



Excerpt from Principles of International Taxation, 7th Edition – Chapter 14 – Transfer Pricing Practice

Basics

14.1

The term 'transfer pricing' simply means the pricing of business transactions between associated persons. Notice that the definition does not mention taxation. When discussing transfer pricing in an international tax context, however, the term is used to represent the artificial manipulation of internal transfer prices within a multinational group, with the intention of creating a tax advantage. For tax purposes, transfer pricing becomes a challenge because of the need to establish the amount of taxable profit for each taxable entity. This will usually be a single company, as most countries do not tax groups of companies as a single entity. It is also important when computing how much profit is attributable to a part of a company that is located in another tax jurisdiction (ie a PE).

Transfer pricing legislation provides a key tool by which governments protect their corporate tax base. To prevent the artificial shifting of profits within multinational groups of companies to countries that provide low effective tax rates, MNEs must be able to demonstrate that intragroup prices are 'arm's length'. This means the prices that would be charged in similar circumstances in a similar transaction between two unrelated parties. If the MNE cannot demonstrate the use of arm's-length pricing, then the tax authority may adjust the profits upwards to what they would have been if arm's-length pricing had been used. Depending on the tax treaty and other relations between the two parties to the transactions, there may or may not be a reciprocal adjustment to tax charged in the other country concerned.

The arm's length-principle is found in Article 9 of the OECD Model Double Tax Convention and is the method recommended in the OECD's influential *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*. It also forms the basis of the US s 482 rules, which tend to be far more detailed. There are two strands to ascertaining an arm's-length price – application of one of the approved methods, accompanied by a functional analysis of the multinational group as regards risk, asset allocation, head office functions assumed, and other factors not apparent at first glance. The approved methods generally consider individual transactions as opposed to a global split of the combined profits of the multinational group.

Because of the fundamental differences in dealings with group companies and those with independent parties, not just in prices charged but also in the types of transactions entered into, it can be extremely difficult to arrive at an arm's-length price. The OECD's BEPS Actions 8–10 deal with particularly problematic aspects of the application of arm's-length pricing rules.

Conceptually, the arm's-length principle is open to much criticism due to the fact that transactions between members of a multinational group are bound, by their very nature, to be considerably different from those between unconnected parties. Some commentators consider

that the global profits of a multinational group would be better split between the relevant tax authorities using an agreed formula rather than trying to impose arm's-length principles.

Although there is a body of thought that transfer prices are not heavily influenced by tax at all, the increasing sophistication of multinational groups, and the potential for reduction of global tax liabilities through manipulation of transfer pricing policies means that tax is likely to be an important driver in the setting of cross-border intragroup prices.

Introduction and key principles

14.2

There are two basic possibilities for allocating taxable profit to the individual entities within a MNE:

- 1 Top down – take the profit of the whole group and divide it between the individual entities ('unitary taxation').
- 2 Bottom up – look at each entity separately and calculate its profit as if it were an independent entity ('separate entity').

The 'separate entity' principle is currently the global norm for taxing MNEs. The separate entity principle allows each country to determine which entities within an MNE (eg subsidiaries or PEs) it is entitled to tax, usually by reference to residence and source principles as we addressed in Chapter 2. Having identified entities which are chargeable to tax in a country, the next step is to devise a mechanism for determining how much profit belongs to each entity. Transfer pricing rules serve this purpose.

Most tax authorities will have legislation aimed at protecting their tax base from manipulative transfer pricing practices by deeming that intra-group transactions must be accounted for, for tax purposes, at market value using the 'arm's-length principle'. However, establishing open market value is not easy. Governments are anxious to ensure that the profits reported by members of multinational groups reflect a fair commercial level of profit. However, they do not want to be so draconian that they fail to attract investment from the multinational groups. This is a particular problem for developing countries.

Transfer pricing disputes between taxpayers and tax authorities are common and are usually settled by negotiation rather than litigation. Only a few cases ever make it to court (although transfer pricing litigation is relatively common in India). The mutual agreement procedure contained in Article 25 of the Model Tax Convention is widely used to resolve transfer pricing disputes. Transfer pricing practices are widely believed to be one of the key ways in which multinationals shift their taxable profits to lower tax countries. Curbing such practices was a key element of the OECD's BEPS Project.

BEPS Actions 8–10 dealt with the difficult issue of aligning transfer prices with value creation, which is important because of concerns that the *Transfer Pricing Guidelines* are open to manipulation – leading to outcomes that don't correspond to the underlying economic activity. Action 8 looks at intangibles, which are particularly difficult to value and ascribe a geographical location to. Action 9 is concerned with the contractual allocation of risks, and the potential for disconnect between the allocation of profits to those risks and the actual activities carried on. Action 10 is focussed on other high risk areas. BEPS Action 13 is concerned with transparency and provides for country-by-country reporting for transfer pricing to provide tax authorities with better information about the geographical location of activities. We consider this and other administrative aspects of transfer pricing in Chapter 15.

Before looking more closely at the OECD BEPS actions relating to transfer pricing, we will first consider the nature of tax transfer pricing, and the way it is dealt with both unilaterally and under bilateral agreements.

Scale of transfer pricing

14.3

During 2004, the UK launched transfer pricing investigations into three major automobile manufacturers: Nissan, Honda and Toyota. The UK subsidiaries of these companies were carrying forward UK tax losses in 2004 in excess of £1 billion.¹ Nissan lost their case and paid an extra £37 million in UK tax.² In 2006, GlaxoSmithKline paid \$3.4 billion extra tax as a result of a US transfer pricing enquiry. In 2008, Glaxo again lost a major transfer pricing case (discussed later in this chapter) which resulted in profits being increased by CAD \$51 million.

A controversial study by Pak and Zdanowicz (2002) undertaken on behalf of Senator Byron Dorgan reported that the total estimated tax loss from manipulative transfer pricing practices by US-based multinationals during 2001 was \$53.1 billion, of which \$12 billion was accounted for by transactions with Japanese group member firms. This study, which was widely reported in the US press, gave examples of blatant price manipulations, such as pairs of tweezers imported from a Japanese member of a group at a price of \$4,896 each and toilet tissue from Chinese group companies at \$4,121 per kg. Briefs and panties were imported from Hungary by one US group member at \$739 a dozen. Such extraordinary pricing within multinational groups also extended to exports; missile and rocket launchers went to Israel at the ridiculously low price of \$52 each, whilst toilet bowls and cisterns went to Hong Kong for \$1.75 a set. Whilst the methods used by Pak and Zdanowicz to arrive at their overall estimate of tax lost have been subjected to considerable criticism,³ their anecdotal evidence certainly attracted the public's attention.⁴

1 *Financial Times*, 22 July 2004.

2 *Daily Telegraph*, 12 November 2004.

3 See for example Fuest, C, and Riedel, N (2009) *Tax evasion, tax avoidance and tax expenditures in developing countries: A review of the literature*, Oxford University Centre for Business Taxation. Available at: www.dfid.gov.uk/r4d/SearchResearchDatabase.asp?OutPutId=181295.

4 For an interesting analysis of some of the misleading statistics that are used in the context of debates about transfer pricing, see Forstater (2015).

The basic problem illustrated

14.4

Example 14.1

Multinat Plc has two trading subsidiaries. One is tax resident in the country of Konganga where the effective rate of corporation tax is 10%. This company extracts and exports greensand, the raw material used in the group's production processes. The open market price for greensand is \$100 per tonne. The other subsidiary is resident in the country of Ruritania, where the effective tax rate is 40%. The Ruritanian subsidiary buys its raw materials in bulk from the Konganga subsidiary. The quantity purchased each year is 80,000 tonnes.

Multinat Plc wishes to instruct the two subsidiaries to adopt a pricing policy that optimizes the after-tax profits for the group as a whole. Questions to be considered are:

- Should the price charged by Konganga for tax purposes be lower or higher than the price it might charge to an unrelated customer?

- Which government might object to the pricing policy and why?

	Tonnes 000s	Intragroup price per 1000 tonnes (\$000)		
		100	70	130
Accounts of Konganga subsidiary:				
Sales to Ruritanian subsidiary	80	8,000	5,600	10,400
Sales to other customers \$100 per tonne	200	20,000	20,000	20,000
	280	28,000	25,600	30,400
Deduct				
fixed and operating costs		15,000	15,000	15,000
Net profit before tax		13,000	10,600	15,400
Konganga tax at 10%		1,300	1,060	1,540
Profit after tax		11,700	9,540	13,860
Accounts of Ruritanian subsidiary				
Sales		20,000	20,000	20,000
Purchase of raw materials from Konganga		8,000	5,600	10,400
Other fixed and operating costs		5,000	5,000	5,000
Profit before tax		7,000	9,400	4,600
Ruritanian tax at 40%		2,800	3,760	1,840
Profit after tax		4,200	5,640	2,760
Tax in Konganga				
		1,300	1,060	1,540
Tax in Ruritania				
		2,800	3,760	1,840
Combined tax liabilities		4,100	4,820	3,380

Setting the price at \$70 per tonne produces an increase in the global tax liability whereas setting it at \$130 per tonne produces a reduction. Given that the combined profit before tax is \$20,000,000 whatever the transfer price, the tax position is optimized if the transfer price is \$130. The government which loses tax revenue as a result of this policy is Ruritania.

Arm's-length principle

14.5

The arm's length principle is the cornerstone of transfer pricing and effectively states that the prices charged, for the purpose of calculating taxable profits, within MNEs must be comparable to those that would be charged between independent enterprises. This principle is contained in

Article 9 of the OECD Model Tax Convention (MTC) which deals with associated enterprises, as we saw in Chapter 7. To recap, the text of the article is as follows:

‘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 ... and ... 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, may be included in the profits of that enterprise and taxed accordingly.’

The purpose of Article 9 is to achieve a fair share of a multinational group’s tax base for all the tax jurisdictions in which it operates by preventing the artificial manipulation of profits for tax purposes earned in various countries through uncommercial tax pricing practices. It is a necessary consequence of the separate entity principle that requires the entities comprising MNEs to be treated separately for tax purposes, which means that intra group dealings need to be carefully evaluated.

The requirement to use arm’s-length prices for intragroup tax transfer pricing is applied to a whole range of items, not merely goods sold from one subsidiary to another. Members of groups will supply technical and financial services to one another, will pay interest and patent royalties to one another as well as management and marketing fees, to name but a few.

In the example given above, the arm’s-length price is \$100 per tonne. As Multinat Plc controls both the Konganga and the Ruritanian subsidiaries it is open to the Ruritanian tax authority to argue that the transfer price of \$130 per tonne represents a difference in commercial relations from those which would be expected between independent enterprises. The extra taxable profits which would have been included in the Ruritanian subsidiaries’ accounts if arm’s-length pricing had been used are \$2,400,000 (\$7,000,000 profit before tax minus \$4,600,000 profit before tax). Ruritania will levy tax at 40 per cent on an additional \$2,400,000 of profits.

Whether Konganga would grant a reciprocal reduction of \$2,400,000 in profits to be taxed there depends on the wording of any DTT between the two countries. This is discussed further later in the chapter.

A very brief history of transfer pricing legislation

14.6

In 1928 the US Congress granted the Internal Revenue Service (IRS) the power to adjust the accounts of related companies. Here is a famous quote from that time: ‘subsidiary corporations, particularly foreign subsidiaries are employed to “milk” the parent corporation or otherwise improperly manipulate the financial accounts of the parent company’.¹

There was no requirement for consolidated accounts, but the IRS was given the power to adjust the accounts of individual companies. The League of Nations (the predecessor of the OECD) introduced in its 1935 Model Tax Treaty a requirement for the arm’s-length method. Where arm’s-length profits were difficult to determine, permitted profits were to be determined within groups of companies on the ‘percentage of turnover’ method. This alternative method forms the basis of *unitary taxation*, which is the main alternative to the arm’s-length principle. This method is widely used in the US and Canada to allocate the taxable profits of a company or group of companies for the purposes of state/provincial (local) taxation. This method is also referred to as global formulary apportionment. For an interesting history of the development of the arm’s-length principle in the US, see Avi Yonah (1995).

In the UK, temporary provisions were introduced during the First World War to prevent the avoidance of high wartime taxes by foreign companies trading in the UK. The problem was not

properly addressed until in 1945 the League of Nations' Model Treaty was adopted as the basis for the agreement of bilateral treaties. To deal with enforcement of Article 9, the UK introduced transfer pricing provisions in the Finance Act 1951. These were updated in the Finance Act 1999² to more closely reflect the provisions of Article 9 and to take account of the growing variety and sophistication of transactions taking place within multinational groups. The UK also wanted its domestic legislation to follow Article 9 more closely as this makes it easier to resolve disputes.

In the 1950s and 1960s the growth of the international tax-planning industry led to the introduction in the US of the s 482 Regulations in 1968.

'Section 482: Allocation of income and deductions among taxpayers

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.'

The primary pricing test adopted was the comparable uncontrolled price (CUP) (see below). Relevant circumstances accounting for differences between actual prices and open market prices may be taken into account. The legislation contains the 'safe harbour' concept: for loans, services and leasing. This means that if firms stay within set limits, they can expect their policies to escape attack under s 482. Like most US legislation, s 482 is accompanied by copious detailed regulations,³ which were substantially updated in 1994 to cover the transfer pricing of intangibles and the sharing of costs.

1 Report 350 67th Congress 1st Session p 14, cited in Picciotto (1992), p 174.

2 Taxation (International and Other Provisions) Act 2010, s 147.

3 Available at: www.irs.gov/pub/irs-apa/482_regs.pdf.

Role of the OECD

14.7

The OECD has been instrumental in promulgating best practice in relation to transfer pricing rules. In 1979, the OECD issued a landmark report, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*. The OECD firmly rejected global methods of profit allocation (top down, or unitary taxation) or the use of predetermined formulae to allocate the profits of multinationals between the various host countries in which they operate. It is committed to the separate entity principle and its corollary, arm's length pricing.

In 1994 the OECD *Guidelines* were reissued, reconfirming opposition to global formulary methods: 'the global formulary apportionment approach would not be acceptable in theory, implementation or practice'. New chapters were added dealing with transfer pricing of intangibles and cost-sharing agreements (see below). A further revised set of guidelines was issued on 22 July 2010. Further changes have been made to the guidelines to accommodate the recommendations of the BEPS project, specifically Actions 8–10 and 13.

It should be noted that some commentators continue to prefer the US legislation to the OECD *Guidelines*, believing it to be superior in terms of the certainty that it affords to multinational groups. The US has always taken responsibility for developing its own rules rather than relying on the OECD *Guidelines* and the regulations accompanying s 482 of the Internal Revenue Code are a

good deal more detailed than the OECD material. This higher level of detail is often preferred by taxpayers and tax administrations alike as it allegedly provides a higher level of certainty. A common criticism of the OECD materials is that they are too general.

The UN has also issued transfer pricing guidelines that largely mirror the OECD guidelines.

OECD Guidelines

14.8

The OECD Guidelines are divided into chapters dealing with different aspects of transfer pricing. The first chapter contains an explanation of the arm's length principle together with guidelines for its application. It stresses that tax administrations should not assume that associated entities have sought to manipulate their profits. The difficulty in accurately determining a market price should be acknowledged and consideration of transfer pricing should not be confused with problems of tax avoidance or fraud.

The OECD has historically recommended the use of bottom-up, transactions-based methods, rather than any other method of allocating the total profits of multinational groups to different countries. The methods recommended by the OECD are:

- comparable uncontrolled price;
- resale price minus;
- cost plus;
- profit split; and
- transactional net margin method.

This list closely resembles the methods permitted under s 482 of the US Internal Revenue Code. The individual methods are considered further below.

In 2010, the OECD *Transfer Pricing Guidelines* were re-issued with some substantial modifications. In relation to comparability and transactional profit methods, this was the culmination of a seven-year project. Draft notes on comparability and transactional profit methods were released in 2006 and 2008 respectively and both elicited considerable comment from the business community. The revised Chapters I–III of the *Guidelines* were released for comment in September 2009, and the response to those comments by the Committee of Fiscal Affairs was published on 22 July 2010.¹ In 2017, new Guidelines were issued to incorporate the changes resulting from the BEPS project, in particular Chapters IV and VII.²

All the methods recommended by the OECD are based on establishing an arm's-length price for a transaction. The inherent problem with this requirement is that internal prices within companies and within groups of companies are invariably different to those which would be charged between independent enterprises. This is so, even where no tax-avoidance motive is present. Governments generally recognize this problem and have developed frameworks for adjusting actual prices to take account of justifiable differences.

¹ Available at: www.oecd.org/dataoecd/23/10/45690455.pdf.

² Available at: https://read.oecd-ilibrary.org/taxation/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-2017_tpg-2017-en#page18.

Comparability Analysis

14.9

The starting point for evaluating internal pricing is a comparability analysis of controlled and uncontrolled transactions. Controlled transactions are those between associated entities. Uncontrolled transactions are those between MNE entities and parties external to the MNE. In an ideal world, it would be possible to find an equivalent transaction between independent parties to use as a benchmark for determining an appropriate transfer price. In reality this is extremely rare and a careful analysis of both controlled and uncontrolled transactions (as far as is possible in relation to the latter) is required to identify any points of difference that need to be factored into the computation of an arm's length price.

A comparability analysis involves two key aspects:

- the commercial or financial relations between the associated enterprises and the circumstances of those relations; and
- a comparison between those circumstances and the circumstances of comparable transactions between independent enterprises.

This initial process is preliminary to determining the pricing of the controlled transaction – it allows us to determine how close the comparator is and whether any adjustments need to be made to reflect any differences. It involves understanding of the sector in which the MNE operates and the factors influencing its performance as well as the functions performed, assets used and risks assumed (FAR). These broader issues will be included in the master file (see Chapter 15). There is then a need to drill down to the specifics of the transaction under consideration. The guidelines list the factors to be considered as follows:

- the contractual terms of the transaction;
- the functions performed by each of the parties to the transaction;
- the characteristics of the property transferred or services provided;
- the economic circumstances of the parties and of the market in which the parties operate; and
- the business strategies pursued by the parties.

Chapter III of the OECD Guidelines includes a description of a typical process in 9 steps for conducting a comparability analysis. The steps are as follows:

Step 1 determination of the years to be covered.

Step 2 analyse the taxpayer's circumstances.

Step 3 understand the controlled transaction(s) under examination, based in particular on a functional analysis, in order to choose the tested party (where needed), the most appropriate method and identify the significant comparability factors.

Step 4 review any existing internal comparables.

Step 5 determine available sources of information on external comparables.

Step 6 select the most appropriate transfer pricing method.

Step 7 identify potential comparables.

Step 8 determine and make any comparability adjustments

Step 9 interpret data collected to determine the arm's length remuneration.

In relation to comparability analyses, following the release of the BEPS report on Actions 8–10, chapters I–II of the OECD *Transfer Pricing Guidelines* have been amended to provide additional explanations and examples to deal with the following:

- *Location savings* – these are defined as cost reductions arising due to operating in certain local markets. Determining the cost saving attributable to operating in a particular market is problematic and requires consideration of whether such savings exist, and if so, whether they are retained or passed on, and if not fully passed on, the manner in which independent enterprises would allocate such retained savings. If comparables are available, this will be the most reliable indication of how any net location saving should be shared. In the absence of comparables, a functional analysis is needed along the lines of that applicable to business restructuring in Chapter 11.
- *Other local market features* – may have to be considered for the purposes of comparability adjustments even if they do not lead to location savings, for example, local infrastructure, regulatory requirements (eg licencing) and workforce capabilities.
- *Assembled workforce* – the existence of a ‘uniquely qualified or experienced cadre of employees’ should be taken into account in a comparability analysis.
- *Multinational enterprise group synergies* – can arise through pooling purchasing power, joint information and communication facilities, integrated management, etc. Where a group benefits from synergies through ‘deliberate concerted action’ which creates a material advantage, this must be analysed through a functional and risk analysis and the benefit allocated to group members according to their respective contribution to its creation.

Risk

14.10

An important component of a comparability analysis is the identification of commercial and financial relations between associated enterprises. Written contractual arrangements provide a starting point, but in the absence of contractual arrangements or in the case of ambiguity, the delineation of a transaction can be deduced from the actual conduct of the parties. The BEPS project has resulted in new guidance on identifying risks in commercial and financial transactions, defining risk as ‘the effect of uncertainty on the objectives of the business’ and providing a framework for analysing risk as follows:

- ‘Taking into account the nature and sources of risk, what are the specific risks included in the commercial or financial arrangements of the parties?’
- How are those specific risks allocated in contractual arrangements? How are the risks assumed? Do the specific risks relate to operational activities from which the risks arise?’
- What is the potential impact of those specific risks?’
- How is each risk actually managed by members of the MNE group? How does risk management related to the risk – influence the occurrence or the impact of the risk?’
- Does the party contractually assuming the risk either: (a) perform operational activities from which risk arises; (b) manage the risk; or (c) assess, monitor, and direct risk mitigation?’
- What are the actual transactions undertaken? Are the contractual arrangements in relation to the risk allocation, the operational activities to which the risk relates and risk management aligned with the conduct of the parties?’

In 2015, the Platform for Collaboration on Tax published a toolkit¹ for addressing difficulties in accessing comparables data for transfer pricing analyses. The toolkit, aimed at developing countries, explains the comparability analysis process and contains a number of practical examples and case studies.

Safe harbours

14.11

It will be clear by now that transfer pricing is complex and time consuming for both the taxpayer and the tax administration. In deference to this, the OECD guidelines suggest that it may be appropriate to introduce 'safe harbour' provisions to relieve the cost burdens and also to provide some certainty, especially given that disputes over arm's length pricing can be very protracted. Safe harbour provisions usually provide a simplified approach and require a trade off between strict compliance with the arm's length principle and its administrability. The pros and cons of safe harbours are discussed in Chapter IV, section E4.

Transfer Pricing Methods

14.12

There are two broad categories of methods that the OECD recommends, transaction-based methods and transactional profit methods. In previous guidelines, the individual methods within these categories were presented as a hierarchy with priority given to the former category. The current guidelines require the selection of the 'most appropriate method' for a particular case. Each of the methods described below should be evaluated as to appropriateness in light of the particular controlled transaction under consideration, including the reliability of the information available, the degree of comparability between controlled and uncontrolled transactions and the comparability adjustments that may be required. It is recognised that no one method is suitable in every possible situation, and importantly, it is acknowledged that it is not necessary to prove that a particular method is not suitable.

Importantly, MNE groups have the freedom to apply methods not described in the guidelines ie other methods, so long as they satisfy the arm's length principle.

US s 482 Regulations require the use of the 'best method' rule. This means that a firm must consider the methods outlined below and use the one for which the most reliable comparables are available. For a distribution company, buying from a fellow group member and selling to unconnected customers without adding significant value, the best method is likely to be resale price minus. For a manufacturing company in a vertically integrated group, making sales only to group members where few comparable sales to unconnected parties are made, cost plus is likely to be the best method. This 'best method' rule generally means that complying with the US regulations is more difficult than complying with OECD *Guidelines*, which only require calculations under a single method.

It is important to be aware that transfer pricing is far from being an exact science. Provided intra-group prices are shown to be within an acceptable range of prices, an adjustment to taxable profits by the tax authority may be avoided. Determining the acceptable range is itself difficult and is essentially a qualitative matter requiring skill and judgement, considering all relevant factors. The US insists on a statistical approach: only values within the inter-quartile range (excluding the lowest 25% and the highest 25% of results) are considered acceptable. The IRS also favours the median point as the most appropriate point in the range for a comparable.

Transaction based methods

14.13

The transaction based methods have long been regarded as the most direct, being based on identifiable comparable transactions. Where, however, a traditional transaction method and a transactional profit method can be applied 'in an equally reliable manner', the traditional transactional method is preferred. The three methods in this category are comparable uncontrolled price, resale price minus and cost plus.

Comparable uncontrolled price

14.14

The rationale behind comparable uncontrolled price is to compare the actual transfer prices in controlled, or intragroup, transactions with comparable prices applying between unrelated parties (ie uncontrolled). An uncontrolled transaction is comparable to a controlled transaction for the purpose of this method if one of two conditions is met. First, none of the differences (if any) could materially affect the price in the open market. Second, reasonably accurate adjustments could be made to eliminate any differences.

The main problem with this method is the difficulty in finding an exact match in terms of product, firms, market, risk, geographic location and so forth. A number of governments (eg Canadian) are known to use 'secret' comparables, ie they do not disclose where they are getting their information from. This is a controversial practice.

Example 14.2 Establishing an arm's-length price using CUP

Black Ltd, a UK wholly-owned subsidiary of Orange Plc, a UK company, supplies 1,000 Z-type widgets each month to its fellow subsidiary tax resident in Iceland, White Inc at a price of \$700 per widget. The price charged by Black Ltd to unconnected customers is \$1,000 per widget. These widgets are in common use in most of the countries to which Black Ltd sells, with many suppliers in the market. However, the Icelandic market is just opening up and Black is the first supplier in it. Because White Inc has detailed knowledge of the performance and reliability of the product it has agreed to forgo the usual product warranties.

Price charged to unconnected customers per unit for an order of 1000 Z-type widgets	1000
<i>Adjustments needed:</i>	
Premium for first supplier in new market	+100
Adjustment for absence of warranties	-80
Absence of bad debt risk: discount	-50
Repeat/bulk order discount	-100
Immediate payment discount*	-50
Adjusted arm's-length price	820

Note: * Since settlement is by means of accounting (book) entries only, with no cash changing hands, payment is considered to be made as soon as the sale to White Inc is recorded in the books of Black Ltd. It would be normal to allow unconnected customers 30 days' credit.

The initial discrepancy in pricing appears to be \$300 per widget. By making appropriate adjustments, the difference is narrowed to \$120 (\$820–\$700). Any adjustment to profits of either company will be made based on \$120 per widget, not \$300.

Resale price method

14.15

This method tends to be most appropriate where a group company (Company A) sells on to another group company (Company B) which makes the sale to the final (unconnected) consumer with a minimum of processing or otherwise adding value to the goods. It can be used to check the transfer price from the viewpoint of Company A or Company B although it would most likely be used to verify the price paid by Company B.

The method works by taking the price charged by Company B to the final consumer and deducting an appropriate gross margin – the resale price margin. This margin must be sufficient to cover the operating and selling expenses of Company B and to leave it with an appropriate net profit.

The difference between the price charged by Company B to its customers and the appropriate gross margin attributed to Company B should be the price charged by Company A to Company B. As with CUP, some adjustments may be appropriate to allow for differences in the characteristics of intragroup sales and sales to unconnected parties. In its crude form, an industry average gross profit percentage might be applied. A more accurate calculation would examine purchases by Company B from independent suppliers to establish an arm's-length gross profit margin.

Example 14.3

James Ltd is the UK distributor of Wasch brand televisions. It sources its stocks from its parent company in Germany. The only value added to the televisions by James Ltd is the provision of English language instruction manuals and delivery to wholesale customers. The margin earned by similar television distribution firms in the UK is 15 per cent. The price per television to the final customer is £3,000. The cost per television to James Ltd is £2,500. The cost of adding the instruction manuals is £10.

<i>Price charged by German parent company</i>	<i>Costs incurred by James Ltd</i>	<i>Margin 15%</i>	<i>Price to UK customers</i>
2,500+	10+	376.5	= 3,000?

The sums do not add up. If the 15 per cent margin is correct, the figures should read as below:

2,598+	10+	391.2*	= 3,000
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Note: * 391.2 = 3000 × 15/115

The German tax authority may object to the transfer price of £2,500 which appears too low. The German parent company supplying James Ltd will have to defend the price by putting forward

the types of adjustments referred to above: low risk of bad debt, immediate payment, market differences, bulk ordering, risk assumed, functions performed etc.

Cost plus

14.16

This is a popular method of establishing an arm's-length price, because it can be applied to transactions where there are no comparable sales of the commodity concerned to independent third parties (eg in the case of intermediate or partly finished goods).

This method takes cost of production plus an 'arm's-length' profit. It is most frequently used for group companies performing specific services or contract manufacturing.

This differs from resale minus in that it focuses on the seller and attempts to set a comparable gross margin between transactions with associates and transactions with unconnected third parties.

This method is of most use where two or more companies in the group add significant amounts of value to the product (eg by further processing). However, a frequent problem is the lack of an independent market in such intermediate goods.

Example 14.4

Browneyes Plc is a major chain of UK opticians. It has patented a new type of contact lens and contracts with a wholly-owned subsidiary in Guernsey for the manufacture of the lens. The raw materials have a negligible cost but the Guernsey factory has had to invest heavily in plant and machinery and staff training to utilize the manufacturing process patented by Browneyes Plc.

All other products sold by Browneyes are purchased from independent suppliers in the Far East. The Guernsey subsidiary is routinely engaged in manufacturing specialized optical equipment for a range of independent customers. The new plant and machinery purchased to fulfil the orders from Browneyes is capable of producing at approximately four times the current level of activity. This level of investment was made on the basis of the schedule of likely future orders from Browneyes Plc. The mark-up on cost added by the Guernsey subsidiary to other customers ranges from 40% to 60%. The mark-up on current sales to Browneyes Plc is 80%.

This mark-up is well outside the normal range and so the group must expect the UK tax authority to object to the prices charged by the Guernsey subsidiary, particularly since corporate taxes in Guernsey on non-financial business is zero per cent.¹ It might be argued that the normal mark-up range of 40% to 60% requires adjustment to take account of:

- the risk assumed by the Guernsey company in investing in new plant, equipment and staff training;
- the fact that they have installed capacity well in excess of that currently required, presumably at the request of Browneyes Plc; and
- the market risk that the new contact lenses might not be a success and therefore resources will have been diverted to production of an unsuccessful product at the expense of servicing existing established markets.

Counter-adjustments which the UK tax authority might propose could include:

- lack of customer risk – dealing with the parent company;

- immediate payment via the inter-company account;
- lack of any apparent charge to the Guernsey subsidiary for the use of intangibles developed by Browneys Plc (the patent and the production know-how); and
- bulk ordering with a healthy forward order book.

All these would suggest that a lower mark-up might have been applied.

1 Except for banking and certain other financial services companies.

Transactional profits-based methods

14.17

Transactional profits-based methods were originally identified by the OECD as methods of last resort but are increasingly being used, particularly in the US, where as previously noted a 'best method' rule applies. A transactional profit method looks at the profits that arise from particular controlled (intragroup) transactions. The two principal transactional profits methods are the transactional net margin method and the profit split method. These methods differ from comparable uncontrolled price, resale price minus and cost plus (the transactional methods) in that they look at net profit on a transaction rather than the gross profit. The OECD now accepts that there are situations where the transactional profit methods are more appropriate than traditional transaction methods, but cautions against using transactional profit methods only because it might be difficult to obtain data concerning uncontrolled transactions.

Transactional net margin method

14.18

The transactional net margin method (TNMM) is a variant of the comparable profits method and, despite its name, is not really transactional, as it involves a comparison of the earnings before interest and tax of a company suspected of having depressed profits due to manipulative transfer pricing practices with that of unrelated companies in the same industry.

Example 14.5

A Ltd wishes to defend its transfer pricing policies but cannot make use of the three transactional methods (CUP, retail price and cost plus) and no other method appears suitable. It decides to defend the level of its taxable profits by using the TNMM. A review of the financial ratios of comparable companies indicates that the arm's-length range of earnings before interest and tax (EBIT) compared to sales for a company such as A Ltd lies between 2% and 4%. A Ltd has an EBIT/sales ratio of only 1.5%. However, A Ltd considered that there are significant differences in its working capital structure which have the effect of depressing its EBIT relative to comparable companies. A central feature of the TNMM is that any comparison using EBIT should adjust for differences in working capital structure.

First, a raw comparison of a suitable profits ratio would be made (eg EBIT/sales):

	<i>Year 1</i>	<i>Year 2</i>
Company A	\$k	\$k
Sales	300.00	350.00
EBIT	4.56	5.15
EBIT/sales	1.52%	1.47%

Comparable Company 1		
Sales	260.00	280.00
EBIT	6.50	8.40
EBIT/sales	2.50%	3.00%

In practice, the comparison and all the adjustments would be done for at least five years and comparisons would be drawn between Company A and a number of comparable companies. On this raw comparison, the EBIT/sales ratio of Company A appears very low by comparison to Comparable Company 1. However, at least part of the difference may be accounted for by differences in the working capital structures of the two companies. The working capital/sales ratio would next be computed as below:

	<i>Year 1</i>	<i>Year 2</i>
	\$k	\$k
Company A working capital		
Trade receivables (R)	57.00	65.00
Inventory (I)	55.00	58.00
Trade payables (P)	67.00	69.00
R + I – P	45.00	54.00
(R + I – P)/Sales	15.00%	15.43%

Comparable Company 1		
working capital		
Trade receivables (R)	64.00	72.00
Inventory (I)	70.00	80.00
Trade payables (P)	47.00	55.00
R + I – P	87.00	97.00
(R + I – P)/Sales	33.46%	34.64%

Comparable Company 1 has a higher ratio of working capital to sales than Company A. Its EBIT/sales ratio needs to be adjusted to take into account the fact that it is using more working capital than Company A. This is done by applying an interest rate to the difference in working capital/sales ratios to account for the cost of the extra working capital. Thus the EBIT/sales ratio of Comparable Company 1 is reduced by the cost in notional interest of carrying more working capital than Company A.

	<i>Year 1</i>	<i>Year 2</i>
	\$k	\$k
Working capital adjustment		
Company A (R + I – P)/sales	15.00%	15.43%
Comparable Company 1		
(R + I – P)/sales	33.46%	34.64%
	–	–
Difference	18.46%	19.21%
Apply interest rate of		
Interest rate applied to the difference	5.00%	5.00%
	–0.92%	–0.96%
Comparable Company 1 EBIT/Sales		
	2.50%	3.00%

Working capital adjustment	-0.92%	-0.96%
Adjusted Comparable Company 1		
EBIT/Sales	1.58%	2.04%
Company A EBIT/sales	1.52%	1.47%

For Year 1, after the working capital adjustment, the EBIT/sales ratios of the two companies appear on a par. However, there remains an unexplained difference in Year 2, which could be due to Company A being party to manipulative transfer pricing practices. TNMM has helped a little but there is still some work to be done by Company A in defending its transfer pricing. For instance, it might be able to argue that the Year 2 results are not typical for Comparable Company 1.

In a 2011 Australian case,¹ the Federal Court of Australia rejected the TNMM favoured by the Australian Taxation Office and accepted the taxpayer's evidence of the existence of comparable transactions. The case concerned the application of Australia's domestic transfer pricing legislation and it has been suggested that the outcome may have been different had Article 9 of a DTT been at issue.

¹ *Commissioner of Taxation of the Commonwealth of Australia v SNF (Australia) Pty Ltd* [2011] FCAFC 74.

Profit split method

14.19

The profit split method aims to split the total profit earned on a transaction by all the group companies involved in it using an 'equitable' formula (eg by reference to capital employed). This formula is arrived at by studying comparable pairs of companies and the contribution made by each company to the overall profit achieved. There are two steps:

- 1 Identify the profit to be split for the associated enterprises from the controlled (comparable) transactions in which the associated enterprises are engaged.
- 2 Split those profits between the associated enterprises on an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm's length.

Note that strictly speaking, the computation should be done by reference to individual transactions, or groups of similar transactions. Unsurprisingly, the principal difficulty is the lack of publicly available information about the likely split of profits. This method is likely to be used in industries where there is a high degree of vertical integration. Under vertical integration, group entities supply everything from raw materials, through processing, right up to the finished product. Telecommunications, pharmaceuticals and automobile industries are good examples. One strength of this method is that it considers the profit position of all entities involved, meaning that it is more likely to arrive at a realistic result rather than allocating most of the profit to one entity, leaving the others in a theoretically loss-making position.

Example 14.6

Bells Ltd is a wholly-owned UK subsidiary of Whistles Inc, an Indonesian company. Bells Ltd imports unfinished traditional musical instruments from Whistles which it then completes, packages and markets to UK customers. The instruments are only otherwise available on a

limited local scale in Indonesia. The UK tax authority is unhappy with the level of profitability of Bells Ltd and instigates a transfer pricing enquiry. Using the profits split method, the following results are obtained:

<i>Profit split</i>	<i>Bells Ltd</i>	<i>Whistles Inc</i>	<i>Consolidated</i>
	£	£	£
Sales	700	400	700
Cost of sales	400	50	50
Gross profit	300	350	650
Gross profit split	46.15%	53.85%	100%
Administration and payroll	200	50	250
Selling and marketing	90	10	100
Operating profit	10	290	300
Operating profit split	3.33%	96.67%	100%

This profit split is unlikely to be acceptable to the UK tax authority: at the gross profit level, profits are fairly evenly split, but at the operating profit level only 3% of the profit on the transactions accrues to the UK company, Bells Ltd. The pricing arrangements do not appear to be arm's length. Ideally, the way profit is split on similar transactions between unconnected parties would be examined to provide comparables, but it is unlikely that such information would be available. In practice, a variant known as 'residual profit split' is more likely to be used. This would typically involve defending prices using comparable uncontrolled price as far as possible and then using the profit split method.

A discussion draft dealing with the transactional profit split method was issued by the OECD in December 2014 which presented a variety of scenarios and invited comments, followed by a public consultation in March 2015. The overall view following consultation is that notwithstanding practical difficulties in its application, transactional profit split can offer a useful method in terms of aligning profits with value creation. The final report on Actions 8–10 published in October 2015 included some clarification and strengthening of the guidance on transactional profit splits that forms the basis of subsequent work by WP6 leading to draft guidance being published in 2016, and in 2017.

Comments received by the OECD on the 2014 *Discussion Draft* expressed concern about the potential for adoption of the method in inappropriate cases, merely because reliable comparables are not available. Difficulties arise not so much in the functional analysis of the contributions made by the various parties, but rather in valuing those contributions, ie the profit splitting factors.

Revisions to the guidance on the transactional profit split method were released in June 2018 to clarify and expand on when a profit split method may be most appropriate. It is concerned with situations in which each party makes unique and valuable contributions, the operations are highly integrated and economically significant risks are shared. The guidance provides numerous examples which will be incorporated into Chapter II of the guidelines.

Comparable profits method

14.20

The comparable profits method (CPM) is a commonly used method in the US. Some commentators query whether it really represents a transactional method at all. Others think that the US is misunderstood and that the way in which the US uses the comparable profits method should produce a result very similar to the transactional net margin method. CPM is not recommended by the OECD, indeed the OECD's current review of transactional methods does not include CPM, although it is widely used in the US and increasingly so in Canada as well. The CPM examines the amount of operating profit that the company under investigation would have earned on controlled, related-party, transactions if its profit level indicators were equal to that of an uncontrolled comparable. In other words, the operating profit of the company is compared to the operating profit of comparable companies. It relies on being able clearly to identify the exact business activity in which the company and the comparable companies are involved. For instance, if Company A makes hats, but Company B makes hats and gloves, then only the operating profit of Company B with respect to hats should be considered.

This method applies various profit level indicators: broadly speaking, financial ratios such as rate of return on capital, operating profit to sales as well as other ratios examining the relationship between profits, costs and sales revenues. As with the other arm's-length methods, strenuous efforts must be made to adjust for differences between the company under consideration and other companies in the industry. For instance, the company under investigation may have a particularly skilled workforce, or own the know-how for an advanced form of manufacturing process compared to its competitor firms.

The CPM is popular for two main reasons. First, it is relatively easy for the IRS to apply. Under CUP, detailed transactional data is required which is probably only available to the taxpayer, who will use it selectively when presenting evidence to the IRS. It can take many months or years to gather sufficient evidence using the CUP method, with the IRS at an inherent disadvantage. However, when using CPM, industry statistical data is readily available in the public domain to which the financial ratio analysis can be applied. The IRS is thus far less reliant on evidence supplied directly by the taxpayer and less constrained by confidentiality. The method lends itself to statistical analyses of firms and as noted earlier the IRS generally only consider results within the inter-quartile range (ie they eliminate from consideration the top and bottom 25 per cent of results when applying ratio analysis to a selection of firms).

Second, as discussed below, because it takes a broader approach than a method such as CUP it is more suitable for use when negotiating an advance pricing agreement (see later in this chapter).

The method is criticized as not being overtly transactional and being applied retrospectively to the profit outcome of transactions rather than to the pricing policies governing those transactions. However, it should give the same results, broadly speaking, as transactional net margin method when that method is applied to a series of transactions.

The following Example 14.7 is adapted from the s 482 regulations.¹

Example 14.7

Jones Plc, a UK company has a US subsidiary, USSub, that is under transfer pricing audit by the IRS for its XX06 taxable year. Jones Plc manufactures a consumer product for worldwide distribution. USSub imports the assembled product and distributes it within the United States at the wholesale level under the Jones Plc name.

Jones Plc does not allow uncontrolled taxpayers to distribute the product. Similar products are produced by other companies but none of them is sold to uncontrolled taxpayers or to uncontrolled distributors. The comparable uncontrolled price method is not appropriate here due to the lack of comparable transactions between independent enterprises. Neither is resale price minus, as there are no competitors selling similar products in similar markets under uncontrolled conditions. Cost plus is not appropriate as Jones Plc is not incurring significant additional costs, being merely a distributor.

Based on all the facts and circumstances, the IRS may determine that the comparable profits method will provide the most reliable measure of an arm's length result. USSub is selected as the tested party because it engages in activities that are less complex than those undertaken by Jones Plc.

There is data from a number of independent operators of wholesale distribution businesses. These potential comparables are further narrowed to select companies in the same industry segment that perform similar functions and bear similar risks to USSub. An analysis of the information available on these taxpayers shows that the ratio of operating profit to sales is the most appropriate profit level indicator, and this ratio is relatively stable where at least three years are included in the average. For the taxable years XX04 to XX06, USSub shows the following results:

	<i>XX04</i>	<i>XX05</i>	<i>XX06</i>	<i>Average</i>
	\$	\$	\$	\$
Sales	500,000	560,000	500,000	520,000
Cost of goods sold	393,000	412,000	400,000	401,800
Operating expenses	80,000	110,000	104,600	98,200
Operating profit	27,000	37,600	-4,600	20,000

After adjustments have been made to account for identified material differences between USSub and the uncontrolled distributor companies, A–J below, the average ratio of operating profit to sales is calculated for each of the uncontrolled distributors. Applying each ratio to USSub would lead to the following comparable operating profit (COP) for USSub:

<i>Uncontrolled distributor company</i>	<i>Operating profit/sales %</i>	<i>USSub Comparable Operating Profit (\$520,000 × Op profit/sales ratio of competitor company)</i>
		\$
A	1.7	8,840
B	3.1	16,120
C	3.8	19,760
D	4.5	23,400
E	4.7	24,440
F	4.8	24,960
G	4.9	25,480
H	6.7	34,840

I	9.9	51,480
J	10.5	54,600

The data is not sufficiently complete to conclude that it is likely that all material differences between USSub and the uncontrolled distributors have been identified. The IRS will measure the arm's-length range in these circumstances by using the interquartile range of results, which consists of the results ranging from \$19,760 to \$34,840. In simple terms, the lowest 25% and the highest 25% of results will be discarded. Although USSub's operating income for 2006 shows a loss of \$4,600, the IRS will determine that no transfer pricing adjustment should be made, because USSub's average reported operating profit of \$20,000 is within this range.

1 §1-482-5 Comparable profits method.

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