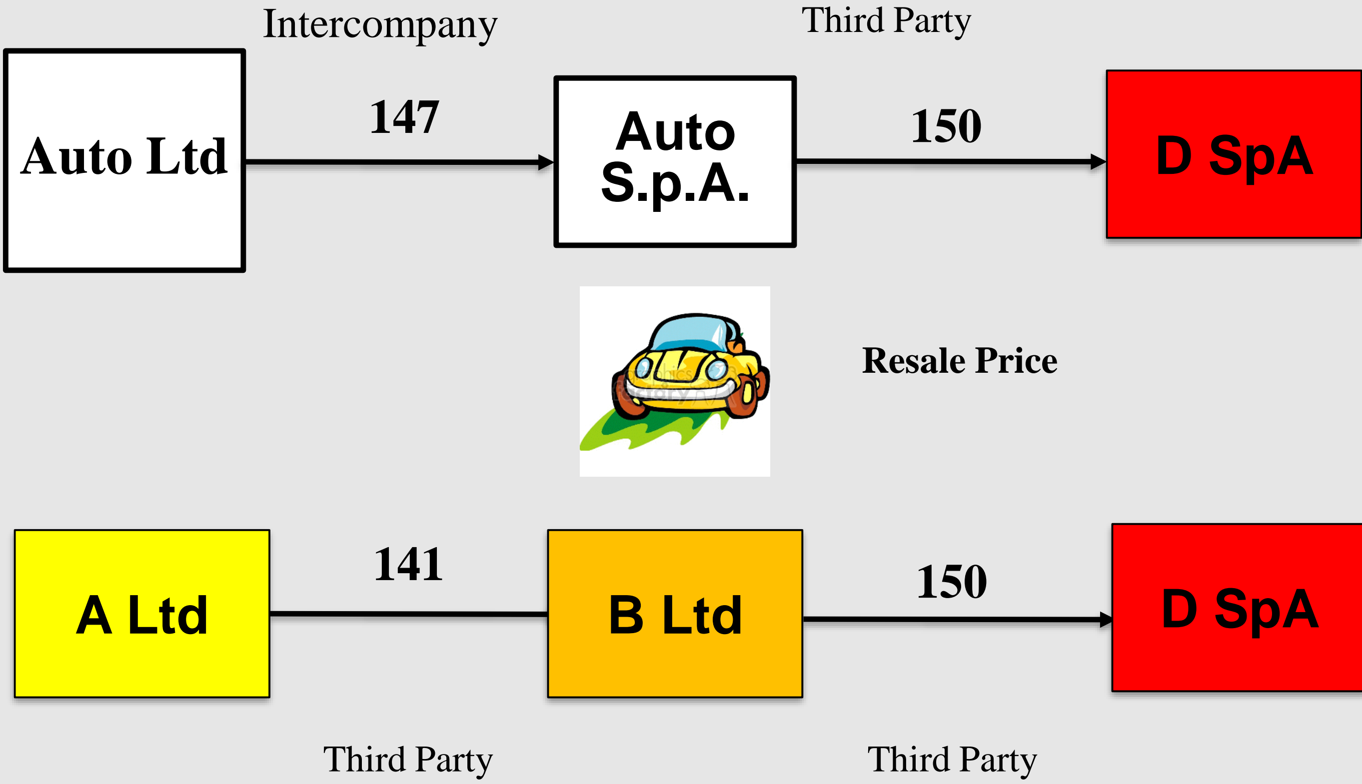
- **Comparison of the Resale Price Margin realized by the enterprise in its IC transaction with**:

  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 not between Prices**

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 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
Costs of sales	-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;

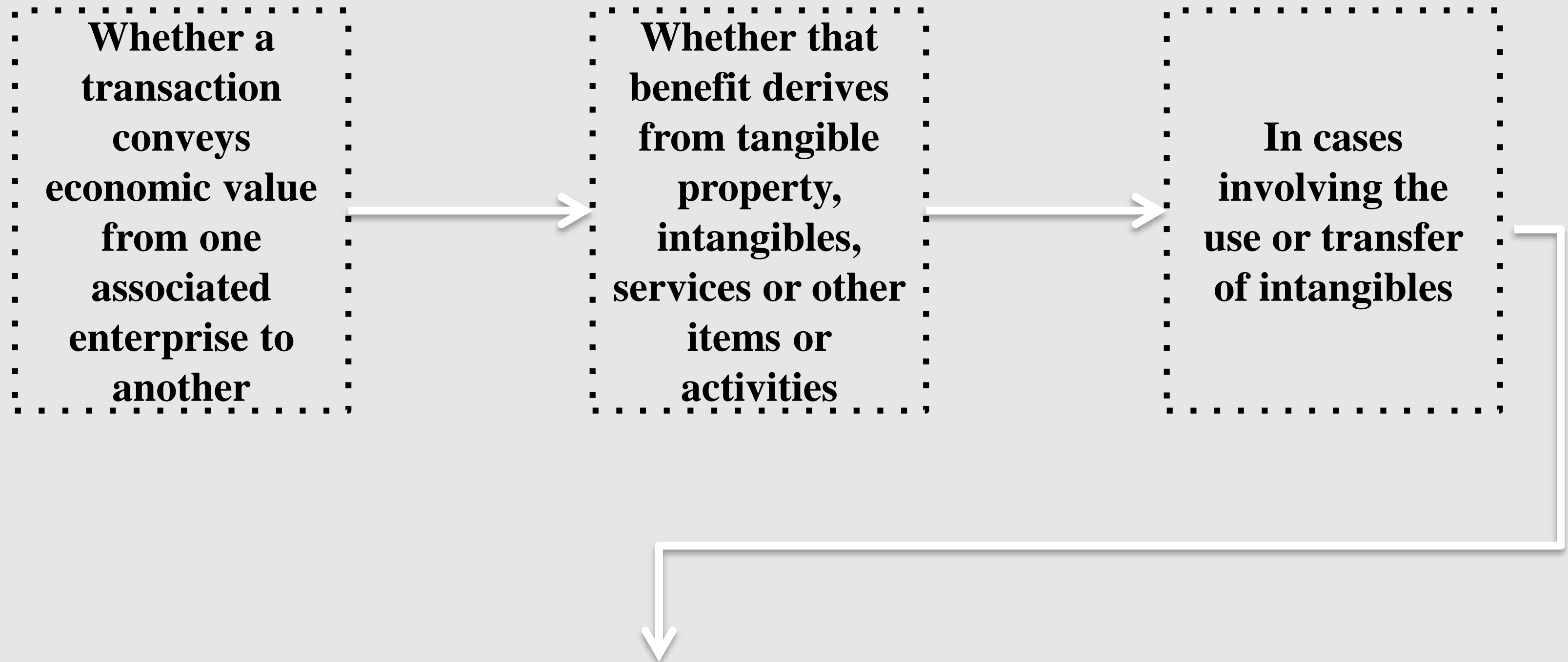
   b) Allocation of the **residual profit** (or loss) between the related parties based on market parameters and depending on the facts and circumstances of the case.

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;

TRANSFER PRICING AND TRANSACTIONS INVOLVING INTANGIBLES

Chapter VI OECD TPG



Chapter VI provides guidance specially tailored to determining arm's length conditions for transactions that involve the use or transfer of intangibles

Definition of intangible

- Broad definition
- The word «**intangible**» is intended to address someting:
  - which is not a physical asset or a financial asset;
  - whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances;
  - which is capable of being owned or controlled for use in commercial activities.

Definition of intangible

- Autonomous definition of «**intangible**» for TP purposes:
  - Intangibles that are important to consider for transfer pricing purposes are not always recognized as intangible assets for accounting purposes;
  - Not all intangibles deserve compensation separate from the required payment for goods or services in all circumstances, and not all intangibles give rise to premium returns in all circumstances;
  - Separate transferability is not a necessary condition for an item to be characterized as an intangible for transfer pricing purposes.

Categories of intangibles

- **Marketing intangible**
  - An intangible that relates to marketing activities, aids in the commercial exploitation of a product or service and/or has an important promotional value for the product concerned.
    - Trademarks
    - Trade names
    - Customer Lists
    - Customer relationships
    - Proprietary market
    - Customer data

- **Trade intangible**
  - An intangible other than a marketing intangible
    - Patents
    - Know-how and secrets
    - Designs

Transaction involving the use or transfer of intangibles

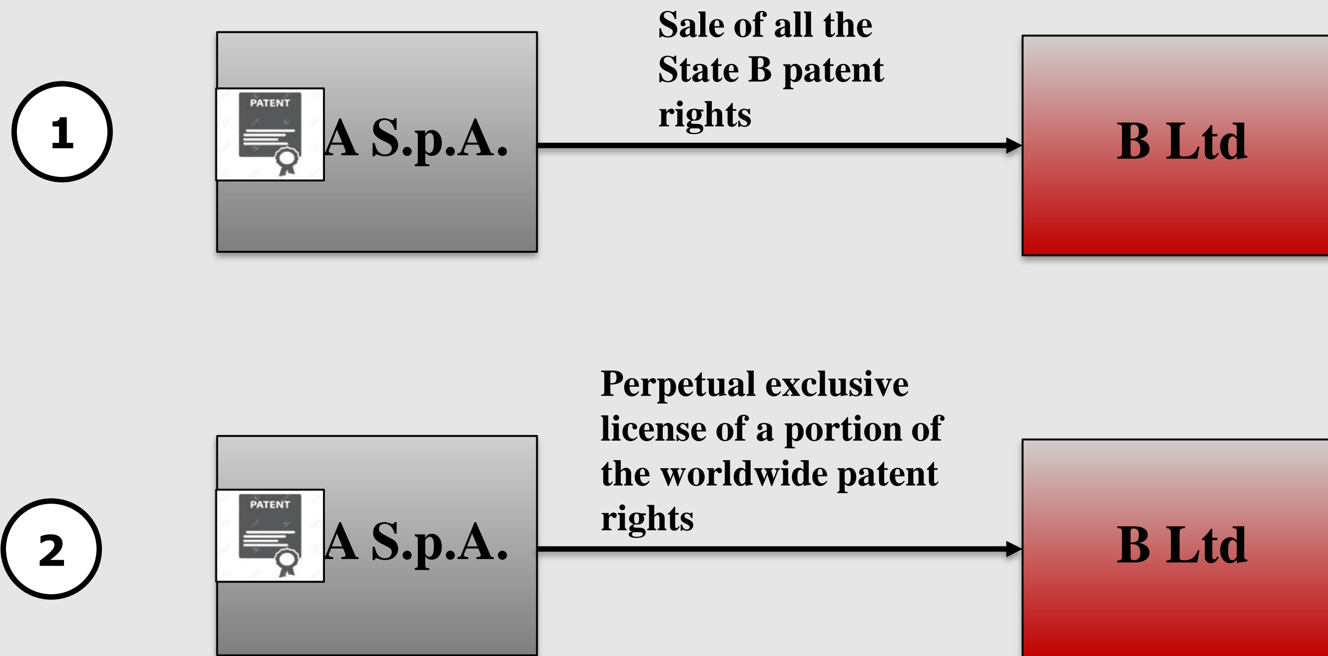
- In transfer pricing cases involving intangibles, the determination of the entity or entities within an MNE group which are ultimately entitled to share in the returns derived by the group from exploiting intangibles is crucial.
- The ultimate allocation of the returns derived by the MNE group from the exploitation of intangibles, and the ultimate allocation of costs and other burdens related to intangibles among members of the MNE group, is accomplished by compensating members of the MNE group for functions performed, assets used, and risks assumed in the **Development, Enhancement, Maintenance, Protection and Exploitation of intangibles ("DEMPE" functions)**

Transaction involving the use or transfer of intangibles

- **Transactions involving transfers of intangibles or rights in intangibles**
  1. Transfers of intangibles or rights in intangibles
  2. Transfers of combinations of intangibles
  3. Transfers of intangibles or rights in intangibles in combination with other business transactions

- **Transactions involving the use of intangibles in connection with sales of goods or performance of services**

1. Transfers of intangibles or rights in intangibles



The labels applied to transactions do not control the transfer pricing analysis

2. Transfers or combination of intangibles

In considering transactions involving transfers of combinations of intangibles, two related issues often arise:

1. the nature and economic consequences of interactions between different intangibles (e.g. a pharmaceutical product will often have associated with it three or more types of intangibles);
2. the importance of ensuring that all intangibles transferred in a particular transaction have been identified (e.g. the transfer of rights to use a trademark under a license agreement will usually also imply the licensing of the reputational value, sometimes referred to as goodwill associated with that trademark).

3. Transfers of intangibles or rights in intangibles in combination with other business transactions

Intangibles or rights in intangibles may be transferred in combination with tangible business assets or in combination with services

- In some cases, it is possible to separate transactions in tangible goods or services from transfers of intangibles or rights in intangibles for purposes of conducting a transfer pricing analysis (e.g. franchising) **disaggregation of the price package.**

- In some cases, the provision of a service and the transfer of one or more intangibles may be so closely intertwined that it is difficult to separate the transactions for purposes of a transfer pricing analysis (e.g. software and maintenance services): **determination of the arm's length price on an aggregate basis**

Transactions involving the use of intangibles in connection with sales of goods or performance of services

Intangibles may be used in connection with controlled transactions in situations where there is no transfer of the intangible or of rights in the intangible

- Any relevant intangibles used by either of the parties in connection with the controlled transaction should be identified and taken into account in the comparability analysis, in the selection and application of the most appropriate transfer pricing method for that transaction, and in the choice of the tested party

Comparability analysis

Comparability analysis involving transfers of intangibles or rights in intangibles may consider the following elements

1. Exclusivity
2. Extent and duration of legal protection
3. Geographic scope
4. Useful life
5. Stage of development
6. Rights to enhancements, revisions, and updates
7. Expectation of future benefit

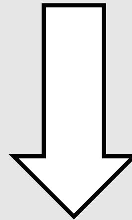
Comparison of risks

In conducting a comparability analysis involving the transfer of intangibles or rights in intangibles, the existence of risks related to the likelihood of obtaining future economic benefits from the transferred intangibles must be considered

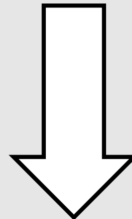
1. Risks related to the future development of the intangibles
2. Risks related to product obsolescence and depreciation in the value of the intangibles
3. Product liability and similar risks related to the future use of the intangibles.
4. Risks related to infringement of the intangible rights

Comparability adjustments

Differences between intangibles can have significant economic consequences that may be difficult to adjust for in a reliable manner



If reliable comparability adjustments are not possible



it may be necessary to select a transfer pricing method <u>that is less dependent</u> on the identification of comparable intangibles or comparable transactions

Selection of the most appropriate method in case involving intangibles

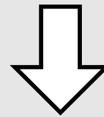
- **General principle**
  - Depending on the specific facts, any of the five OECD transfer pricing methods described might constitute the most appropriate transfer pricing method to the circumstances of the case where the transaction involves a controlled transfer of one or more intangibles.

- **One sided methods**
  - However, one sided methods, including the resale price method and the TNMM, are generally not reliable methods for directly valuing intangibles.

- **Most appropriate methods**
  - The transfer pricing methods most likely to prove useful in matters involving transfers of one or more intangibles are the CUP method and the transactional profit split method.

CUP

Where reliable comparable uncontrolled transactions can be identified, the CUP method can be applied to determine the arm's length conditions for a transfer of intangibles or rights in intangibles

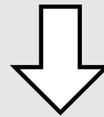


Particular consideration must be given to the comparability of the intangibles or rights in intangibles transferred in the controlled transaction and in the potential comparable uncontrolled transactions

In case of intangibles transferred to a member of the MNE group in a controlled transaction immediately following the acquisition, the price paid for the acquired intangibles will often (after any appropriate adjustments, including adjustments for acquired assets not re-transferred) represent a useful comparable for determining the arm's length price for the controlled transaction under a CUP method

Profit Split Method

Where it is not possible to identify reliable comparable uncontrolled transactions for a transfer of intangibles or rights in intangibles



Application of a transactional profit split method

The transactional profit split method seeks to establish arm's length outcomes or test reported outcomes for controlled transactions in order to approximate the results that would have been achieved between independent enterprises engaging in a comparable transaction or transactions

Profit Split Method

- The main strength of the profit split method is that it can offer a solution for cases where both parties to a transaction contribute unique and valuable intangibles to the transaction.
- The profit split method may be the most appropriate method for a transfer (including rights in intangibles) of
  - Fully developed intangibles
  - Partially developed intangibles
- High uncertainty in case of hard-to-value intangibles

Profit Split Method

- A weakness of the transactional profit split method relates to difficulties in its application
- In evaluating the reliability of transactional profit split methods, however, the availability of reliable and adequate data regarding combined profits, appropriately allocable expenses, and the reliability of factors used to divide combined income should be fully considered
- Caution should be exercised in applying profit split approaches to determine estimates of the contributions of the parties to the creation of income in years following the transfer, or an arm's length allocation of future income, with respect to partially developed intangibles