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OECD Transfer Pricing Methods

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Agenda

- Introduction
- Traditional Transactional Methods
  - Comparable Uncontrolled Price Method
  - Cost Plus Method
  - Resale Price Margin Method
- Transactional Profit Methods
  - Transactional Net Margin Method
  - Profit Split Method

The arm's length principle

- Purpose of a transfer pricing method is described in the **OECD Guidelines 2.1**:

"to establish whether the conditions imposed in the commercial or financial relations between associated enterprises are consistent with the arm's length principle"

- OECD definition based on **Article 9 of the OECD Model Tax Convention**:

'[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 occurred, may be included in the profits of that enterprise and taxed accordingly'

Comparability

OECD Guidelines 1.33-1.63; Chapter III

- Application of the arm's length principle is generally based upon a comparison of the economically relevant characteristics of a controlled transaction with the economically relevant characteristics of transactions between independent enterprises.
- To establish the degree of actual comparability it is necessary to compare the controlled and uncontrolled transactions based on 5 comparability factors:
  - Characteristic of property or services
  - Functional Analysis
  - Contractual Terms
  - Economic Circumstances
  - Business strategies
- The importance of each factor will vary from case to case and depending on the Transfer Pricing method used.

OECD Methods

Traditional transactional methods

Rely on data relating to actual comparable transactions between companies

- Comparable uncontrolled price method (CUP)
- Cost plus method (CP)
- Resale price method (RP)

Transactional profit methods

Rely on companies involved in comparable transactions or on the appropriate apportionment of total profit between related enterprises

- Transactional net margin method (TNMM)
- Profit split method (PSM)

Selection of the most appropriate method

OECD Guidelines 2.2 & 2.11

The appropriateness of the method is based on a consideration of:

- the respective strengths and weaknesses of each method;
- the nature of the controlled transaction;
- the degree of comparability between controlled and uncontrolled transactions; and
- the availability of reliable information needed to apply the selected method.

There is no hierarchy of methods, however:

- Where, after taking account of the above, the CUP and another method can be applied in an equally reliable manner, the CUP method is preferred (OECD Guidelines 2.3).
- Since it provides a direct estimate of the price the parties would have agreed to had they resorted directly to a market alternative to the controlled transaction.

TP Methods - relationship to P&L accounts

Comparable Uncontrolled Price (“CUP”) Method

CUP Method

OECD Guidelines 2.13-2.20

Introduction:

- The method compares the **price charged for property or services** transferred in a controlled transaction to the price charged in a comparable uncontrolled transaction in comparable circumstances.
- Where it is possible to locate comparable uncontrolled transactions, the CUP method is the most direct and reliable way to apply the arm's length principle. Consequently, in such cases the CUP is preferable over all other methods.

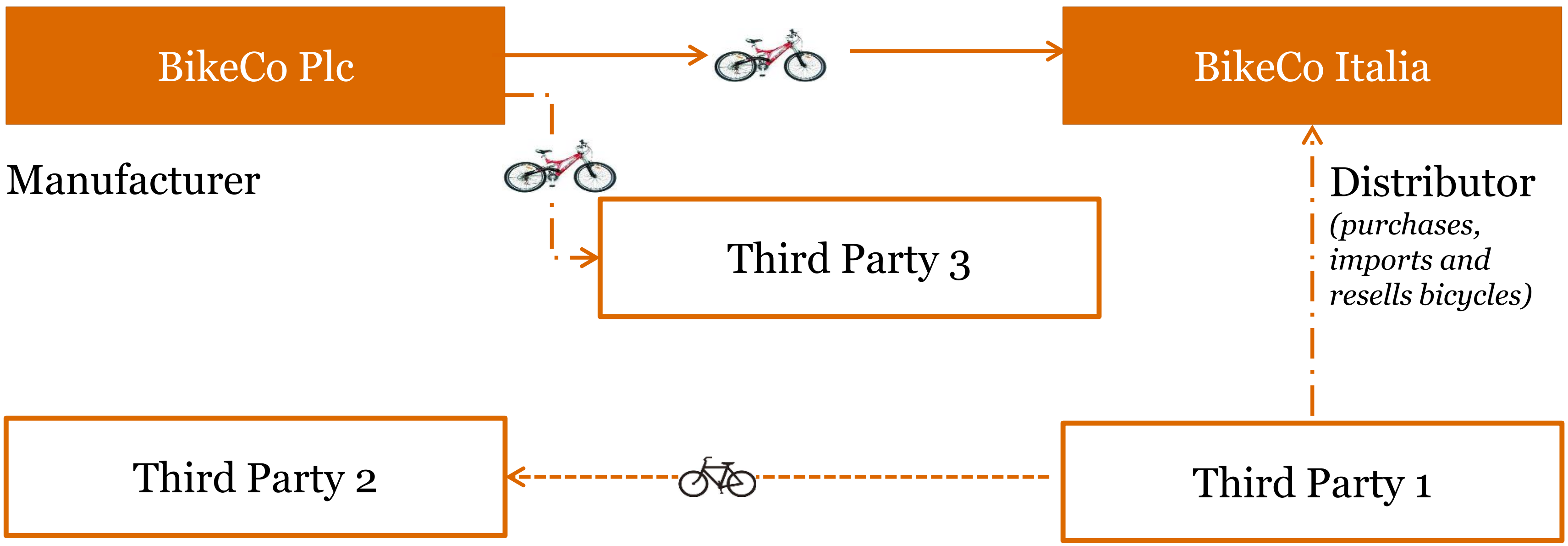
Application:

- Royalties
- Interest rates
- Raw materials, sold on open market (oil, sugar, metals)

CUP Method - Comparability

- The reliability of a CUP analysis is highly dependent upon the comparability in product and contractual terms (e.g. volume, credit terms, shipment, insurance, warranty) between the controlled and uncontrolled transactions.
- Comparable only if the products/services and circumstances are "substantially the same" as in the uncontrolled transaction(s), i.e. where no difference exist which would materially affect the price.
- Reasonably accurate adjustments may be able to be performed to account for differences between the controlled and uncontrolled transaction, where differences can be quantified.

CUP Method
Case Study



Uncontrolled transactions

— · → Internal comparable transaction

----→ External comparable transaction

—→ **Controlled transaction**

CUP Method
Case Study

In which of the following circumstances would you make an adjustment?

Delivery terms

- BikeCo Plc sells similar bicycles to BikeCo Italia and Third Party 3. All relevant information on the controlled and uncontrolled transactions is available to BikeCo Plc. It is noted that the price relating to the controlled transaction is a delivered price (i.e. including transportation and insurance), while the uncontrolled transaction is made ex works, with the buyer taking responsibility from the named place of delivery, which is BikeCo Plc's factory.

Volume of sales and related discounts

- BikeCo Plc sells 5000 bicycles to BikeCo Italia for £90 per bicycle, while it sells 1000 similar bicycles to Third Party 3.

Product characteristics

- The sale of bicycles to Third Party 2 by Third Party 1 involve bicycles on which modifications have been made. However, the bicycles sold in the controlled transactions do not include these modifications.

Contractual terms

- BikeCo Plc sells the bicycles to BikeCo Italia offering a 90 day credit term but the contract terms dictate that all sales to Third Party 3 are Cash On Delivery.

Application of the CUP method post BEPS

How to apply the CUP

- Default method for use in commodity transactions.
- Commodity – physical product for which a quoted price is used a reference.
- How is the CUP applied?
    - Physical comparability
    - Contractual terms eg vol,
    - Period and timing
    - Incoterms
    - Currency

Application of the CUP method post BEPS

How to apply the CUP

- Emphasis on comparability of functions, assets and risks between controlled and uncontrolled transactions.
- If not comparable, reasonably accurate adjustments should be made.

Documentation needed for a CUP

- Price index (emphasis on date) and adjustments to the price index in line with the functionality of the parties to the transaction.

Resale Price ("RP") Method

Resale Price Method

OECD Guidelines 2.21-2.38

Introduction:

- Compares the resale margin (i.e. the gross margin) earned by the tested party with the resale margins earned by comparable independent distributors
- The gross profit represents the amount a reseller would seek to cover its operating expenses and make an appropriate profit (in light of its functions and risks)
- This calculation provides an arm's-length costs of sales (COS) for the reseller.

Application:

- Applicable for analysing transactions involving tangible goods
- Typically used for testing a reseller/distributor who has not added substantial value to the products

Comparability:

- Comparability depends on functions performed and market circumstances
- Less sensitive to small product differences compared to the CUP method

Resale Price Method - illustrated

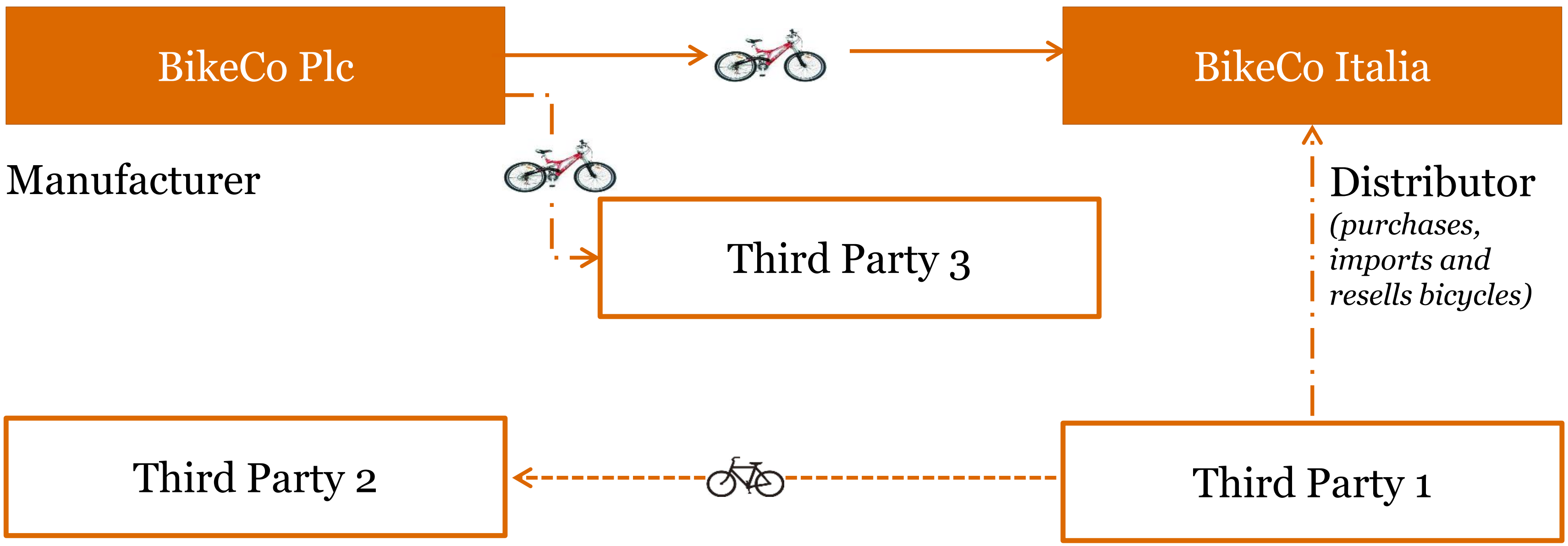
Selling price to third party (b) = £1,000

Resale price margin (20%) = £(200)

Arm's length price (a) = £800

Resale Price Method

Case Study



Uncontrolled transactions

Internal comparable transaction

External comparable transaction

Controlled transaction

Resale Price Method
Case Study

Transactional comparison

- You could determine the gross profit margin that BikeCo Italia earns when reselling bicycles purchased from Third Party 1.
- May initially have been rejected as an internal comparable for purposes of applying the CUP Method because, for example, the transaction involves a different type of bicycle.
- If products are broadly similar with comparable accounting measures of COS, this would make gross margin comparisons sufficiently reliable.

Functional comparison

Involves a search for comparable distribution companies rather than comparable transactions. This could, for example, include comparable distributors of wheelbarrows, carts etc.

Resale Price Method Post BEPS

Compensation for enhancement and development of marketing intangibles

- Traditionally, benchmarking of Bike Co Italia's gross margin against that of comparable independent distributors would have been adequate.
- In accordance with BEPS Action on intangibles, further analysis on the application of the Resale Price Method would be necessary to establish:
    - Legal obligations and rights;
    - Functions, assets and risks;
    - Intangible value to be created through activities; and
    - Compensation provided for the functions performed
    - How do the intangibles related return impact on application of Resale Price Method i.e discount on price , royalty, etc ?

Cost Plus ("CP") Method

Cost Plus Method

OECD Guidelines 2.39-2.55

Introduction:

- An appropriate arm's length "cost-plus" mark-up is applied to costs incurred by the supplier of property or services in a controlled transaction for property transferred or services provided to an associated purchaser.
- Compares the return on costs the tested party earns with the return on costs earned by comparable companies

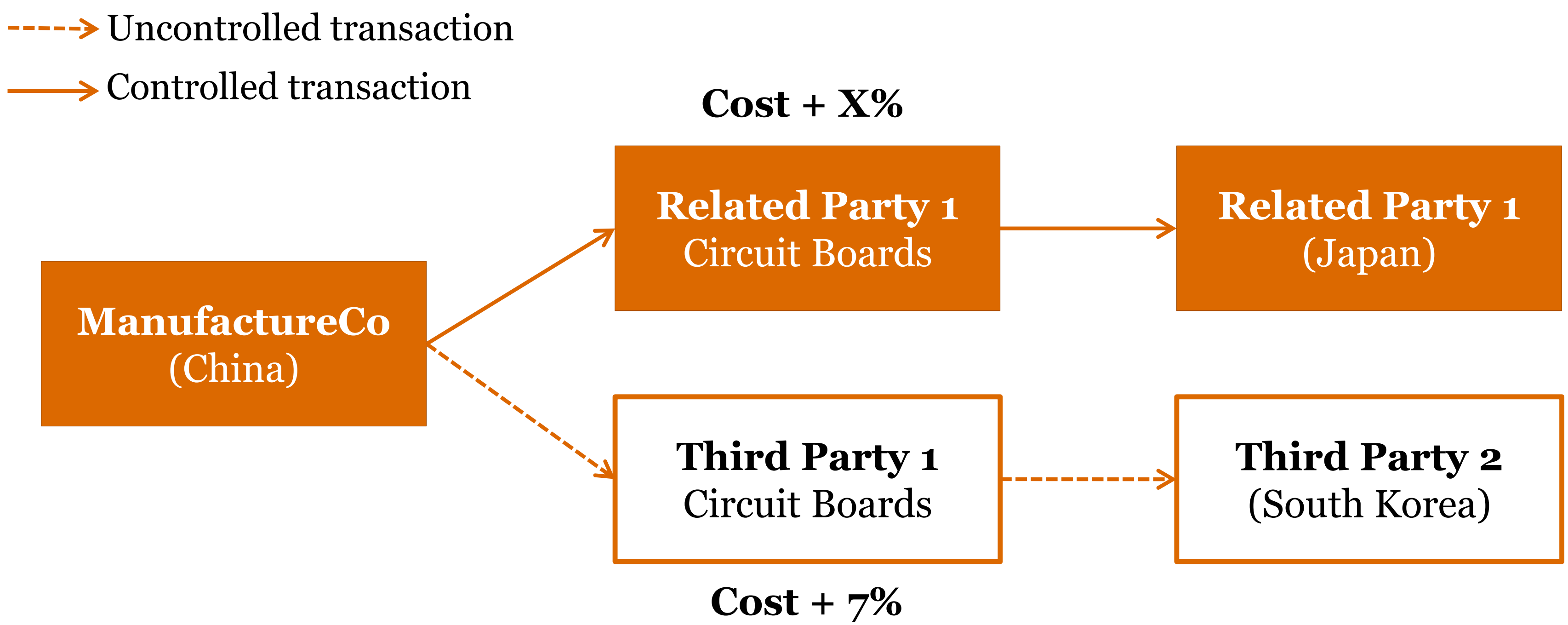
Application:

- Per paragraph 2.39, the method is most useful where:
  - semi-finished goods are sold between related parties
  - there are long-term buy and supply agreements (e.g. contract manufacturing), or
  - the controlled transaction is the provision of services.

Comparability:

- Comparability depends on functions performed and risks borne (e.g. complexity of manufacturing, R&D activities, inventory levels)
- May be difficult to identify the cost base to be marked up

Cost Plus Method - illustrated



If ManufactureCo sells similar products to an unrelated company, performs the same functions and bears the same risks under similar market conditions – sales to Third Party 1 may be considered a Cost Plus Method comparable.

Cost Plus Method – the cost base

- e.g. Comparable enterprises may **classify costs in different ways** in their accounts - some at operating expense level, some at gross margin level.
- **Costs may not be the determinant of the appropriate profit** in a specific case for any one year (e.g. where a valuable discovery has been made and the owner has incurred only small research costs in making it).
- The **costs that may be considered are limited to those of the supplier of goods or services**. This limitation may raise a problem of how to allocate some costs between suppliers and purchasers.

Thus, although in principle the cost plus methodology should compare margins at the gross profit level, the guidelines recognise that there may be practical difficulties in so doing (Guidelines 2.46 - 2.52).

Cost Plus Method
Shortcoming of the Cost plus post BEPS

- The Cost Plus works on the premise that costs are a driver of value and that profits are referenced or reflective of the costs incurred.
- In the post BEPS world, need to further investigate where the value is created (BEPS Action 8 to 10) through a value chain analysis:
  - In an industry where consumers are brand sensitive, a cost based method may not be appropriate.
  - Where a highly valuable product is developed with minimal costs going into R & D, a cost based method may be inaccurate.
  - Comparability of cost structure of tested party vis a vis the comparable very relevant as different cost structures maybe indicative of non comparability.
  - Cost Plus method focuses more on the supplier to the transaction. In the post BEPS world, increased emphasis on a two sided analysis.

Transactional Net Margin Method (“TNMM”)

TNMM

OECD Guidelines 2.58-2.107

Introduction:

- Tests the profitability of the related party against the profitability of "comparable" third parties engaged in similar business activities relative to an appropriate base.
- Profits are compared using Profit Level Indicators ("PLIs"), which are ratios that measure relationships between profits and costs incurred or resources employed, e.g.
  - Operating profit to sales (operating margin)
  - Operating profit to total costs (full cost mark-up)
  - Operating profit to assets (return on assets)
- The TNMM is a "one-sided" method. The 'tested party' is the least complex of the related parties, i.e. performs less functions, has no intangibles, etc.

Application:

- Where there are several varied transactions
- Data for traditional transactional methods is limited (uses operating profits)

TNMM – comparability

The OECD Guidelines makes it clear that to use TNMM should begin by:

- Comparing the net margin which the tested party makes from a controlled transaction with the net margin it makes from an uncontrolled one (an **"internal comparable"**).
- Only where this proves impossible (perhaps because there are no transactions with uncontrolled parties), then the net margin which would have been made by an independent enterprise in a comparable transaction (an **"external comparable"**) may serve as a guide.
  - Functional analysis of the transactions to determine comparability is key
  - It might be possible to adjust results for minor functional differences, provided that there is sufficient comparability to begin with.
- Based on net profits, therefore comparability standards are not as stringent as for traditional transacational methods.
- Fewer issues over inconsistent allocation of costs to COS/OPEX.
- However, the PLI of a company can be influenced by a range of factors that either have no effect or a different effect on gross margins or the actual price of a transaction.

Sensitivity of using a gross vs. a net margin profit indicator

	Distributor (limited marketing)	Distributor (significant marketing)
Sales price (same good/volume/price)	£1,000	£1,000
Purchase price from manufacturer (considers extent of marketing activity)	£600	£480
Gross margin	**£400 (40%)**	**£520 (52%)**
Marketing spend	£50	£150
Other OPEX	£300	£300
Net profit margin	**£50 (5%)**	**£70 (7%)**

Depending on comparability, risk of error could amount to £120 (in case a gross margin method is applied) compared to £20 (in case a net margin method would be applied).

TNMM Post BEPS

In the post BEPS world, the following should be considered in applying the TNMM:

- More focus on a value chain and functional analysis in order to identify who creates and drives value in the business which may have an impact on both selection of tested party and selection of external comparable.
- The TNMM is traditionally a one sided method but in line with the BEPS recommendations, a two sided analysis should be done in order to identify the simpler party to test.

Profit Split Method (“PSM”)

Profit Split Method

OECD Guidelines 2.108-2.145

Introduction:

- Evaluate whether the allocation of the combined operating profit or loss attributable to one or more intercompany transactions is arm's length based on the **relative value of each controlled party's contribution** to that operating profit or loss.

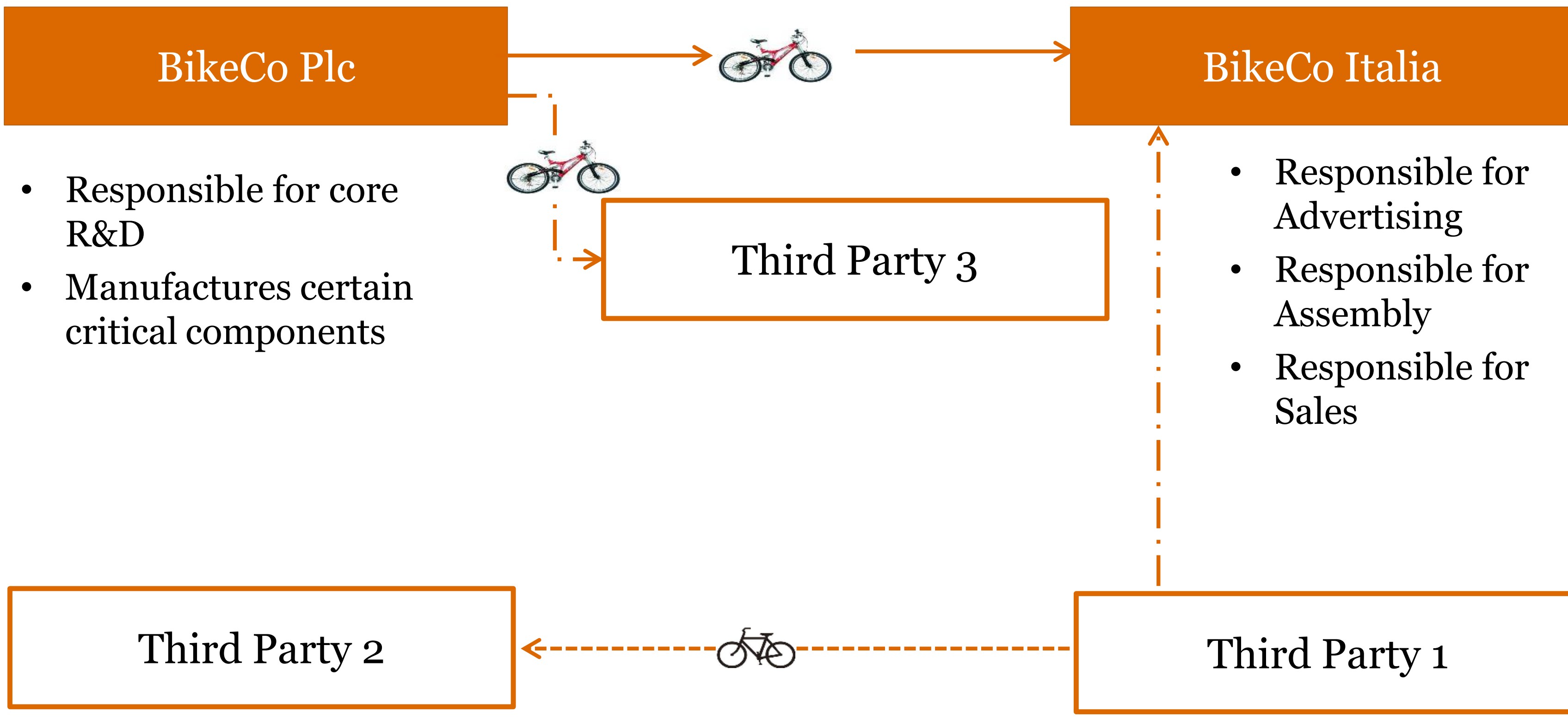
Application:

- Interdependent and integrated transactions exist
- Transactions involve valuable intangibles or high-value services

Comparability:

- Each taxpayer's relative contribution must reflect the functions performed, risks assumed, and resources employed by each participant.

Profit Split Method
Case Study



The profit split method divides the profit or loss that would result from an arrangement between uncontrolled taxpayers, each performing functions similar to those of the various controlled taxpayers engaged in the relevant business activity.

Profit Split Method

There are two types of PSMs:

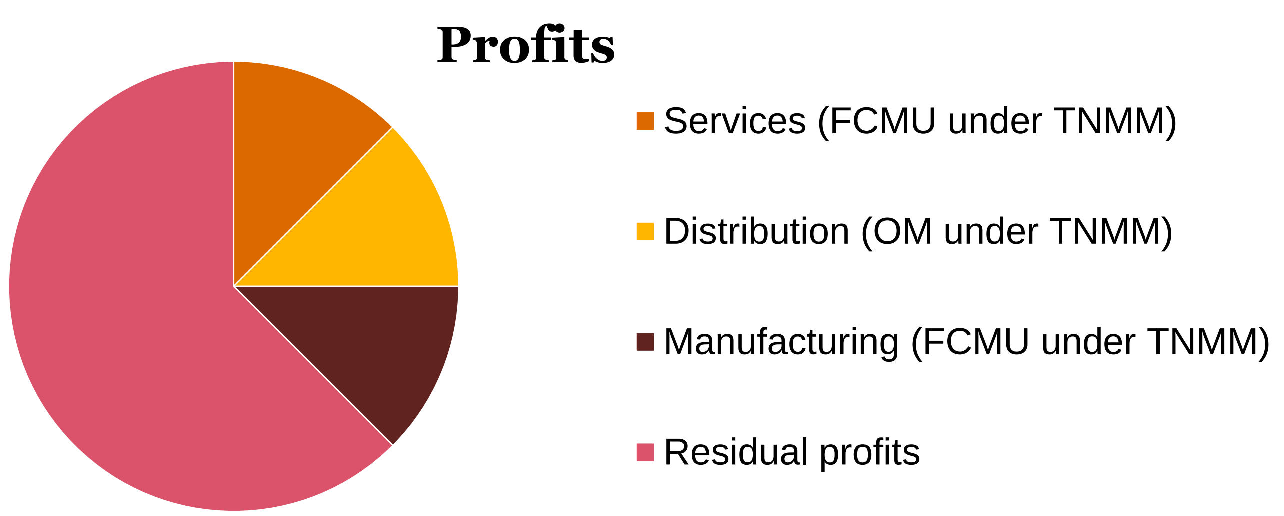
- **<u>Contribution analysis:</u>** the total profits from the controlled transaction(s) are split between the associated enterprises based on the relative value of their functions performed, assets employed and risks borne participating in the controlled transaction(s).

- **<u>Residual analysis:</u>** requires the allocation of market returns to routine functions based on a functional analysis and the allocation of the residual profit in proportion to the relative value of non-routine contributions (e.g. intangibles) as measured by, for example, expenditures related to development of intangible assets.

Profit Split Method
Residual Analysis

The total profits from the controlled transaction(s) are split between the associated enterprises in two stages:

- Each participant is rewarded for its non-unique contributions
- The residual profit is split between each participant based on the relative value of their unique and valuable contributions



Profit split method post BEPS

The Profit Split method as it currently stands is intended to provide solutions for highly integrated operations for which a one-sided method would not be appropriate.

Need to further consider clarifying, improving, and strengthening the guidance on when it is appropriate to apply a transactional profit split method and how to do so.

Further draft guidance expected in 2016, final version in 2017.

Most appropriate method
Potential for the PSM to be misused, depending on the nature of the transaction and functional circumstances of parties

Highly integrated business operations
Significant levels of integration alone should not be enough to justify use of a PSM

Unique and valuable contributions
Further attempts to define “unique” and “valuable”
This will link to revised guidance on intangibles.

Profit splitting factors
Need to ensure that there is a strong correlation between profit allocation factors and value creation

Interaction between profit split and TNMM
Additional guidance to be provided on circumstances where PSM can be used as a secondary ‘sense check’ for TNMM

Synergistic benefits
Additional guidance to be provided on circumstances where PSM could be appropriate for dealing with scenarios with significant Group synergies