

## Transfer Pricing

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### What is Transfer Pricing?

- Transfer pricing is used to justify the arm's length nature of inter-company pricing arrangements between related parties operating in different tax jurisdictions
- Cross border transactions between related entities: applies to transactions relating to goods, services, assets and financing
- Arm's length principle → related parties should undertake transactions under the same terms and conditions as unrelated parties
- Principle is universal → countries enact laws to implement principles



## Why is Transfer Pricing relevant?

- Objective of Tax Authorities → Maximize tax payments in their jurisdictions
- Objective of Tax Payers → Rationalise global tax costs / Avoid double taxation / Avoid Disputes with Tax Authorities
- Strong focus of MNEs and Tax Authorities globally
- Most countries have transfer pricing regulations and adhere to the arm's length principle - most countries have documentation requirements
- Transfer pricing audits are becoming more common – high stakes for MNEs / Increasingly stringent penalties for failure to comply

## Relevance of OECD in Transfer Pricing

- Organization for Economic Co-operation and Development ("OECD") is an organization of more than 30 countries
- OECD has published Transfer Pricing Guidelines for Multinational Enterprises
- Provides guidance for application of the arm's length principle → remuneration to be commensurate with functions, risks and assets (Functional Analysis)
- Provides framework for determination of the arm's length price for the transactions between two related parties
- Prescribes methods to determine the arm's length price

## Arm's Length Principle

- Internationally accepted yardstick to ensure correct and fair transfer prices in each jurisdiction
- Arm's Length Price → price at which two independent / unrelated parties enter into business transactions
- Arm's Length Range → range of results that are acceptable for establishing whether the terms & conditions (price / profit) of a controlled transaction are arm's length
- Controlled transaction → transaction between related parties
- Uncontrolled transaction → transaction between two independent / unrelated parties

## Associated Enterprises / Related Parties

- Association / relation through management / control / capital of other enterprise
- Management → one enterprise or person having right to nominate persons to manage the affairs of the other enterprise
- Control → one enterprise being economically dependent on the other enterprise or person e.g. provision of technical know how, purchase of majority of finished goods, use of trade mark, etc.
- Capital → an enterprise or person subscribes to the share capital or provides loans to the other enterprise

## What should a Transfer Pricing study include?

- Understanding of the tax payers overall business, group structure, transactions with related and unrelated parties, intercompany agreements etc.
- Functional analysis → description of functions undertaken, risks assumed and assets owned by each party to the transaction
- Industry analysis → analysis of industry of the tax payer (markets, drivers, competitors, customers etc.)
- Economic analysis → Choice (incl. rationale) of transfer pricing methodology & evidence that the chosen method results in an arm's length outcome (e.g. benchmarking study)

## Functional Analysis - an introduction

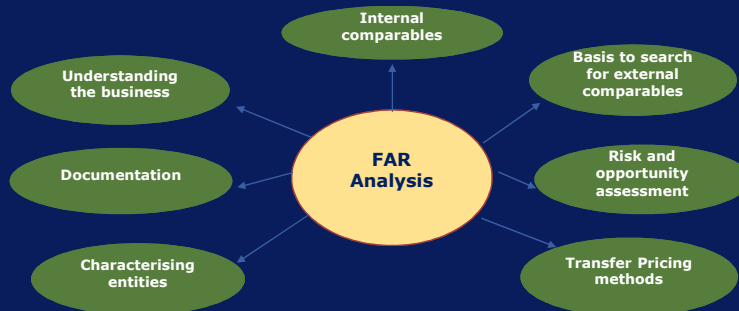
- Functional analysis is an exercise to determine and document / map the significant economic activities performed by the tax payer and its related parties in a particular transaction or set of transactions
- Significant economic activities have a bearing on the price charged by an enterprise
- A functional analysis is not limited to functions only, risks and assets also play a crucial role → referred to as Functions, Risks, Assets (FAR) analysis
- Based on the FAR analysis, different related parties to the transaction are characterised → selection of tested party, choice of transfer pricing method & remuneration model, comparability with external companies etc.

## What goes into a functional analysis?



- Interviews with responsible people within the tax payer
- Analysis of financial statements and websites

## What comes out of FAR analysis?



## Transfer Pricing methods

### Traditional Methods

- Comparable Uncontrolled Price Method (CUP)
- Resale Price Method (RPM)
- Cost Plus Method (COST+)

### Transaction based methods

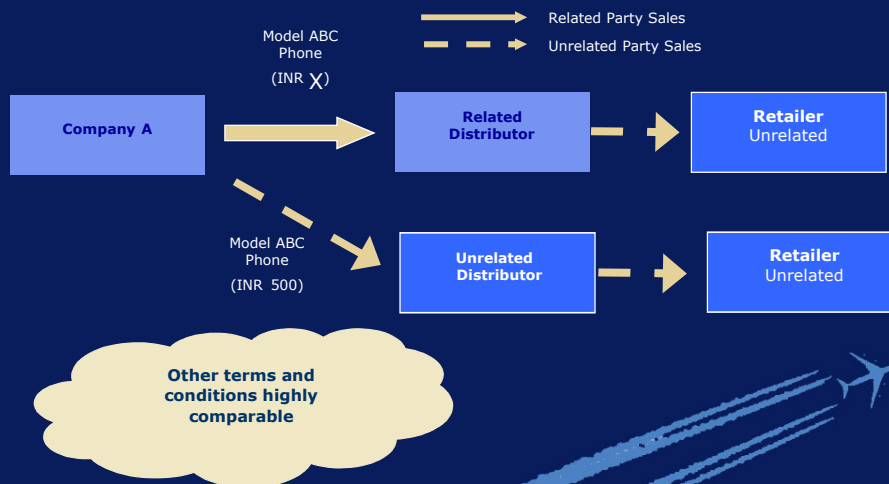
- Profit Split Method (PSM)
- Transactional Net Margin Method (TNMM) / Comparable Profit Method (CPM)

### Unspecified Methods

## Comparable Uncontrolled Price ("CUP") Method

- Arm's length price is measured directly by comparison to one or more comparable uncontrolled transactions
- Comparable only if high degree of comparability exists between products / services and circumstances or if reliable adjustments can be made
- Comparability factors → quality, volume, market (level and geography), time, alternatives available, and associated intangible property
- Arm's length price is measured directly by comparison to one or more comparable uncontrolled transactions → best method if applicable (rarely used in practice in case of tangible goods)
- May be internal or external

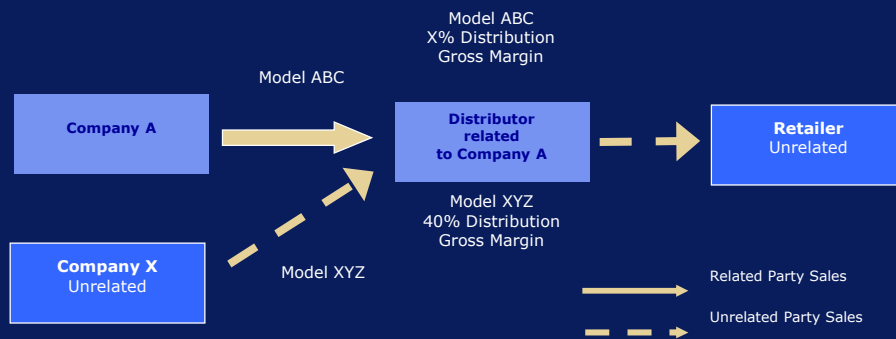
## Comparable Uncontrolled Price ("CUP") Method



## Resale Price Method

- Used for testing transfer of a distributor who adds no value to the products
- Arm's length price = Controlled taxpayer's resale price *minus* arm's length gross profit percentage for tax payer
- Arm's length gross profit should cover the selling, other operating expenses [in light of the functions performed, assets employed and risk assumed] and an appropriate profit
- Comparability depends on functions performed and economic circumstances – broad product comparability
- May be internal or external

## Resale Price Method Illustrated

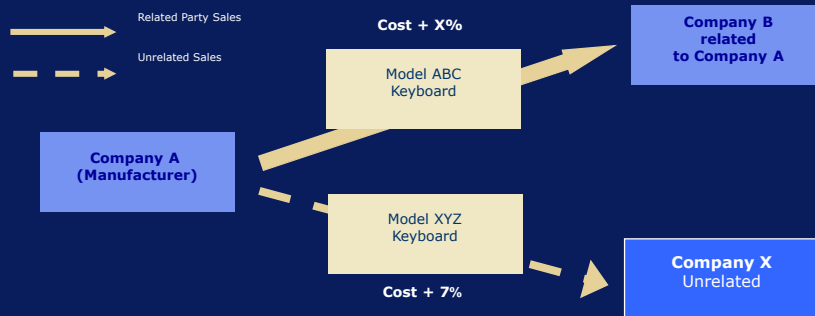


The Distributor purchases and resells similar products from Company A and Company X, performs the same distribution functions and bears the same risks under similar market conditions - Internal Comparable

## Cost Plus Method

- Used for testing transfer prices of manufacturers, assemblers, or others that add value
- Arms Length Price = Cost of production (direct and indirect cost of production) + arm's length mark-up on such costs
- Arm's length mark-up determined with reference to internal / external comparables (uncontrolled)
- Comparability in functions (manufacturing process and complexity, degree of processing / assembly, level of research and development etc.)

## Cost Plus Method Illustrated



Company A sells similar products to an Company B and Company X, performs the same functions and bears the same risks under similar market conditions – Internal Comparable

## Profit Split Method ("PSM")

- Used in case of interdependent and integrated transactions involving valuable intangibles or high-value services
- Involves evaluation of arm's length allocation of the combined operating profit or loss attributable to one or more controlled transaction based on relative value of each controlled taxpayer's contribution to that combined operating profit or loss
- Each taxpayer's relative contribution should reflect the functions performed, risks assumed, and resources employed by each participant
- Complex method – involves subjectivity

## Transactional Net Margin / Comparable Profit Method

- Used for testing the net profit margin of the tax payer from a controlled transactions relative to an appropriate base (benchmarking of profits earned by uncontrolled parties engaged in similar business activities)
- In practice, this is the most commonly used method (although sometimes viewed as last resort – change in OECD view)
- Functional comparability important – always external
- Similar transactions may be aggregated - Not advisable to be applied on company level data if company is involved in a variety of transactions
- Profitability compared using Profit Level Indicators (“PLIs”) - ratios that measure relationships between profits and costs incurred or resources employed (e.g. OM, FCMU etc.)

## Types of business models:

- ✓ Manufacturer:
  - Principal manufacturer
  - Contract manufacturer
  - Toll manufacturer
- ✓ Distributor:
  - Full-fledged / Marketer distributor
  - Limited risk distributor
  - Commission agent
- ✓ Service provider:
  - Risk taking service provider
  - Limited risk service provider
  - Captive service provider

## Types of Transfer Pricing Studies

- Benchmarking study
  - Undertaken to determine the arm's length price in case of newly set-up entities having international transactions or new international transactions
- A full scope study
  - Undertaken to determine whether the values of the existing international transactions meet the arm's length test
  - It involves undertaking:
    - Industry analysis
    - Functional analysis
    - Economic analysis
- Updation study
  - Undertaken to determine whether the values of the existing international transactions meet the arm's length test
  - It involves undertaking only an economic analysis (i.e., the functional analysis of the existing international transactions have remained unchanged from the previous year) and updating industry overview

**Deloitte.**